WUST09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Write-Up Services

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Interactive Self-study CPE

Companion to PPC's Guide to Write-Up Services

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's Guide to Write-Up Services consists of two interactive self-study CPE courses. These are companion course to *PPC's Guide to Write-Up Services* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

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

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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 **OnlineGrading.Thomson.com** 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 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 Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

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 of $79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

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COMPANION TO PPC'S GUIDE TO WRITE-UP SERVICES

COURSE 1

BOOKKEEPING SERVICES (WUSTG091)

OVERVIEW

COURSE DESCRIPTION:	This course offers guidance on designing a bookkeeping system to meet the needs of a particular business, identifying and gathering information about transactions, and converting that information into a general ledger. This course also presents general information about sales and use taxes, and provides guidance on preparing sales and use tax returns. In addition, there is also a discussion that addresses various independence issues surrounding write-up engagements.
PUBLICATION/REVISION DATE:	December 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Write-Up Services*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **December 31, 2010**
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES:

Lesson 1—Bookkeeping Services

Completion of this lesson will enable you to:
- Identify the elements of financial statements and the bases of accounting.
- Identify accounting records such as the general ledger, special journals, subsidiary ledgers, and source documents.
- Summarize the basics of cash disbursements, unpaid invoices, and cash receipts.
- Prepare to design a chart of accounts, select an accounting basis, and use a record maintenance and retention system.
- Identify what bookkeeping information to collect and methods to utilize to avoid delays in receiving information.

Lesson 2—Processing Information and Maintaining Independence

Completion of this lesson will enable you to:
- Identify how raw data can help to prepare a complete and accurate general ledger and organized bookkeeping workpapers.
- Describe the basics of sales and use taxes.
- Determine how write-up services could impair the accountant's independence.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
WUSTG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Bookkeeping Services

INTRODUCTION

Often, the most important service that accountants can provide is capturing and summarizing reliable financial information. Information about sales, expenses, receivables, and payables is vital to those that want to manage their companies effectively. For accountants in public practice, the fees generated from bookkeeping services can provide a steady source of revenue throughout the year. In addition, the regular client contact, as well as the insight about a company that can be gained by performing bookkeeping services, may provide opportunities to sell other services.

This course offers guidance on designing a bookkeeping system to meet the needs of a particular business, identifying and gathering information about transactions, and converting that information into a general ledger. This course also presents general information about sales and use taxes, and provides guidance on preparing sales and use tax returns. In addition, there is also a discussion that addresses various independence issues surrounding write-up engagements. Although experienced accountants will benefit from the guidance offered in this course, it is written primarily for accountants and paraprofessionals who may be unfamiliar with bookkeeping procedures. Accordingly, the course discusses basic accounting issues and providing bookkeeping services. Specifically, the course covers the following topics:

- *The Basics of Accounting* provides an overview of the accounting terminology and accounting records that accountants and paraprofessionals should be familiar with.

- *The Bookkeeping System* covers the issues that accountants should consider when designing a bookkeeping system for a business.

- *The Bookkeeping Information* discusses the information needed to accurately record transactions and describes procedures for collecting that information.

- *Processing the Information and Preparing the General Ledger* explains how raw data is converted into a general ledger. The lesson also describes procedures for reviewing the general ledger for accuracy and completeness and ways for organizing bookkeeping workpapers.

- *Paying State, Sales and Use Taxes* discusses procedures accountants may apply to prepare sales and use tax returns. The lesson gives information on identifying taxable transactions, recording tax liabilities, preparing returns, and retaining sales and use tax records.

- *Independence Issues Surrounding Write-up Engagements* addresses whether certain write-up services could impair the accountant's independence. Independence becomes an issue when the accountant generates and reports on financial statements. According to authoritative literature, when a CPA's independence is impaired, the accountant is permitted only to compile the financial statements for that client and specifically must disclose his or her lack of independence within the accountant's compilation report.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the elements of financial statements and the bases of accounting.
- Identify accounting records such as the general ledger, special journals, subsidiary ledgers, and source documents.
- Summarize the basics of cash disbursements, unpaid invoices, and cash receipts.
- Prepare to design a chart of accounts, select an accounting basis, and use a record maintenance and retention system.
- Identify what bookkeeping information to collect and methods to utilize to avoid delays in receiving information.

THE BASICS OF ACCOUNTING

Obviously, individuals that perform bookkeeping services must have a basic knowledge of accounting. They also must be able to apply that knowledge when recording transactions. In some instances, however, the entry-level accountants and paraprofessionals that provide much of the bookkeeping work do not possess that basic knowledge.

A detailed discussion of accounting theory is beyond the scope of this course. The following paragraphs, however, discuss basic financial statement terminology and the accounting records commonly used in bookkeeping.

Balance Sheets

The balance sheet (or statement of financial position) is a financial statement that reports an entity's assets, liabilities, and equity at a specific point in time. On the balance sheet, the total of the assets presented equals the sum of total liabilities and total equity.

Balance sheets may be classified or unclassified. A classified balance sheet distinguishes current assets and current liabilities from other assets and liabilities. Because classified balance sheets disclose the components of working capital (or current assets less current liabilities), they are presumed to be more useful. Generally, classified balance sheets are presented unless an industry accounting or auditing guide specifically permits an unclassified presentation or an unclassified balance sheet is industry practice. (For example, it is accepted practice for financial institutions to present unclassified balance sheets because the working capital distinction is not relevant.)

Assets. Assets are economic resources that have the following essential characteristics: (a) they represent probable future benefits that can contribute directly or indirectly to future net cash flows, (b) an entity can obtain those benefits and control others' access to it, and (c) the event giving rise to the entity's right or control of the benefits has already occurred. Examples of assets include cash, marketable securities, accounts receivable, inventories, and equipment.

Current assets are defined as cash and other assets that are reasonably expected to be realized in cash or sold or consumed within one year (or within an entity's normal operating cycle if it is longer than a year). Current assets normally include cash, marketable securities, receivables, inventories, and prepaid expenses.

Liabilities. Liabilities are economic obligations that have the following characteristics: (a) they represent present duties to one or more entities that will be settled by the transfer or use of assets at a specified date, on occurrence of a specified event, or on demand; (b) they obligate an entity, leaving it little or no discretion to avoid the future sacrifice of assets; and (c) the transaction obligating the entity has already occurred. Examples of liabilities include accounts payable, accrued expenses, notes payable, and revenues collected in advance.

Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities within one year. Generally, current liabilities include short-term obligations such as payables for materials and supplies, wages, taxes, amounts collected in advance of delivery of goods or services, the current portion of long-term obligations, and any other obligations expected to be liquidated within a year.

Equity. Equity is often referred to as net assets and is the residual interest in an entity's assets after deducting its liabilities. Equity accounts vary depending on the type of legal entity. For example, a corporation's equity accounts may include common stock, preferred stock, treasury stock, additional paid-in capital, and retained earnings. A partnership's equity accounts, however, may consist only of partners' capital.

Income Statements

An income statement is a financial statement that reports an entity's results of operations for a specific period. That is, it presents an entity's revenues, expenses, gains, and losses for a given period.

- *Revenues* are actual or expected cash inflows that have occurred or will eventuate as a result of an entity's major or central operations. Revenues increase assets or decrease liabilities (or both) and, thus, increase equity. Revenue accounts vary depending on the type of business and the type of transaction that generated the revenue. Examples of revenue accounts include sales, royalty income, interest and dividend income, and rent income.

- *Expenses* are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from producing or delivering goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Expenses decrease assets or increase liabilities (or both) and, thus, decrease equity. Examples of expenses include cost of sales, salaries, taxes, interest expense, and supplies.

- *Gains* are increases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

- *Losses* are decreases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

Classifying amounts as revenues, gains, expenses, or losses varies among companies and depends on the nature of a company's operations. Events or circumstances that are sources of revenues for one company may be gains for another. The primary differences between revenues and gains and between expenses and losses are that (a) revenues and expenses result from an entity's ongoing major or central operations such as producing or delivering goods or rendering services, while gains and losses result from incidental or peripheral events or circumstances; and (b) revenues and expenses usually are recorded at their gross amounts while gains and losses usually are recorded at net amounts.

Depreciation. Depreciation is the accounting process of allocating the cost of an asset to expense over the useful life of the asset. For example, if manufacturing equipment is expected to have a useful life of five years, a portion of its cost would be allocated each year for five years to the cost of production. It is important to note that depreciation is merely a method of allocating the cost of assets to expenses. It is not a method of valuing assets.

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 type of balance sheet distinguishes current assets and current liabilities from other assets and liabilities?

   a. Statement of financial position.

   b. Classified.

   c. Unclassified.

   d. Current.

2. Liabilities are economic obligations. Which one of the following is **not** an example of a liability:

   a. Accounts payable.

   b. Notes payable.

   c. Accounts receivable.

   d. Revenues collected in advance.

3. One of the elements of the income statement is revenues. Which of the following statements best describes revenues:

   a. They are outflows or other using up of assets from producing or delivering goods.

   b. They are increases in net assets from peripheral or incidental transactions of an entity.

   c. They are decreases in net assets from peripheral or incidental transactions of an entity.

   d. They are actual or expected cash flows that have occurred as a result of an entity's operations.

SELF-STUDY ANSWERS

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

1. What type of balance sheet distinguishes current assets and current liabilities from other assets and liabilities? **(Page 4)**

   a. Statement of financial position. [This answer is incorrect. A statement of financial position is another name for the balance sheet—a statement that reports an entity's assets, liabilities, and equity at a specific point in time.]

   b. Classified. [This answer is correct. Under basic financial statement terminology, balance sheets may be classified or unclassified. A classified balance sheet distinguishes current assets and current liabilities from other assets and liabilities. Because classified balance sheets disclose the components of working capital (or current assets less current liabilities), they are presumed to be more useful.]

   c. Unclassified. [This answer is incorrect. An unclassified balance sheet does not distinguish current assets and current liabilities from other assets and liabilities. Unclassified balance sheets are presented only if an industry accounting or auditing guide specifically permits an unclassified presentation or an unclassified balance sheet is industry practice.]

   d. Current. [This answer is incorrect. Current assets and liabilities are expected to be resolved within one year.]

2. Liabilities are economic obligations. Which one of the following is **not** an example of a liability? **(Page 4)**

   a. Accounts payable. [This answer is incorrect. Liabilities are economic obligations that have the following characteristics: (a) they represent present duties to one or more entities that will be settled by the transfer or use of assets at a specified date, on occurrence of a specified event, or on demand; (b) they obligate an entity, leaving it little or no discretion to avoid the future sacrifice of assets; and (c) the transaction obligating the entity has already occurred. Accounts payable is an example of a liability.]

   b. Notes payable. [This answer is incorrect. Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities within one year. Notes payable is an example of a liability.]

   c. Accounts receivable. [This answer is correct. Accounts receivable are current assets, which are defined under basic financial statement terminology as cash and other assets that are reasonably expected to be realized in cash or sold or consumed within one year (or within an entity's normal operating cycle if it is longer than a year).]

   d. Revenues collected in advance. [This answer is incorrect. Generally, current liabilities include short-term obligations such as payables for materials and supplies, wages, taxes, amounts collected in advance of delivery of goods or services, the current portion of long-term obligations, and any other obligations expected to be liquidated within a year. Revenues collected in advance are an example of liabilities.]

3. One of the elements of the income statement is revenues. Which of the following statements best describes revenues? **(Page 4)**

   a. They are outflows or other using up of assets from producing or delivering goods. [This answer is incorrect. Expenses are defined as outflows or other using up of assets or incurrences of liabilities (or a combination of both) from producing or delivering goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Examples of expenses include cost of sales, salaries, taxes, interest expense, and supplies.]

   b. They are increases in net assets from peripheral or incidental transactions of an entity. [This answer is incorrect. Gains are defined as increases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.]

   c. They are decreases in net assets from peripheral or incidental transactions of an entity. [This answer is incorrect. Losses are defined as decreases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.]

   d. They are actual or expected cash flows that have occurred as a result of an entity's operations. [This answer is correct. As defined as part of basic financial statement terminology, revenues are actual or expected cash inflows that have occurred or will eventuate as a result of an entity's major or central operations. Revenues increase assets or decrease liabilities (or both). Examples of revenue accounts include sales, royalty income, interest and dividend income, and rent income.]

Accounting Records

General Ledgers. A general ledger is a record containing all of an entity's asset, liability, equity, revenue, expense, gain, and loss accounts. It is the record from which the information necessary to prepare financial statements is obtained. Accordingly, it contains summary totals of all transactions entered in special journals (or books of original entry).

Special Journals (Books of Original Entry). Transactions are first recorded in special journals and then totaled periodically and recorded in the general ledger as one amount. Because entries in special journals come directly from documents that authorize the transactions, the journals are referred to as "books of original entry." Special journals are used in many computerized (and manual) accounting systems because they:

- *Promote Efficiency.* For example, a company that records all transactions in the general journal and makes several hundred sales on account in one month would have to make several hundred entries each debiting accounts receivable and crediting sales. Each entry in the general journal would then have to be posted to the accounts receivable and sales general ledger accounts. Using special journals, however, the total of all sales on account would be posted to the accounts receivable and sales general ledger accounts only once, at the end of the month.

- *Strengthen Internal Control.* A company may require that each special journal be handled by a different person. Thus, for example, the person recording cash receipts need not be the same person that records the payment in the accounts receivable subsidiary ledger.

- *Reduce Errors.* Special journals reduce the amount of postings to the general ledger, which reduces the possibility of errors.

- *Increase Control over Cash.* Separate journals for cash receipts and disbursements provide daily and weekly information about cash balances.

Depending on the size and type of business, different special journals may be used to record different types of transactions. For example, a small company may record all of its transactions in the general journal. A larger company, however, may find that it is inefficient to use a single journal to record all transactions. As a result, it may use a sales journal to record sales on account and a cash receipt journal to record subsequent payments from customers. (Regardless of the number of special journals used, however, the company would not record a specific transaction in more than one journal. Thus, it would not record a sale on account in the sales journal and the general journal.) Companies often use the following specialized journals:

- *Sales Journal*—used to record the sale of merchandise on account.

- *Sales Returns and Allowances Journal*—used to record returns of merchandise by customers.

- *Purchases Journal*—used to record purchases of merchandise on account.

- *Purchase Returns and Allowances Journal*—used to record returns of merchandise or supplies to suppliers.

- *Cash Receipts Journal*—used to record the receipt of cash from all sources.

- *Cash Disbursements Journal*—used to record the disbursement or payment of cash.

- *General Journal*—used to record all other transactions not recorded in specialized journals.

Accountants should be aware that, when using computerized accounting systems, the titles of the special journals may differ from those mentioned above. For instance, the sales journal in a particular software package may be called the "sales transaction register." Although the titles may differ between computerized accounting systems, the overall content of the specialized journals generally remains the same.

Subsidiary Ledgers. A subsidiary ledger is used to keep track of various details that may relate to a specific general ledger account. When a subsidiary ledger is used, the related general ledger account functions as a control account and equals the total of all accounts maintained in the subsidiary ledger. For example, rather than set up a separate general ledger accounts receivable account for each customer, a company may record only summary information in its accounts receivable general ledger account and maintain an accounts receivable subsidiary ledger. The subsidiary ledger would keep track of information about amounts due from individual customers, and the total of all of its customer accounts would equal the general ledger accounts receivable balance. The following are some of the advantages of using subsidiary ledgers:

- The balance due from a customer or due to a supplier may be easily located in a single account on the subsidiary ledger.
- The balance of a general ledger account may be determined by looking at a single amount rather than by totalling several general ledger accounts.
- Errors are easier to locate since many accounts may be eliminated from the general ledger and instead be listed separately in a subsidiary ledger.

Subsidiary ledgers are often used for cash (when there are numerous cash accounts), accounts receivable, accounts payable, operational assets, capital stock, revenues, and expenses.

Source Documents. Generally, when a business transaction is entered into, documents are prepared showing that the transaction took place. Those documents, referred to as source documents, are used to prepare the journal entries that record the transaction. Source documents vary depending on the type of transaction. In many cases, the source document that evidences a transaction will be no more than a deposit slip, check, or check stub. In other instances, a transaction's source documents will consist of invoices, receipts, or signed agreements. Exhibit 1-1 lists examples of common business transactions or events, the source documents that generally result, and where each transaction is recorded.

Exhibit 1-1

Transactions and Related Source Documents

Transaction or Event	Source Document[a]	Where Transaction Is Recorded[b]
Purchase of goods or services:		
For cash	Purchase invoice, buyer's check and check stub	Cash disbursements journal
On account	Purchase invoice, receiving report	Purchases journal
Payment of accounts payable	Purchase invoice, vendor statement, buyer's check and check stub	Cash disbursements journal
Purchase returns	Debit memo, deposit slip	Purchases journal (if credit is received), cash receipts journal (if cash is received)
Sales of goods or services:		
Cash sales	Sales invoice, cash register tape, deposit slip	Cash receipts journal
On account	Sales invoice, cash register tape	Sales journal
Sales returns	Credit memo, cash register tape, check and check stub	Sales journal (if credit is issued), cash disbursements journal (if cash is returned)

Transaction or Event	Source Document[a]	Where Transaction Is Recorded[b]
Collection of accounts receivable	Remittance advice, deposit slip (or other form of cash receipt document)	Cash receipts journal
Note receivable transactions:		
Issuance	Loan agreement, check and check stub (or debit advice)	Cash disbursements journal (if cash is disbursed), general journal (if assets other than cash are given up)
Collections	Remittance advice, deposit slip (or other form of cash receipt document)	Cash receipts journal
Note payable transactions:		
Receipt of proceeds	Loan agreement, deposit slip (or other form of cash receipt document)	Cash receipts journal (if cash is received), general journal (if assets other than cash are received)
Repayment	Receipt, check and check stub (or debit advice)	Cash disbursements journal
Depreciation of assets	Depreciation schedules	General journal
Lease transactions:		
Lessor	Lease agreement (when lease is signed), deposit slip and rental notice (when lease payment is received)	General journal (to record capital leases when they are entered into), cash receipts journal (to record receipt of lease payments)
Lessee	Lease agreement (when lease is signed), rental receipt and check and check stub (when lease payment is made)	General journal (to record capital leases when they are entered into), cash disbursements journal (to record lease payments)
Capital transactions:		
Contribution	Deposit slip or credit advice (if cash contribution), letter agreement	Cash receipts journal (if cash is received), general journal (if no cash is received)
Distribution	Minutes of board of directors' (or partners') meetings, check and check stub (or debit memo)	Cash disbursements journal (if cash is distributed), general journal (if no cash is distributed)
Stock issuance	Stock certificate book, deposit slip (or credit advice)	Cash receipts journal (if cash is received), general journal (if no cash is received)
Stock repurchase	Stock certificate book, check and check stub (or debit advice)	Cash disbursements journal (if cash is paid), general journal (if no cash is paid)
Noncash transaction	Written agreement	General journal

Notes:

[a] Source documents may vary with each transaction. This exhibit lists the possible source documents that may be found in typical transactions.

[b] As discussed previously, each entity may use different special journals to record transactions. For example, one company may record transactions using cash receipts, cash disbursements, and general journals while another company may record similar transactions using only a general journal. This exhibit assumes that the business is using a cash receipts journal, cash disbursements journal, sales journal, purchases journal, and general journal.

* * *

Bases of Accounting

The basis of accounting determines how accounting transactions are recorded. For example, recording transactions based solely on cash receipts and disbursements (that is, cash in/cash out) is considered the cash basis of accounting. Some of the more common bases of accounting are explained in the following paragraphs.

GAAP Basis of Accounting. The method of accounting in which assets, liabilities, revenues, and expenses are recorded in the same period that the related transactions occur, regardless of whether cash was received or paid by the entity during the period, is referred to as the GAAP (or accrual) basis of accounting. The accrual basis of accounting is based on cash transactions as well as credit transactions. For example, under the accrual basis of accounting, a company that buys inventory in 20X1 but does not pay for it until 20X2 would record the purchase in 20X1 (when the transaction occurred). The accrual basis of accounting is the basis prescribed by generally accepted accounting principles.

Cash Basis of Accounting. The cash basis of accounting is a method of accounting in which transactions are recorded only when cash is collected or paid. For example, under the cash basis of accounting, a company that sells a product in 20X1 but collects the cash proceeds from the sale in 20X2 would record the sale in 20X2 (when the cash proceeds were collected).

Income Tax Basis of Accounting. The income tax basis of accounting is the method of accounting that an entity uses, or expects to use, to file its income tax return. It is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures.

SELF-STUDY QUIZ

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

4. Special journals or books of original entry are used because they:

   a. Promote efficiency.

   b. Increase posts made to general ledger.

   c. Lessen the need for internal control.

   d. Decrease the level of cash control.

5. Which of the following is **not** a type of specialized journal?

   a. Purchases journal.

   b. General journal.

   c. Cash receipts journal.

   d. Subsidiary ledgers journal.

6. Which of the following is the correct combination of transaction, source document, and location of the recorded transaction?

   a. Cash sales; purchase invoice; cash receipts journal.

   b. Account purchase; purchase invoice; purchases journal.

   c. Account sales; sales invoice; cash disbursements journal.

7. In which basis of accounting are assets, liabilities, revenues, and expenses are recorded in the same period that the related transactions occur, regardless of whether cash was received or paid by the entity during the period.

   a. Income tax.

   b. GAAP.

   c. Cash.

SELF-STUDY ANSWERS

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

4. Special journals or books of original entry are used because they: **(Page 10)**

   a. Promote efficiency. [This answer is correct. Special journals, one of the types of accounting records commonly used in bookkeeping, are used in many computerized (and manual) accounting systems because they promote efficiency. For example, a company that records all transactions in the general journal and makes several hundred sales on account in one month would have to make several hundred entries each debiting accounts receivable and crediting sales. Each entry in the general journal would then have to be posted to the accounts receivable and sales general ledger accounts. Using special journals, however, the total of all sales on account would be posted to the accounts receivable and sales general ledger accounts only once, at the end of the month.]

   b. Increase posts made to the general ledger. [This answer is incorrect. Special journals reduce the amount of postings to the general ledger, which reduces the possibility of errors.]

   c. Lessen the need for internal control. [This answer is incorrect. Special journals can strengthen internal control. A company may require that each special journal be handled by a different person.]

   d. Decrease the level of cash control. [This answer is incorrect. Separate journals for cash receipts and disbursements provide daily and weekly information about cash balances, thereby increasing control over cash.]

5. Which of the following is **not** a type of specialized journal? **(Page 10)**

   a. Purchases journal. [This answer is incorrect. The purchases journal is a specialized journal used to record purchases of merchandise on account.]

   b. General journal. [This answer is incorrect. The general journal is a specialized journal used to record all other transactions not recorded in specialized journals.]

   c. Cash receipts journal. [This answer is incorrect. The cash receipts journal is a specialized journal used to record the receipt of cash from all sources.]

   d. Subsidiary ledgers journal. [This answer is correct. A subsidiary ledger, one of the types of accounting records commonly used in bookkeeping, is used to keep track of various details that may relate to a specific general ledger account. When a subsidiary ledger is used, the related general ledger account functions as a control account and equals the total of all accounts maintained in the subsidiary ledger.]

6. Which of the following is the correct combination of transaction, source document, and location of the recorded transaction? **(Page 11)**

   a. Cash sales; purchase invoice; cash receipts journal. [This answer is incorrect. Cash sales would have a sales invoice, not a purchase invoice. Cash sales are recorded in the cash receipts journal.]

   b. Account purchase; purchase invoice; purchases journal. [This answer is correct. Source documents are one of the types of accounting records commonly used in bookkeeping. The account purchase is a transaction with a purchase invoice as its source document, which is recorded in the purchases journal.]

   c. Account sales; sales invoice; cash disbursements journal. [This answer is incorrect. Account sales do have a sales invoice, but the transaction is recorded in the sales journal, not the cash disbursements journal.]

7. In which basis of accounting are assets, liabilities, revenues, and expenses are recorded in the same period that the related transactions occur, regardless of whether cash was received or paid by the entity during the period. **(Page 13)**

   a. Income tax. [This answer is incorrect. The income tax basis of accounting is the method of accounting that an entity uses, or expects to use, to file its income tax return. It is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures.]

   b. GAAP. [This answer is correct. The basis of accounting determines how accounting transactions are recorded. The GAAP basis of accounting is one of the more common bases of accounting, and it is defined as described above. The GAAP basis of accounting is based on cash transactions as well as credit transactions.]

   c. Cash. [This answer is incorrect. The cash basis of accounting is a method of accounting in which transactions are recorded only when cash is collected or paid.]

THE BOOKKEEPING SYSTEM

Because no two businesses are exactly alike, it is difficult to design a single bookkeeping system that will work for all companies. For example, a bookkeeping system designed to meet the needs of a service company may not capture all of the transactions or provide the necessary financial information for a manufacturing company. Even if businesses are similar (for example, two medical practices), a bookkeeping system may need to be modified slightly to meet the needs of each business. Accordingly, a bookkeeping system should be designed for each entity. It should not be overly complex and should consider (a) the types of transactions the business enters into and how information about those transactions can be captured and (b) the type of financial information the business needs to efficiently manage its operations. The following paragraphs discuss designing a system that considers those issues. They also offer suggestions on how to make the bookkeeping system more efficient by delegating the work, automating the system, and establishing policies for the retention of bookkeeping records.

Understanding the Client's Business and Industry

Before designing a bookkeeping system, accountants need to understand the client's business and industry. Generally, accountants can accomplish that by completing a "Client Information Form." A Client Information Form prompts accountants to consider unusual or significant industry or business characteristics. For example, accountants would need to document on the form whether a construction company accounts for its contracts under the completed-contract or percentage-of-completion method of accounting. Completing the form allows accountants to address significant accounting matters early in the design process.

Keep the System Simple

A bookkeeping system should be simple. Unnecessarily complex systems are inefficient. In addition, complex bookkeeping systems can prevent accountants in public practice from providing profitable services at competitive prices. For most entities, an elaborate recordkeeping system is not required.

Capturing Information about Transactions

Obviously, the financial information generated by a system that fails to record some or all of a business's transactions is of little use. Similarly, the financial information has little value if the system captures all transactions but fails to record them accurately. Therefore, the bookkeeping system should provide controls to ensure that it captures and accurately records information about all of the company's transactions. Since each entity's needs vary, however, it may require adapting to the unique needs of a particular business.

Cash Disbursements. Checks should only be signed by authorized personnel. Restricting the number of personnel authorized to sign checks creates an important control over cash disbursements. In addition, two employees should be required to sign checks that exceed a specified dollar amount. Before signing a check, the authorized employee should determine that:

a. The supporting invoice is attached to the check.

b. A payment explanation (for example, a statement number, invoice number, or account number) is included on the check.

c. An adequate description has been entered in the check register or on the check stub.

After signing the check, the employee should initial and date the invoice and return it for filing. The following are three common methods of filing paid invoices:

- *By Check Number.* This method is most useful if a small number of checks is written. Paid invoices are filed in numerical sequence in one file with the check number of the check that paid the invoice controlling the filing sequence. The primary advantage of this system is its simplicity. Its main disadvantage is the difficulty in finding a paid invoice unless the check number is known.

- *Alphabetically.* This method is most useful if the number of checks written is small, but frequent reference to paid invoices is desirable. Paid invoices are filed alphabetically by vendor in a file for each letter of the alphabet. This system retains a level of simplicity but allows convenient access to paid invoices.

- *By Vendor.* This system is most useful if the number of checks written is large. Paid invoices are filed in separate files for each vendor. The main advantage to this system is the convenience of locating specific paid invoices. Its main disadvantage is the additional filing time required.

If completed properly, the procedures discussed in the preceding paragraphs will create an adequate level of control over disbursements and, in most cases, will provide enough information for accountants to record the disbursements accurately. To ensure that all of the business's cash disbursements are recorded, see the discussion in the next lesson.

Unpaid Invoices. For many small to medium-sized businesses, a simple unpaid invoice file provides adequate control over unpaid invoices. Under such a system, each vendor invoice is approved when it is received and then placed in a "tickler" file according to the date that it should be paid. Periodically, the unpaid invoice file is reviewed by an authorized employee. Invoices that are due are removed, a check is prepared, and the invoice and check are forwarded to the employee authorized to sign checks.

Using such a system centralizes control over unpaid invoices. As a result, it is not necessary to search through several files to predict when cash payments will be required. In addition, management can readily determine the balance of unpaid invoices at a particular point in time by totaling the invoices in the unpaid invoice file.

Cash Receipts. The system for recording cash receipts will vary depending on the type of business. For example, the cash receipt system of a retail business that primarily makes cash sales could be designed to capture information about sales as well as cash receipts. The cash receipt system of a company that only makes sales on account, however, would, in most cases, only capture information about the collection of accounts receivable.

Regardless of the type of business, the primary objective of a cash receipt system is to ensure that all collections are deposited and properly recorded. That can be accomplished by performing the following steps:

a. *Identify and Summarize Cash Collections.* For some companies, that will involve totaling cash register tapes or prenumbered sales receipts. In other companies, the summary may be in the form of a worksheet that lists each cash receipt and its purpose. The summary should be forwarded to the accountants so that they can (a) properly record sales and collections of cash and accounts receivable and (b) compare the summary to bank deposits to determine that all cash received was deposited. (A completed Cash Receipts Summary is illustrated in Exhibit 1-2.)

b. *Deposit Cash Receipts Promptly.* Checks should be restrictively endorsed as they are received so that they may be deposited only in the company's bank account. Then, at the end of the day (or several times during the day if volume is sufficient), cash receipts should be deposited and the validated deposit slip attached to the cash summary.

Exhibit 1-2

Cash Receipts Summary

Company: New Concepts, Inc. Date: 9-1-X4

Completed by: D. Simmons Reviewed by: B. Davis

Instructions: This form may be used to summarize cash receipts. Supporting documents, such as cash register tapes and validated deposit slips, should be attached.

RECEIPTS

Opening cash on hand	$ 500.00	L1		
Sales (excluding tax exempt sales)	3,431.40	L2		
Tax exempt sales	60.00	L3		
Sales taxes	257.36	L4		
Payments on layaways (attach list)	350.00	L5		
Payments on account (attach list)	816.00	L6		
Other (describe) ________	—	L7		
Total receipts (sum of Lines 1–7)			5,414.76	L8

DEPOSITS

Cash	568.23	L9		
Checks	847.54	L10		
American Express	1,005.49	L11		
Visa/MasterCard	986.50	L12		
Discover	774.00	L13		
Other (describe) ________	—	L14		
Total deposits (sum of Lines 9–14)			4,181.76	L15

CASH OUT AND ADJUSTMENTS

Petty cash vouchers	—	L16		
Sales on accounts receivable (attach list)	733.00	L17		
Other (describe) ________	—	L18		
Ending cash on hand	500.00	L19		
Total cash out and adjustments (sum of Lines 16–19)			1,233.00	L20

TOTAL DEPOSITS AND CASH OUT AND ADJUSTMENTS

(Line 15 + Line 20)	5,414.76	L21
CASH OVER (SHORT) (Line 21 − Line 8)	$ -0-	L22

* * *

SELF-STUDY QUIZ

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

8. There are three methods of filing paid invoices. Which of the following is most useful for businesses that write a large number of checks?

   a. Alphabetically.

   b. By vendor.

   c. By check number.

9. The primary objective of a cash receipt system is:

   a. To identify and summarize cash collections.

   b. To ensure that all collections are deposited and properly recorded.

   c. To deposit cash receipts promptly.

SELF-STUDY ANSWERS

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

8. There are three methods of filing paid invoices. Which of the following is most useful for businesses that write a large number of checks? **(Page 18)**

   a. Alphabetically. [This answer is incorrect. This method is most useful if the number of checks written is small, but frequent reference to paid invoices is desirable. This system retains a level of simplicity but allows convenient access to paid invoices.]

   b. By vendor. [This answer is correct. This system is most useful if the number of checks written is large. Paid invoices are filed in separate files for each vendor. The main advantage to this system is the convenience of locating specific paid invoices. Its main disadvantage is the additional filing time required.]

   c. By check number. [This answer is incorrect. This method is most useful if a small number of checks is written. The primary advantage of this system is its simplicity. Its main disadvantage is the difficulty finding a paid invoice unless the check number is known.]

9. The primary objective of a cash receipt system is: **(Page 19)**

   a. To identify and summarize cash collections. [This answer is incorrect. This is a step in the cash receipt system, not the objective. This step will be performed different ways in different businesses.]

   b. To ensure that all collections are deposited and properly recorded. [This answer is correct. Regardless of the type of business, this is the primary objective of a cash receipt system. If the cash receipts system meets this objective, it will record all the needed business transactions and do so accurately, which is how a bookkeeping system should capture information about transactions.]

   c. To deposit cash receipts promptly. [This answer is incorrect. This is a step in the cash receipt system, not the objective. Checks should be restrictively endorsed as they are received so that they may be deposited only in the company's bank account. Then, at the end of the day (or several times during the day if volume is sufficient), cash receipts should be deposited and the validated deposit slip attached to the cash summary.]

What Information Should the System Provide?

The most important aspect of a bookkeeping system is that it produces a general ledger that contains financial information that management can use. At a minimum, the system must provide the information necessary to prepare tax returns. Depending on the company, the system may also need to produce information for balance sheets, income statements, statements of cash flows, and supplementary information. Therefore, how the financial information will be used should be considered when designing a bookkeeping system.

Developing a Chart of Accounts. It is not necessary to use a chart of accounts that provides for every conceivable transaction. Instead, the chart of accounts should include the minimum number of accounts necessary to capture the appropriate financial information and be flexible enough to allow for future growth. Accountants should design the chart of accounts to include the accounts necessary for financial and income tax reporting. For example, for income tax reporting, a company may require two accounts for business meals and entertainment—one to record the expenses that are fully deductible and another to record the expenses that are only 50% deductible.

A chart of accounts usually begins with accounts that are used to prepare the balance sheet and continues through the accounts that are used to prepare the income statement. For example, the following series of account numbers may be used:

Category	Account Numbers
Assets	1000–1999
Liabilities	2000–2999
Equity	3000–3999
Revenues	4000–4999
Expenses	5000–5999
Other Income and Expense	6000–6999
Income Tax Expense	7000–7999
or	
Assets	100–199
Liabilities	200–299
Equity	300–399
Revenues	400–499
Expenses	500–599
Other Income and Expense	600–699
Income Tax Expense	700–799
or	
Assets	100.00–199.99
Liabilities	200.00–299.99
Equity	300.00–399.99
Revenues	400.00–499.99
Expenses	500.00–599.99
Other Income and Expense	600.00–699.99
Income Tax Expense	700.00–799.99

The number of specific accounts within each category depends on the entity's needs.

Selecting a Basis of Accounting

Selecting the most appropriate basis of accounting is important from a cost-effective standpoint since it reduces the effort required to prepare financial statements and tax returns. Three of the more important considerations in choosing the basis of accounting are:

- *Keeping the Number of Adjusting Journal Entries at a Minimum.* Preparing adjusting journal entries takes additional time. If the basis of accounting selected requires a significant number of monthly adjusting journal entries (for example, to convert general ledger information from the GAAP basis of accounting to the tax basis for tax reporting and to another basis for financial reporting), it becomes more difficult to provide bookkeeping services efficiently.

- *Providing Businesses with Useful Information.* Clients need financial information to assist them in making business decisions. The accountant should carefully consider the client's financial needs before selecting a basis of accounting. For example, certain nonprofit organizations must closely monitor cash receipts and disbursements. Consequently, cash basis financial statements may be more useful to them than accrual basis statements.

- *Can the Same Basis of Accounting Be Used for Both Tax and Financial Reporting?* Generally, small to medium-sized businesses can use the same basis of accounting for the general ledger and for tax and financial reporting, particularly if the basic financial statements are supplemented with schedules that provide information on significant accrual basis items (such as accounts receivable). If the same basis of accounting is used, few, if any, adjustments will be necessary to prepare financial statements and tax returns from general ledger information.

The following paragraphs discuss bases of accounting that are commonly used and considerations for selecting each.

GAAP Basis. GAAP basis financial statements present financial position and results of operations in accordance with generally accepted accounting principles. GAAP basis statements are prepared using the accrual method. Under the accrual method of accounting, revenues and expenses are recorded when they are earned or incurred, which may or may not coincide with the time cash is actually received or paid. Few small to medium-sized businesses need GAAP basis financial statements on a regular basis. However, some may occasionally prepare GAAP basis financial statements if, for example, they are required to do so by creditors.

Other Comprehensive Bases of Accounting (OCBOA). The financial statements of many small to medium-sized businesses will be prepared in conformity with an OCBOA (that is, a comprehensive basis of accounting other than generally accepted accounting principles). The most common OCBOA presentations are summarized below:

a. *Tax Basis of Accounting.* How transactions are recorded (for example, whether amounts are capitalized) depends entirely on tax regulations. Therefore, the cash or accrual method could be used depending on 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.

b. *Pure Cash Basis.* Only cash receipts and disbursements are recorded, and no transactions are capitalized. Financial statements presented on the pure cash basis essentially present a summary of receipts and disbursements and reconcile beginning and ending cash.

c. *Modified Cash Basis.* Substantially all transactions recognized are cash receipts and disbursements. However, some noncash transactions may be recognized (for example, depreciation), and some transactions are capitalized and amortized following GAAP requirements. (For example, capital expenditures may be recorded as fixed assets and depreciated following GAAP guidelines.)

d. *Regulatory Basis.* The basis of accounting is prescribed by a regulatory agency having authority over the entity.

Income Tax Basis. The income tax basis eliminates the need for converting from one basis for bookkeeping purposes to another for tax reporting. When the income tax accrual basis is used (or the income tax cash basis supplemented with appropriate accrual basis information such as accounts receivable and payable data), income tax basis statements are meaningful practice management tools. In addition, they are often easier for non-accountants to understand and use than GAAP financial statements.

Many companies elect the accrual method of accounting for income tax purposes. Some companies use the cash method for income tax purposes, however. Acceptable OCBOA is the cash basis modified as follows:

a. Revenues are recognized when payment is received.

b. Expenses are recognized when paid with certain exceptions. (See items d. and e.)

c. Fixed assets are capitalized and recognized as assets.

d. Depreciation of fixed assets is recognized as an expense based on depreciation methods allowed for tax reporting.

e. Other than qualified retirement plan contributions that must be made by the due date of the tax return and unremitted payroll tax withholdings, expense accruals are usually not recognized.

A major drawback of using the cash method income tax basis for monthly or quarterly financial reporting occurs when an expense that will benefit several future periods is paid. Such an expense, if material, will distort the usefulness of the financial information. For example, insurance premiums often benefit 12 months but are paid only once a year. Large premium payments can reduce the usefulness of month-to-month comparisons.

Delegating the Work

Accountants in public practice can delegate much of the bookkeeping work to the client. For example, the client can code the check stubs (that is, write on the check stub the general ledger account to which the check should be charged), summarize sales and deposits, or reconcile bank accounts. Any work that cannot be performed by client personnel should be delegated to paraprofessionals. Bookkeeping services are a valuable professional service. However, just as attorneys use paralegals to perform recurring legal work, accountants can use paraprofessionals to perform bookkeeping services. Well-trained and appropriately supervised paraprofessionals can generally perform all bookkeeping services and prepare financial statements and tax returns.

Supervision. Clients will ultimately hold the accountants responsible for the services provided, not the paraprofessionals. Therefore, it is important to supervise adequately the work performed by paraprofessionals. Adequate supervision includes being available to answer technical questions as well as reviewing the paraprofessional's work.

Automating the System

Personal computers and related software are more efficient than the best manual systems. In fact, they have grown to such popularity and efficiency that manual accounting systems are seldom used. Automated accounting systems can produce the appropriate special journals and general ledger by merely entering the transactions and adjustments and instructing the software to post the entries. Once the general ledger is produced, accountants can also use the software to produce financial statements. In addition, software packages are often integrated with modules for accounts receivable, accounts payable, inventory, and payroll. In such instances, the transactions entered are not only posted to the general ledger but produce subsidiary ledgers for those accounts as well.

QuickBooks® is one of the most popular accounting software programs for small businesses. QuickBooks is a double-entry accounting program and can be used to perform such activities as creating invoices, entering cash sales, receiving payments, creating purchase orders, paying bills, tracking inventory, paying employees, processing sales taxes, reconciling bank statements, and accumulating income tax information. In addition to the standard QuickBooks product, Intuit offers solutions for many industries, such as QuickBooks Premier-Accountant customized for accounting professionals, QuickBooks Premier-Contractor customized specifically for construction contractors, QuickBooks Premier-Manufacturing & Wholesalers customized for manufacturers and wholesalers, QuickBooks Premier-Nonprofit customized specifically for nonprofit organizations and QuickBooks Premier-Retail for retailers. *PPC's QuickBooks Solutions: A Problem-solving Guide for Accounting Professionals* provides solutions to common problems that arise when small businesses use QuickBooks and advice on using QuickBooks data. That *Guide* can be ordered by calling (800) 323-8724 or via PPC's website at **ppc.thomsonreuters.com**.

In addition to QuickBooks, there are numerous other commercial accounting systems available including Internet-based accounting packages. Selecting the one that best meets a company's needs can be difficult. Many accountants select a system that meets their immediate needs only to be surprised by future problems and system limitations.

Keep the Automated System Simple. Even though computers are capable of great efficiencies, they can lead to unnecessary complications. That is especially true if the computer is used by improperly trained personnel. The advice on keeping the system simple also applies to computer environments. In fact, accountants should use the same bookkeeping system and flexible chart of accounts discussed previously whether the system is manual or automated.

Automated Systems Are Not Always Needed. In some cases, a manual system may be maintained because of familiarity or because the staff providing the services may not be computer trained. Those situations should be evaluated individually and reevaluated periodically to determine if further efficiencies can be obtained by using computers.

One manual system used by some companies is the "one-write" system. The one-write approach allows the bookkeeper to write a check or record a deposit slip and, at the same time, post the cash receipt and disbursement journal. Although efficient in concept, the one-write systems can produce a negative experience. The resulting cash receipts and disbursements journal is often difficult to use, and account postings are likely to be incorrect unless the staff is well trained in bookkeeping. Correcting one-write entries is often more time consuming than completely re-entering the data.

SELF-STUDY QUIZ

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

10. Which of the following statements most accurately describes the most important aspect of a bookkeeping system?

    a. It produces information to prepare a tax return.

    b. It produces information to prepare financial statements.

    c. It creates a general ledger that contains financial information that management can utilize.

11. Which of the following businesses has selected the most cost effective basis of accounting?

    a. Stop-N-Shop selects the GAAP basis of accounting for financial reporting, and uses adjusting journal entries to convert transactions into the income tax basis of accounting to fill out its tax return.

    b. Helping Hands, a small nonprofit organization that closely monitors its cash receipts and disbursements, uses the GAAP basis of accounting.

    c. Whammy Inc., a small business, uses the income tax basis of accounting for its general ledger and its tax and financial reporting. It supplements its financial statements with additional schedules of information.

12. Select the accounting basis that will best meet the needs of the client.

    1. The client is a government contractor and must meet the reporting needs of the United States government.

    2. The client is an individual taxpayer with an annual salary and a few investment instruments.

    3. The client is a small corporation and has no audit requirements.

    4. The client is an international corporation and files a 10K.

    i. Cash basis.

    ii. Tax basis.

    iii. Accrual basis.

    iv. Regulatory basis.

    a. 1 and ii, 2 and iii, 3 and i, 4 and iv.

    b. 1 and iv, 2 and i, 3 and ii, 4 and iii.

    c. 1 and i, 2 and ii, 3 and iii, 4 and iv.

    d. 1 and iv, 2 and iii, 3 and ii, 4 and i.

13. Sam has selected the income tax basis of accounting. He uses the cash method for income tax purposes. This means Sam will record **all but which one** of the following:

    a. Fixed assets will be capitalized and recognized as assets.

    b. Depreciation of fixed assets will be recognized as an expense.

    c. Revenues will be recognized when they are earned.

    d. Expenses will be recognized when they are paid.

SELF-STUDY ANSWERS

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

10. Which of the following statements most accurately describes the most important aspect of a bookkeeping system? **(Page 23)**

    a. It produces information to prepare a tax return. [This answer is incorrect. Though this is a minimum requirement of such a system, this in not the most important aspect of a bookkeeping system.]

    b. It produces information to prepare financial statements. [This answer is incorrect. Depending on the company, the system may need to produce information for balance sheets, income statements, statements of cash flows, and supplementary information; however, this is not the most important aspect of such a system.]

    c. It creates a general ledger that contains financial information that management can utilize. [This answer is correct. A unique bookkeeping system must be designed for each business entity. At a minimum, the system must provide the information necessary to prepare tax returns. Depending on the company, the system may also need to produce information for balance sheets, income statements, statements of cash flows, and supplementary information.]

11. Which of the following businesses has selected the most cost effective basis of accounting? **(Page 23)**

    a. Stop-N-Shop selects the GAAP basis of accounting for financial reporting, and uses adjusting journal entries to convert transactions into the income tax basis of accounting to fill out its tax return. [This answer is incorrect. The most cost effective basis of accounting is one that reduces the effort to prepare financial statements and tax returns. One consideration for this effort is keeping the number of adjusting journal entries at a minimum, because preparing them takes additional time. In this situation, Stop-N-Shop should select a different basis of accounting to minimize adjusting journal entries, which would allow the business to have more efficient bookkeeping services.]

    b. Helping Hands, a small nonprofit organization that closely monitors its cash receipts and disbursements, uses the GAAP basis of accounting. [This answer is incorrect. One important decision in selecting the basis of accounting is that it must provide the business with the financial information needed to assist them in making business decisions. In this example, using the cash basis of accounting would be more useful to Helping Hands than the GAAP basis of accounting. Providing useful information will be more cost effective because the effort to prepare the organization's financial statements and tax returns will be reduced.]

    c. Whammy Inc., a small business, uses the income tax basis of accounting for its general ledger and its tax and financial reporting. It supplements its financial statements with additional schedules of information. [This answer is correct. Selecting the most appropriate basis of accounting is important from a cost-effective standpoint since it reduces the effort required to prepare financial statements and tax returns. Generally, small to medium-sized businesses (like Whammy Inc.) can use the same basis of accounting for the general ledger and for tax and financial reporting, particularly if the basic financial statements are supplemented with schedules that provide information on significant accrual basis items. If the same basis of accounting is used, few, if any, adjustments will be necessary to prepare financial statements and tax returns from general ledger information.]

12. Select the accounting basis that will best meet the needs of the client. **(Page 24)**

    1. The client is a government contractor and must meet the reporting needs of the United States government.

    2. The client is an individual taxpayer with an annual salary and a few investment instruments.

    3. The client is a small corporation and has no audit requirements.

    4. The client is an international corporation and files a 10K.

    i. Cash basis.

    ii. Tax basis.

    iii. Accrual basis.

    iv. Regulatory basis.

    a. 1 and ii, 2 and iii, 3 and i, 4 and iv. [This answer is incorrect. While it may be desirable for an entity deriving the majority of its business from the government to use the tax basis of accounting, it will be most efficient for the entity to meet the accounting basis prescribed by the agency with regulatory authority. Since this first match in this answer choice is incorrect, the remainder of the matches are also incorrect.]

    b. 1 and iv, 2 and i, 3 and ii, 4 and iii. [This answer is correct. To achieve efficiency in governmental reporting requirements, it will be most advantageous for the entity with governmental contracts to use the regulatory basis of accounting. An individual taxpayer is most likely to use the cash basis of accounting. A client with no audit requirements may find the tax basis of accounting most efficient. A large corporation with SEC reporting requirements will want to use the accrual basis of accounting to comply with GAAP.]

    c. 1 and i, 2 and ii, 3 and iii, 4 and iv. [This answer is incorrect. A business with substantial government contracts is too sophisticated to us the cash basis of accounting. Since this match is incorrect, other matches in this answer choice are also incorrect.]

    d. 1 and iv, 2 and iii, 3 and ii, 4 and i. [This answer is incorrect. An individual taxpayer with only a salary and cash investment instruments would not need the complexity of accrual basis accounting. Since this match is incorrect, other matches in this answer choice are also incorrect.]

13. Sam has selected the income tax basis of accounting. He uses the cash method for income tax purposes. This means Sam will record **all but which one** of the following: **(Page 24)**

    a. Fixed assets will be capitalized and recognized as assets. [This answer is incorrect. The rules for using the cash method for income tax purposes treat fixed assets in this way.]

    b. Depreciation of fixed assets will be recognized as an expense. [This answer is incorrect. The rules for using the cash method for income tax purposes recognize depreciation of fixed assets as an expense based on depreciation methods allowed for tax reporting.]

    c. Revenues will be recognized when they are earned. [This answer is correct. Under the rules for using the cash method for income tax purposes, revenues are recognized when payment is received.]

    d. Expenses will be recognized when they are paid. [This answer is incorrect. The rules for using the cash method for income tax purposes recognize expenses when they are paid, with certain exceptions.]

Maintaining Bookkeeping Documents

When accountants in public practice provide bookkeeping services, questions often arise about ownership of bookkeeping documents. For example, "Which documents belong to the CPA firm and which documents belong to the client?" Interpretation 501-1 of Rule 501 (ET 501.02) of the AICPA *Code of Professional Conduct* divides workpapers into the following three groups and identifies which workpapers the accountants must provide to the client:

a. *Client Records.* This includes information that is normally a part of the client's accounting records such as source documents and depreciation schedules. The accountants may not ethically withhold such information from the client to obtain payment of fees.

b. *Member's Workpapers.* This includes analyses and schedules prepared by the client at the accountants' request. The accountants are not required to make such workpapers available to the client.

c. *Necessary Financial Information.* This includes information that is not reflected in the client's books and records but that is necessary for the client's records to be complete. Examples include journal entries (such as adjusting, closing, reclassification, or consolidating entries), and information that is normally contained in the books of original entry and general ledgers or subsidiary ledgers. The accountants should make such records available to the client upon request. However, the information can be withheld until the fee for the engagement is paid.

In addition to the AICPA rules noted above, certain state accounting boards societies have adopted specific rules regarding withholding client documents.

Most of the records generated during the write-up process fall into categories a. or c. above. Accordingly, the accountants should provide a copy of those bookkeeping documents to the client. The types of documents generated may vary depending on each client's circumstances. Generally, however, the accountants should return all source documents to the client and provide the client with a copy of all journal entries, special journals, subsidiary ledgers, and general ledgers produced during the engagement. Revised Interpretation No. 501-1 under Rule 501 of the Code of Professional Conduct, *Response to Requests by Clients and Former Clients for Records*, among other things, stipulates that client documents prepared by the accountant should be provided to the client, except when the preparation of such documents is incomplete or fees are due to the accountant for the preparation of those documents.

How Long Should Bookkeeping Documents Be Kept? Determining how long documents should be kept is a major problem. The cost of storage space and the administrative burden of maintaining documents require that documents be kept for only so long and then be discarded. In addition, many attorneys and CPAs believe that it is easier for a firm to defend itself in a lawsuit if the related workpapers have been discarded in accordance with a reasonable document retention policy. How long bookkeeping documents are kept varies depending on regulatory requirements, company (or CPA firm) policies, and the type of documents. For example, SAS No. 103, *Audit Documentation*, specifically indicates a minimum audit documentation retention period of five years from the report release date. Obviously, the documents should be kept so long as they serve a useful purpose or until all legal and regulatory requirements are met. Firms often base how long they keep files on the length of the statute of limitations for breach of contract, breach of fiduciary duty, and professional liability claims. Exhibit 1-3 presents suggestions for retaining bookkeeping documents. However, they are only examples. The firm should consider consulting its attorney and insurance carrier when establishing a document retention policy. In addition, review the document retention policy annually and update it as necessary, while considering changes in governmental and professional requirements and the cost of retaining documents. Although they are directed toward accountants in public practice, accountants in industry may also follow the suggested retention periods.

Exhibit 1-3

Example Document Retention Periods

Description	Retention Period (In Years)[a]
Accounting records	
General ledger	
Present clients	Indefinitely
Former clients	7
Payroll ledger	
Present clients	Indefinitely
Former clients	7
Cash receipts and disbursements journals	
Present clients	Indefinitely
Former clients	7
Journal entries	
Present clients	Indefinitely
Former clients	7
Accounts receivable subsidiary ledgers	7
Accounts payable subsidiary ledgers	7
Daily cash reports and bank deposit slips	7
Sales invoices	7
Check stubs or check voucher copies	7
Paid checks and vendor invoices[b]	7
Petty cash slips	7
Expense reports	7
Employee payroll data	7
Financial statements	
Annual	Indefinitely
Interim	7
Tax returns	
Payroll tax returns	
Present clients	Indefinitely
Former clients	7
Income tax returns	
Present clients	Indefinitely
Former clients	7
Sales tax returns	
Present clients	Indefinitely
Former clients	7
Legal documents	
Unexpired documents	Indefinitely
Expired documents	6

Notes:

[a] Because legal requirements vary among states and among governmental agencies, accountants should consult with local counsel before establishing a document retention policy. Accountants should consult their state board of accountancy to determine the applicable requirements in their states. A discussion on the importance of a formal document retention policy follows this exhibit. In addition, various professional requirements or guidelines exist. For example, the Sarbanes-Oxley Act of 2002 requires that the workpapers for public company audit clients be maintained for seven years. In July 2007, the National Association of State Boards of Accountancy (NASBA) amended the UAA Model Rules to require a five-year retention period for attest documentation, measured from the report date, if applicable professional standards do not specify otherwise.

[b] Normally, paid checks and vendor invoices should be retained for seven years. Copies of checks and invoices for the purchase of assets, where the determination of basis may be important in the future, should be retained indefinitely, however.

* * *

Importance of a Formal Document Retention Policy. A filing and retention system can only be effective if its procedures are followed. Therefore, staff members should be familiar with the firm's filing system and be given specific instructions for maintaining it. Having formal written document retention policies and procedures facilitates communication and understanding throughout the firm which, in turn, enhances effective implementation.

From a legal perspective, a formal written policy provides an additional benefit. One of the dangers of discarding documents that subsequently become the subject of litigation is the "spoliation doctrine." Under this doctrine, a jury may reach adverse inferences based upon the accounting firm's destruction of seemingly relevant records. A jury might infer that the accountant disposed of its workpapers out of fear that they would reveal substandard practice. By carefully adhering to well-conceived written document retention policies, a firm can generally overcome such adverse inferences, especially if the retention period is set to coincide with applicable statutes of limitations.

It is not enough to simply adopt a well-conceived document retention policy—a firm must also strictly *adhere* to that policy. That lesson was demonstrated vividly by the Arthur Andersen/Enron experience. Though subsequently overturned by the U.S. Supreme Court in 2005, Arthur Andersen received a criminal obstruction of justice conviction in connection with its efforts to comply with the firm's document retention policy in the Enron case. Every document retention policy should incorporate procedures to ensure that the policy is being applied on a continuous, rather than sporadic, basis. In addition, document alteration or destruction should be deferred pending known governmental, criminal, or disciplinary investigations even if the CPA firm is not currently the target of the investigation. Even documents that should have been previously disposed of, in accordance with firm policy (such as personal files or review notes) should be maintained pending completion of the investigation. This further points out the need to dispose of unnecessary documentation *immediately* at the completion of the engagement.

Compliance with document retention policies can only be assured when there is a single centralized file of material maintained in support of each engagement. Maintaining client and engagement information separately in personal files or permitting other ad hoc duplication significantly increases the risk that drafts and superseded material, informal or gratuitous commentary, or other material that should not have been retained will be available to plaintiff's counsel and produce unnecessary legal risks if the quality of the work is later challenged. As indicated below, this principle presents a particular challenge as it applies to electronic files.

Engagement documentation may need to be retained for a specified period because of legal, regulatory, or professional requirements. It also may be advantageous to maintain such documentation for reference in subsequent engagements, for use in response to client inquiries, or to serve as a helpful aid if the quality of the work is challenged prior to the expiration of a statute of limitations. However, to arbitrarily retain documentation beyond the time required to meet the above needs is unnecessary and costly.

A firm's document retention policy must be able to accommodate and respond to the need to retain documents beyond their normal retention period. As the Arthur Andersen/Enron experience reveals, an accounting firm can be accused of having obstructed justice if it destroys documents with respect to a known governmental or criminal investigation. Accordingly, document retention policies should provide for a suspension of the planned destruction of documents relevant to litigation and criminal or governmental investigations, even though the firm has neither received a subpoena nor a summons relating to its work for the client. Accounting firms should also establish procedures for alerting engagement personnel to safekeep all relevant documents when it learns of an investigation or litigation involving a client. Additionally, document retention policies should provide for the prompt delivery of information relating to such litigations and investigations to those persons charged with implementing the disposal of outdated records.

Disposing of Old Files. Rather than purge old files each month, many firms select a single day during the year (which usually is a day during the summer months when the firm is less busy) to identify and dispose of old files. As workpapers are initially filed, many firms write the date each file should be disposed of on the outside of the file folder or electronic data file. By doing so, such firms are able to quickly identify old files that should be discarded.

The method used to dispose of old files should ensure that confidential information contained in the files remains confidential. Consequently, it is usually not appropriate to throw them in a dumpster or place them in a recycling bin. Most firms shred old files or contract with paper recycling companies that guarantee confidentiality and reduce all papers to pulp. Shredding confidential information is even more important as the crime of identify theft has become more prevalent in recent years.

Document Imaging. In the past, the cost of imaging technology has been beyond reach for most accounting firms. Today, many firms are using imaging as a means of efficiently managing document capture, indexing, routing, processing, and retrieval.

Firms with a large number of files and limited storage space may want to consider using document imaging to scan files. Doing so offers several advantages over maintaining paper files:

a. The amount of space needed to store files can be significantly reduced.

b. Workpapers can be quickly located, particularly if they are stored on electronic media with search and retrieval capabilities.

c. Files are less likely to be misplaced or lost.

d. Files can easily be protected from damage or loss by duplicating them and storing the duplicates off-site.

e. Documents can be used by several people at once.

f. Multiple documents can be matched into one business process.

PPC's Guide to Managing an Accounting Practice contains a more detailed discussion of document imaging and imaging equipment.

Document Retention Challenges for Information in Electronic Form. The preceding discussions regarding overall guiding principles for document retention and document retention periods applies to both hard copy data and information maintained in electronic form. However, when considering the document retention process, maintaining data in electronic form adds a dimension that presents some added challenges.

<u>Understanding Electronic Document Retention Risks.</u> The aspects that create additional challenges to the document retention process arise because of (a) the transition between hard copy and electronic data creation and (b) the increased likelihood that duplicate and off-line information exists in an electronic environment. Since in many cases electronic workpapers are also printed, firms are at risk of having multiple versions of many workpapers (both electronic and hard copy versions). Moreover, the electronic versions may reside on the notebook computers of individual staff members or in various locations on the firm's computer network.

In addition, email correspondence can create unique liability exposures. Therefore, email should also be subject to firm backup and retention policies. While email communication with third parties (including confirmation replies) is acceptable, the firm should verify that the electronic communication channel is secure to ensure that the responses are, in fact, directly from the third parties without risk of an alteration by the client. In addition, email creates an electronic document that is stored on the firm's network computer server. Even deleted email messages can often later be restored from the firm's network or its backup files. Those files are subject to subpoena and other legal document production procedures. Email and its retention are discussed later in this course.

Because document retention is almost certain to involve both electronic files and hard copy records, the risk of inadvertently maintaining draft or superseded documents increases significantly. For example, workpapers that are printed out may also reside on a staff member's notebook computer and/or in various locations on the firm's computer network. At issue is the fact that handwritten notes are sometimes added to the printed version but are not reflected in the original electronic version. Similarly, multiple electronic copies are generated because of the need to incorporate backup procedures, adding to the risk of duplicate and differing versions of the same material. To minimize that risk, one engagement team member should be assigned the responsibility of addressing the risk of incomplete or noncurrent workpapers at the conclusion of the engagement. It might also be prudent to receive confirmation from the other team members regarding the destruction of any drafts, "to do" points, extraneous information, and personal files. Please note that today's higher-end audit engagement, tax workflow, and document management applications transition the vast majority of physical documents and annotations to a digital file format where there are integrated safeguards to enforce the firm's document retention policies. It is important from a legal perspective that the firm adhere to its document retention policies for both physical and digital documents. Retention and disposal of information in electronic form is a challenge that requires a rigorous process at the conclusion of the engagement.

CPA firms should also have internal procedures to prevent staff from copying and retaining electronic files for their own personal use. While this problem currently exists in a hard copy environment, it is far more difficult to address in an electronic record environment as entire directories of files can be stored on relatively small disks, tapes, and CDs. Equally important, they will not be recognizable by casual observation, as they can be easily renamed. Staff will also have the ability to ship files out of the office via emailing them.

The electronic age poses yet another problem for document retention policies—even deleted records often can be restored. On most systems, the delete function only destroys a record's identifiers—it does not destroy the entire record. Thus, by searching the storage devices (hard drive, floppy drive, CD rewritables, etc.) of computers that once stored the record, it may be possible to retrieve a deleted record if no other record has been stored on the section of the computer that once stored the deleted record. Even a search of the files on an accountant's computer will not necessarily reveal the continued existence of a deleted record.

<u>Archiving Electronic Information.</u> As with paper engagements, paperless engagements need to be archived and stored once the engagement is finished. Archived engagements serve as the final copies of the workpapers that are saved for future reference. The archived files should be easily accessible for use in future engagements, for peer review, and for other purposes. In developing an archive and storage policy, firms should consider their own preferences and technology capabilities, as well as any file lockdown provisions required by auditing standards. Archiving is particularly important in light of recent auditing standards related to the integrity, accessibility, and retrievability of documentation.

The following paragraphs discuss archiving and storage issues assuming that engagement workpapers are completed and reviewed electronically. Electronic workpapers are generally not printed (or all printed copies are destroyed) and the only hardcopy documents are manual documents such as confirmations, engagement letters, etc. If the firm chooses another option for printing workpapers, the archiving policies need to be modified accordingly.

The firm's policies for archiving electronic engagements should ensure that:

- All interim backups made during the engagement are deleted.
- Any documents still residing on other media or as email attachments are deleted from those locations.
- Workpapers printed during the engagement are discarded unless they are intended to be part of the final workpapers for the engagement.
- Superseded memos, "to do" lists, and other personal electronic documents that are not intended to be part of the final workpapers are discarded immediately upon completion of the engagement.
- Review notes are deleted.
- Electronic workpapers not part of the archived files are removed from computers used in the engagement.
- Only a limited number of copies of the engagement workpapers are retained in a controlled environment. If the workpapers are in a digital format within the firm's network or document management application, adequate access controls and an audit trail should be implemented.

- The engagement workpapers (including manual hard copy documents) are kept in a secure location with controlled access.

- The engagement workpapers (including manual hard copy documents) are stored in an organized manner so that they can be easily retrieved. There should be an organized system to denote which workpapers are stored electronically and which are stored as hard copies.

After the firm's policies for archiving are established, it should take steps to ensure that the policies are effectively implemented. As with any new policies, it is relatively easy to develop the policies, but it takes a lot of effort to ensure that they are actually implemented. One of the best ways to ensure that the policies are followed is to assign this responsibility to a designated member of the engagement team.

It is important that electronic workpapers be *locked down* at the conclusion of the engagement so that, in the conduct of the subsequent year engagement, a *roll over* or other update does not result in the elimination of the documentation that existed in support of the prior year engagement.

In addition, one of the biggest risks in an electronic workpaper environment is the failure to adequately control and ultimately delete interim draft and in-process documentation and extraneous material that is not intended to be a part of the final workpapers. When document storage involves transfer of materials from one medium to another, firms may choose to have a designated and knowledgeable member of the engagement team review the archived material to ensure that a complete and accurate transfer has been made. The purpose of this review would be to make sure draft and extraneous materials are not inadvertently included and necessary documents are not inadvertently omitted.

To perform the archiving, a backup utility or a backup service can be used. When archiving, steps should be taken to ensure that all other versions of the workpapers or the engagement are deleted. Also, the archived engagement should be deleted from the computer on which it was created (unless this computer is used as one of the storage locations for the engagement).

To guard against an unexpected loss of data (for example, in the case a disk is corrupted, a laptop is stolen, or a server becomes inaccessible because of a disaster or technical issues), multiple copies of the engagement should be retained and stored in different locations. For recovery of a server, the first place firms should go is their most recent tape backup, which should be located offsite from the firm. Firms are also beginning to utilize onsite backups to an archival hard disk and Internet-based storage systems that are managed and backed up by accounting vendors and other third parties. For recovery of a damaged or lost workstation, today's document management systems allow for restoration of files from the most recent point of synchronization. Usually, the most recent version will be stored by the accountant on another field computer or on a storage medium such as a floppy disk, removable storage drives, writable CD/DVD-ROM, or the preferred solution today, a USB memory stick, which is the approximate size of a pack of gum. USB memory sticks plug into the USB port of the computer and can be used to quickly backup and restore files in volumes of up to 64 GB (gigabytes). However, the need for redundancy should be balanced against the need to control access to the engagement workpapers.

Retention of Electronic Workpapers. Another issue that is closely related to archiving is the question of how long electronic workpapers and engagements should be retained. Firms should use the same guidelines they use for printed workpapers.

The most important point is that workpapers should be discarded in accordance with professional standards and legal or regulatory requirements following an established firm policy. Inconsistent application of the firm's policy can be very damaging in the event of litigation. Therefore, deviations from the firm's policy should be infrequent, and the reason for any deviation should be documented.

Also, if engagements are archived to the firm's network, consideration should be given to how periodic network backups affect the firm's document retention policies. Specifically, if a firm has a policy of discarding engagement workpapers after a certain period of time, archive copies of the workpapers that are part of the firm's network backup files should also be deleted.

Storing and Disposing of Electronic Files. If electronic data is archived to the firm's computer network, consideration should be given to how periodic network backups affect the firm's document retention policies. Specifically, at the time the files are disposed of, archived copies of the files that are part of the firm's network backup files should also be deleted.

In addition, firms should recognize that archived electronic files might need to be accessed several years after they have been created. Accordingly, steps should be taken to ensure that when the software applications used in creating the work (or encryption, archival, or compression programs used to archive and store the files) are later updated or superseded, the superseded applications are retained or available from the software vendor so that the stored electronic files can continue to be accessed.

Finally, some electronic records are stored in media that decompose over time or become obsolete. It is important that those electronic records be accessible during the retention period. Therefore, it may be necessary to periodically transfer those records to new storage media.

Email. Email creates an electronic document that is stored on the firm's network computer server. Even deleted email messages can often later be restored from the firm's network or its backup files. These files are subject to subpoena and other legal document production procedures. Accordingly, guidance on maintaining email communications should be included in the firm's document retention policies. Potential legal liability issues could arise from maintaining emails on the firm's system for inordinately long periods. Firm personnel should be cautious about the type of information contained within emails. Sensitive client information may more appropriately be discussed over the telephone.

The trend seen in practice indicates that many firms are setting automatic deletion of emails to 90–180 days. When possible, incoming and outgoing emails should be deleted as soon as any necessary action has been taken. When emails must be preserved for longer than the firm policy recommends, the emails should be transferred to the firm's electronic documentation system where they can be labeled and indexed. The copy in the firm's email system should then be deleted.

The Need for Confidentiality. Whether bookkeeping services are provided by accountants in industry or public practice, the accounting information generated should be kept confidential. The need for confidentiality is particularly important for accountants in public practice. Rule 301 (ET Section 301.01) of the AICPA *Code of Professional Conduct* specifically states that a member of the AICPA should not disclose any confidential client information without the client's consent. Therefore, workpapers can be shown to someone else only with the client's explicit permission. That is true even if an accountant sells the practice to another accountant or if a successor accountant requests information from a predecessor accountant. Explicit permission is not required, however, for making workpapers available if subpoenaed by a court, if requested in an ethical disciplinary proceeding, or if submitted in an AICPA or state CPA society authorized peer review program. Also, as discussed, revised Ethics Ruling No. 1 (ET 391.001–.002) under Rule 301, *Confidential Client Information*, states that if the accounting firm does not enter into a contractual agreement with a third-party service provider requiring the party to (a) maintain the confidentiality of the client's information and (b) have procedures in place to prevent unauthorized release of confidential information, the accounting firm must obtain the client's consent to disclose the client's confidential information to the third-party service provider.

SELF-STUDY QUIZ

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

14. Rule 501 of the AICPA *Code of Professional Conduct* divides workpapers into three groups. Which of the following is **not** one of the groups?

    a. Client records.

    b. Accountant records.

    c. Member's workpapers.

    d. Necessary financial information.

15. Susan is in charge of the firm's annual file review. She has several documents that are more than seven years old and is unsure if they need to be kept. Which one should she be sure to retain?

    a. General ledger of former clients.

    b. Daily cash reports and bank deposit slips.

    c. Expense reports.

    d. Annual financial statements

16. Having a formal document retention policy is important. Which of the following statements is the **most** accurate?

    a. Compliance with document retention policies works best when client files are maintained separately in personal files.

    b. A firm's document retention policy must be able to accommodate and respond to needs to retain documents beyond their normal retention period.

    c. It is a good idea to retain documents beyond the required time for reference in a subsequent engagement.

    d. It is enough to adopt a well-conceived document retention policy.

17. Retention policies must also include all electronic information. When archiving electronic information, the firm's policies should ensure all of the following, **except**:

    a. Discard workpapers printed during the engagement.

    b. Delete review notes.

    c. Save all interim backups made during the engagement.

    d. Delete any documents on other media or email attachments.

18. Carrie has received a call from a bank loan officer asking for financial information on one of her clients. She should:

    a. Fax the papers to the lender as requested.

    b. Contact her client for permission to respond to the lender's request.

    c. Refuse to divulge any information.

SELF-STUDY ANSWERS

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

14. Rule 501 of the AICPA *Code of Professional Conduct* divides workpapers into three groups. Which of the following is **not** one of the groups? **(Page 31)**

    a. Client records. [This answer is incorrect. Client records is one of the groups listed in the *Code*; it includes information that is normally a part of the client's accounting records such as source documents and depreciation schedules.]

    b. Accountant records. [This answer is correct. Accountant records is not one of the groups. Rule 501 divides workpapers into three groups (client records, member's workpapers, and necessary financial information) and identifies which workpapers the accountants must provide to the client.]

    c. Member's workpapers. [This answer is incorrect. Member's workpapers is one of the groups listed in the *Code*. This includes analyses and schedules prepared by the client at the accountants' request.]

    d. Necessary financial information. [This answer is incorrect. Necessary financial information is one of the groups listed in the *Code*. It includes information that is not reflected in the client's books and records but that is necessary for the client's records to be complete. One example is journal entries (such as adjusting, closing, reclassification, or consolidating entries).]

15. Susan is in charge of the firm's annual file review. She has several documents that are more than seven years old and is unsure if they need to be kept. Which one should she be sure to retain? **(Page 32)**

    a. General ledger of former clients. [This answer is incorrect. Documents of former clients do not need to be kept beyond seven years.]

    b. Daily cash reports and bank deposit slips. [This answer is incorrect. Daily cash reports and bank deposit slips do not need to be kept beyond seven years.]

    c. Expense reports. [This answer is incorrect. Expense reports do not need to be kept beyond seven years.

    d. Annual financial statements. [This answer is correct. Annual financial statements should be kept for an indefinite period of time. How long bookkeeping records are kept varies depending on regulatory requirements, company (or CPA firm) policies, and the type of records.]

16. Having a formal document retention policy is important. Which of the following statements is the **most** accurate? **(Page 33)**

    a. Compliance with document retention policies works best when client files are maintained separately in personal files. [This answer is incorrect. Compliance with document retention policies can only be assured when there is a single centralized file of material maintained in support of each engagement.]

    b. A firm's document retention policy must be able to accommodate and respond to needs to retain documents beyond their normal retention period. [This answer is correct. Document retention policies should provide for a suspension of the planned destruction of documents relevant to litigation and criminal or governmental investigations, even though the firm has neither received a subpoena nor a summons relating to its work for the client. (See Enron case).]

    c. It is a good idea to retain documents beyond the required time for reference in a subsequent engagement. [This answer is incorrect. To arbitrarily retain documents beyond the time required to meet the legal, regulatory, or professional needs is unnecessary and costly.]

    d. It is enough to adopt a well-conceived document retention policy. [This answer is incorrect. Strict *adherence* to a document retention policy is a must. This was one lesson from the Arthur Andersen/Enron experience.]

17. Retention policies must also include all electronic information. When archiving electronic information, the firm's policies should ensure all the following, **except**: **(Page 35)**

    a. Discard workpapers printed during the engagement. [This answer is incorrect. The firm's policies should ensure that workpapers printed during the engagement are discarded unless they are intended to be part of the final workpapers for the engagement.]

    b. Delete review notes. [This answer is incorrect. The firm's policies should ensure that all review notes, among other things, are deleted. This should be done in accordance with the firm's electronic archiving policy.]

    c. Save all interim backups made during the engagement. [This answer is correct. Archived engagements serve as the final copies of the workpapers that are saved for future reference. Archiving is particularly important in light of recent auditing standards related to the integrity, accessibility, and retrievability of documentation. The firm's policies should ensure that all interim backups made during the engagement are deleted.]

    d. Delete any documents on other media or email attachments. [This answer is incorrect. The firm's policies for archiving electronic information should ensure that any documents still residing on any other media or as email attachments are deleted from those locations.]

18. Carrie has received a call from a bank loan officer asking for financial information on one of her clients. She should: **(Page 37)**

    a. Fax the papers to the lender as requested. [This answer is incorrect. The need for confidentiality, as discussed in the AICPA *Code of Professional Conduct*, is important whether or not bookkeeping services are provided by accountants in public practice.]

    b. Contact her client for permission to respond to the lender's request. [This answer is correct. Rule 301 (ET Section 301.01) of the AICPA *Code of Professional Conduct* specifically states that a member of the AICPA should not disclose any confidential client information without the client's consent. Therefore, workpapers can be shown to someone else only with the client's explicit permission.]

    c. Refuse to divulge any information. [This answer is incorrect. Confidentiality is discussed in Rule 301 of the AICPA *Code of Professional Conduct*. Under the *Code*, there are steps an accountant can take to respond to a scenario like the one described above.]

THE BOOKKEEPING INFORMATION

Efficient bookkeeping services depend on the timely receipt of information. Starting and stopping the process, because all the necessary information was not submitted, is both frustrating and inefficient. To overcome such delays, many accountants establish due dates for receiving information. That practice is not always enough, however. Even if due dates for receiving the needed information are established, all the necessary information may not be submitted because (a) the individuals do not understand the importance of submitting the information, or (b) the accountants do not precisely specify the information that should be submitted. Therefore, to provide efficient bookkeeping services, it is important to communicate not only when the information is due, but precisely what information is needed and why.

What Information Should Be Provided?

The information needed to perform bookkeeping services varies depending on the types of transactions the company enters into and the basis of accounting used. For example, if a company receives a long-term loan, the accountants would need to review a copy of the loan agreement to properly record the transaction. If a company uses the accrual basis of accounting, information about accounts receivable and accounts payable would be needed. Generally, the following information is needed to process a company's general ledger.

	Cash Basis	Accrual Basis
Bank statements	Yes	Yes
Check register or check stubs (including information about transactions involving petty cash)	Yes	Yes
Paid invoices	Yes	Yes
Deposit information	Yes	Yes
Sales information	Yes	Yes
Accounts receivable information	No	Yes
Accounts payable information	No	Yes
Inventory (or cost of sales) information	Yes	Yes
Information about other transactions	Yes	Yes

Bank Statements. Bank statements for the period (month, quarter, or year) should be obtained and reconciled to the general ledger. (Accountants in public practice should either reconcile the cash accounts or determine that the client has done so.) Accountants also should consider requesting paid checks since paid checks often provide specific information that may be omitted from the check register or check stubs.

Some accountants in public practice request that bank statements be sent to their offices unopened. They view that as a control over cash. Accountants in public practice should not be responsible for maintaining internal controls. Instead, they should instruct their clients on the importance of cash controls. An authorized client employee that is not involved in the cash receipt or cash disbursement function should be given responsibility for opening the bank statement and reviewing its contents.

Check Register or Check Stubs. If the company uses voucher or multipart checks or issues checks by computer, the check register should be furnished to the accountants. Check stubs should be furnished if the company uses a checkbook that includes check stubs. In either case, the date, amount, payee, and purpose of each payment should be provided. Accountants in public practice may request the client to code each disbursement with the appropriate general ledger account number. Unless the client's staff is well-trained and familiar with the general ledger accounts, the codings may often be incorrect. Identifying and correcting numerous incorrect codings can be time consuming for the accountants.

In addition to information about disbursements from checking accounts, information about disbursements from petty cash accounts should also be obtained. Most companies with petty cash accounts maintain petty cash logs that list (at a minimum) the beginning and ending balance of petty cash and each disbursement or addition's date, amount, and purpose. Obtaining a copy of such a log normally will provide sufficient information to properly record petty cash transactions.

Paid Invoices. Paid invoices should be obtained to determine that (a) invoices are paid when due and (b) the purpose of the payment is properly described in the check register or on the check stub. By having immediate access to paid invoices, the accountants can save valuable time if a description of a disbursement is not complete. The accountants can continue processing the information without waiting on additional information.

Deposit Information. Deposit information should be submitted with the check register or check stubs. Each deposit should be identified with a clear description of its source. Care should be exercised when describing deposits since incorrectly coded deposit information can lead to overstating the company's income and distorting operating statistics.

Sales Information. The information needed about the period's sales varies with each company but may include totals for cash sales, sales on account, credit card sales, and sales taxes collected. A completed Cash Receipts Summary is presented in Exhibit 1-2.

Accounts Receivable Information. If the general ledger is kept on the accrual basis of accounting, information about the period's accounts receivable balances is also needed. If the general ledger is kept on the cash basis or modified cash basis, information about accounts receivable is only necessary if supplementary schedules presenting receivable information are prepared. Information about most of the accounts receivable activity during the period (that is, sales on account and payments on account) can be provided by completing a "Cash Receipts Summary." In addition, any other activity during the period that affects accounts receivable (for example, write-offs or other adjustments of accounts receivable) should be provided.

Accounts Payable Information. If the general ledger is maintained on the accrual basis of accounting or if supplementary schedules presenting accounts payable information are prepared, information about the period's accounts payable balance is needed. The information about accounts payable should include a listing of each payable, its balance, and a description of its purpose. As discussed above, many companies maintain a tickler file of unpaid invoices. As a result, they can easily obtain accounts payable information by summarizing the invoices in the file. Other companies may enter vendor invoices as they are received in a manual or computerized accounts payable journal. Consequently, those companies can obtain the necessary accounts payable information from the information contained in their accounts payable journals.

Inventory Information. Inventory information is helpful to adjust inventories to their proper levels and record cost of sales. Many small to medium-sized companies do not have the resources to maintain perpetual inventory records, however. Instead, they take physical inventories periodically (that is, they count the inventory on hand) and use estimates to adjust inventory and record cost of sales in other periods. Thus, rather than provide information about inventories at each interim period, they provide the information only when physical inventories are taken. A discussion about using estimates to adjust inventory and record cost of sales follows.

Information about Other Transactions. Companies may enter into transactions that are not reflected in the information about cash receipts and disbursements, accounts receivable, or accounts payable. For example, a company may finance the purchase of assets or enter into capital lease agreements. Accountants should inquire about any such transactions and obtain the necessary information to properly record them.

Avoiding Delays in Receiving Information

As discussed previously, providing efficient bookkeeping services depends on the timely receipt of information. Delays in receiving the needed information can often be avoided if the accountants:

- Obtain an understanding with the individuals involved about the information that is needed and the consequences of providing that information late.
- Educate the individuals involved about why the requested information is needed and provide assurances that confidentiality will be maintained.
- Clearly state when the information is needed.

Use Transmittal Forms. Some accountants in public practice provide transmittal forms to be returned with their clients' information. The transmittal form serves as a memory joggers for their clients to help ensure that all information is provided. A supply of transmittal forms can be given to a client at the beginning of each year or, as an alternative, a new transmittal form for the next period may be included in the processed accounting information for the current period when it is returned to the client.

Review the Information When It Is Received. Delays in receiving all of the needed information can also be avoided if accountants review the information for completeness as soon as it is received. Generally, such a review will involve only a minimal amount of the accountants' time, particularly if a transmittal form accompanies the information. Any additional time used by such reviews, however, is often offset by the time saved by not having to start and stop an engagement because of incomplete information.

Accountants in public practice should document any additional efforts required to obtain complete accounting information from a client in a memo to the client's file. By documenting those efforts, accountants are in a much better position to explain why:

- An extension of time is necessary to complete the processing of the information.

- Additional fees are needed (assuming that the accountants ultimately had to provide information that initially was to be provided by the client).

Lack of Cooperation. Occasionally, accountants may encounter an individual that will not cooperate—either intentionally or because of lack of training. Accountants should clearly establish an understanding with the individual about the need for cooperation and communicate any lack of cooperation. If the problem is intentional, the accountants should request that the individual's supervisor take immediate action to remedy the problem. Explaining the additional costs and time delays that lack of cooperation causes often hastens a solution. Lack of training can be overcome by working with the individual.

When accountants in public practice encounter clients that will not cooperate, withdrawal is usually not necessary unless such situations deteriorate and become serious problems. Some clients simply will not cooperate regardless of the accountants' efforts to get them to do so. In those situations, the accountants should consider withdrawing from the engagement, because it is extremely difficult to provide acceptable services to such clients.

SELF-STUDY QUIZ

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

19. In which of the following scenarios is the accountant able to complete the bookkeeping services for their client in the most efficient manner?

    a. Stephen has completed the bookkeeping services for Tide-Away, Inc. for the past five years. Stephen communicated to the client the information he needed to obtain in the next week, but was informed by the client that they were moving offices and would not be able to provide Stephen the information in a timely manner. Stephen has decided to not worry about it, since he has completed the service for them for the past five years and feels he can make up the time.

    b. Libby has been engaged by Sewing Thyme to complete bookkeeping services for the year. This is Libby's first bookkeeping engagement since opening her own accounting firm. She has communicated a few needs to her client, but is not sure if the list is complete because she is not exactly sure what information she is going to need to complete the engagement. She has decided to improvise and ask for items from the client as she goes along.

    c. Michael has provided the bookkeeping services for Dolphin Pool Services for the last couple of years. After completing the engagement letter, Michael provides a due date list to Dolphin Pool Services as to when the information requests are due to Michael. He also supplies a listing of the requested information so that Dolphin Pool Services will know what is expected from them. Finally, Michael follows up periodically with the client to make sure there will be no problems fulfilling the requests.

20. Carl has agreed to perform bookkeeping services for a company operating on the cash basis of accounting. What information does he **not** need?

    a. Bank statements.

    b. Deposit information.

    c. Paid invoices.

    d. Accounts receivable information.

21. Which of the following is a true statement regarding inventory?

    a. Inventory is only needed so the company knows how much product they have on hand.

    b. Most small companies do not need to take inventory.

    c. Physical inventory may be taken periodically and estimates used to adjust inventory and record cost of sales in other periods.

    d. Inventory is only used to record cost of sales.

22. Using transmittal forms when communicating with the client can do all of the following, **except**:

    a. Serve as memory joggers.

    b. Ensure the client responds immediately.

    c. Allows the accountant to quickly review that the requested information has been received.

SELF-STUDY ANSWERS

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

19. In which of the following scenarios is the accountant able to complete the bookkeeping services for their client in the most efficient manner? **(Page 42)**

    a. Stephen has completed the bookkeeping services for Tide-Away, Inc. for the past five years. Stephen communicated to the client the information he needed to obtain in the next week, but was informed by the client that they were moving offices and would not be able to provide Stephen the information in a timely manner. Stephen has decided to not worry about it, since he has completed the service for them for the past five years and feels he can make up the time. [This answer is incorrect. Stephen should have communicated with his client and anticipated this hurdle. By communicating the necessary deadlines to the client in advance, the client could have compensated for the moving time and gathered Stephen's needed information before the move. It is important for the accountant to stay in contact with the client, communicate the timeline and convey the importance of adhering to the schedule.]

    b. Libby has been engaged by Sewing Thyme to complete bookkeeping services for the year. This is Libby's first bookkeeping engagement since opening her own accounting firm. She has communicated a few needs to her client, but is not sure if the list is complete because she is not exactly sure what information she is going to need to complete the engagement. She has decided to improvise and ask for items from the client as she goes along. [This answer is incorrect. If the accountant does not precisely specify the information that should be submitted, the bookkeeping services will not be able to be completed in a timely and efficient manner. Libby should research what it entails to complete the engagement and provide her client with an inclusive list of the information needed from Sewing Thyme.]

    c. Michael has provided the bookkeeping services for Dolphin Pool Services for the last couple of years. After completing the engagement letter, Michael provides a due date list to Dolphin Pool Services as to when the information requests are due to Michael. He also supplies a listing of the requested information so that Dolphin Pool Services will know what is expected from them. Finally, Michael follows up periodically with the client to make sure there will be no problems fulfilling the requests. [This answer is correct. To provide efficient bookkeeping services, it is important to communicate not only when the information is due, but precisely what information is needed and why. Michael has conveyed to the client the necessary due dates and information requests, but is also following up with the client to keep them on track and express to them the importance of meeting the deadlines and requests.]

20. Carl has agreed to perform bookkeeping services for a company operating on the cash basis of accounting. What information does he **not** need? **(Page 43)**

    a. Bank statements. [This answer is incorrect. Bank statements for the period (month, quarter, or year) should be obtained and reconciled to the general ledger. Accountants also should consider requesting paid checks since paid checks often provide additional specific information.]

    b. Deposit information. [This answer is incorrect. Deposit information should be submitted with the check register or check stubs. Source documentation should be clearly labeled.]

    c. Paid invoices. [This answer is incorrect. Paid invoices should be obtained to determine that (a) invoices are paid when due and (b) the purpose of the payment is properly described in the check register or on the check stub.]

    d. Accounts receivable information. [This answer is correct. The company operates on the cash basis of accounting and will not have accounts receivable.]

21. Which of the following is an accurate statement regarding inventory for a small company? **(Page 43)**

    a. Inventory is only needed so the company knows how much product they have on hand. [This answer is incorrect. Inventory information is helpful to adjust inventories to their proper levels and record cost of sales.]

    b. Most small companies do not need to take inventory. [This answer is incorrect. Inventory information is helpful to adjust inventories to their proper levels and record cost of goods sold.]

    c. Physical inventory may be taken periodically and estimates used to adjust inventory and record cost of sales in other periods. [This answer is correct. Many small to medium-sized companies do not have the resources to maintain perpetual inventory records. Instead, they take physical inventories periodically and use estimates to adjust inventory and record cost of sales in other periods.]

    d. Inventory is only used to record cost of sales. [This answer is incorrect. Inventory information is helpful for purposes other than recording cost of sales.]

22. Using transmittal forms when communicating with the client can do all of the following, **except**: **(Page 43)**

    a. Serve as memory joggers. [This answer is incorrect. The transmittal forms serve as memory joggers for their clients to help ensure that all information is provided.]

    b. Ensure the client responds immediately. [This answer is correct. Although the transmittal form is helpful, it cannot ensure that the client will respond immediately.]

    c. Allows the accountant to quickly review that the requested information has been received. [This answer is incorrect. Generally, an accountant can perform a quick review of the information submitted, particularly if a transmittal form accompanies the information.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (WUSTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which financial statement reports an entity's liabilities, assets, and equity as of a specific point in time?

   a. Balance sheet.

   b. Statement of income.

   c. Statement of cash flows.

   d. Statement of retained earnings.

2. Which of the following is the residual interest in an entity's assets after its liabilities are deducted?

   a. Assets.

   b. Revenues.

   c. Equity.

   d. Expenses.

3. Which of the following records contain all of an entity's liability, asset, equity, expense, revenue, gain, and loss accounts?

   a. Subsidiary ledger.

   b. Special journals.

   c. General ledger.

   d. Sales journals.

4. Many manual and computerized accounting systems use special journals. Which of the following is **not** a characteristic of special journals?

   a. Promote efficiency.

   b. Strengthen internal control.

   c. Reduce errors.

   d. Allows recording a specific transaction in more than one journal.

5. Which of the following is the purpose of a subsidiary ledger?

   a. Keeping track of various details that could relate to a specific general ledger account.

   b. Recording all of an entity's liability, asset, equity, expense, revenue, gain, and loss accounts.

   c. Reporting an entity's results of operations as of a specific period.

   d. Reporting an entity's liabilities, assets, and equity as of a specific point in time.

6. Which of the following statements most accurately describes the income tax basis of accounting?

   a. It is the method in which transactions are only recorded when cash is paid or collected.

   b. It is the method an entity uses to file its income tax return.

   c. It is the method in which revenues, expenses, assets, and liabilities are recorded in the same period that the related transactions occur, regardless of whether cash was received or paid by the entity during the period.

   d. It is a basis of accounting that can only be used for credit transactions, not cash transactions.

7. A bookkeeping system is best described as:

   a. Difficult to design one system to work for all companies.

   b. Overly complex.

   c. Standard and easily used by all businesses.

   d. Not concerned with the types of transactions the business enters into.

8. Jack has been hired to establish a bookkeeping system for his small business client. Which of the following should he **not** do?

   a. Provide controls to ensure all transactions are captured.

   b. Provide controls to ensure information is recorded accurately.

   c. Develop a complex recordkeeping system.

   d. Understand the client's business and industry.

9. Betty, an employee for Sally's Gift Store, is authorized to sign checks up to $500 in amount. Any disbursement check in the amount of $501 dollars or more requires the signature of the store owner. Betty is processing a check for an invoice in the amount of $350. She should do all but which of the following before signing?

   a. Attach the supporting invoice to the check.

   b. Include a payment explanation on the check.

   c. Have the store owner sign the check.

   d. Enter an adequate description in the check register.

10. Which of the following is an advantage of an unpaid invoice file?

    a. A simple unpaid invoice file does not provide enough control over unpaid invoices for most small businesses.

    b. The balance of unpaid invoices cannot be readily determined.

    c. Having an unpaid invoice file makes it unnecessary to search through several files to predict when cash payments will be required.

    d. This system does not centralize control over unpaid invoices.

11. In which of the following scenarios, is the primary objective of a cash receipts system fulfilled?

    a. Mabel, an accountant, recommends the same type of cash receipts system to both her retail store client and her client that makes sales only on account.

    b. SmallCo endorses all checks as they are received and has them deposited once per week, or less frequently if the amounts are minimal.

    c. 14 Plus lists cash receipts and their purposes in a worksheet that is forwarded to its bookkeeper to be promptly recorded and reconciled to bank deposits.

    d. Fresh Limited does all its business in cash; therefore, it estimates all of its cash receipts during the day and makes a single cash deposit each evening.

12. Sam is designing a chart of accounts for a small business. He should be sure that:

    a. It includes the maximum number of accounts necessary to capture the appropriate financial information.

    b. It includes the specific number of accounts within each category that was used for the previous client.

    c. It includes the accounts necessary for financial and income tax reporting.

    d. It provides for every conceivable transaction.

13. There are many important considerations for choosing the basis of accounting. Listed below are three important considerations along with reasons why the considerations are made. Correctly match the consideration with the reason.

    Considerations:

    1. Keep the amount of adjusting journal entries to a minimum.

    2. Provide useful information to businesses.

    3. Use the same accounting basis for tax and financial reporting.

    Reasons for the Consideration:

    i. Few adjustments will be necessary to prepare tax returns.

    ii. Few adjustments will be necessary to prepare financial statements.

    iii. Financial information is important for making business decisions.

    iv. Businesses need accurate and timely financial information; therefore, the bookkeeping system must be efficient.

    a. 1 and i & iii; 2 and iv; 3 and ii.

    b. 1 and iv; 2 and iii; 3 and i & ii.

    c. 1 and iv; 2 and ii & iii; 3 and i.

    d. 1 and i & iv; 2 and ii; 3 and iii.

14. Which of the following is **not** considered an other comprehensive basis of accounting (OCBOA) presentation?

    a. Tax basis of accounting.

    b. Modified cash basis of accounting.

    c. Regulatory basis of accounting.

    d. GAAP basis of accounting.

15. The income tax basis of accounting is best described as:

    a. Eliminating the need to convert from one accounting basis for bookkeeping purposes to another accounting basis for tax reporting.

    b. Being more difficult than GAAP financial statements for non-accountants to use and understand.

    c. Increasing the usefulness of month-to-month comparisons of expenses paid that benefit several future periods.

    d. Not recognizing depreciation of fixed assets as an expense.

16. The benefits of having a formal document retention policy include all of the following, **except**:

    a. It helps promote communication and understanding throughout the firm.

    b. It can help a firm avoid the dangers of the "spoliation doctrine."

    c. It will provide protection in case of litigation, even if the policy is not strictly adhered to.

    d. It decreases the risk that drafts and superseded material and informal or gratuitous commentary are not retained.

17. Terry is ready to gather information from her small business client who operates on a cash basis. Which of the following is the correct list of data she needs?

    a. Bank statements, check stubs, sales information.

    b. Bank statements, paid invoices, accounts receivable information.

    c. Bank statements, deposit information, accounts payable information.

    d. Bank statements, check stubs, accounts receivable information.

18. Which of the following is **not** a step an accountant should take to avoid delays in receiving information from a client?

    a. Obtain an understanding with the client about what information is needed and the consequences of providing the information late.

    b. Educate the client about the reasons why the requested information is needed.

    c. Only request information as the need for it is determined.

    d. Clearly state when the information needs to be provided.

19. When an accountant encounters an individual who will not cooperate, the accountant should:

    a. Withdraw immediately from the engagement.

    b. Not consider withdrawing, even if the situation deteriorates.

    c. Consider withdrawing, if the client does not cooperate regardless of the accountant's efforts.

    d. Send the client a bill for double the agreed-upon engagement fee.

Lesson 2: Processing Information and Maintaining Independence

INTRODUCTION

Although the types of transactions encountered may vary with each company, the basic steps necessary to process the transactions generally do not change from company to company or period to period. As a result, the same approach to processing accounting information may be used by most small to medium-sized companies. For accountants in public practice, use of the same approach in each write-up engagement is particularly helpful since it allows their write-up practices to operate more efficiently. For example, if a routine for processing information has been established, less time is generally needed to (a) process the information each period, (b) train entry level accountants or new paraprofessionals on the peculiarities of each engagement, or (c) begin processing the accounting information for new clients. In addition, using a single, systematic approach reduces the likelihood that some transactions may not be recorded.

Many accountants use a "Data Processing Checklist" to document the specific steps needed to process a business's accounting information. Using such a checklist can be particularly efficient since it:

a. Guides less experienced accountants (or paraprofessionals) during the bookkeeping procedures.

b. Prevents the omission of necessary processing procedures.

c. Enables the reviewer to determine quickly that all processing procedures have been performed.

This lesson describes an approach to converting transaction information into a general ledger. (Since most accountants use computerized general ledger packages to provide bookkeeping services; this course does not describe procedures that are normally performed by bookkeeping software, such as posting journal entries to special journals and summarizing special journals for posting to the general ledger.) If a CPA firm is providing the bookkeeping services, the firm's accountants or paraprofessionals should perform most of the procedures described. As discussed earlier, certain procedures, such as reconciling cash accounts and coding cash disbursements, may be performed by clients. A suggested approach consists of the following steps:

a. Reconcile cash accounts,

b. Record cash receipts and disbursements,

c. Record sales (if not recorded in conjunction with entries to record cash receipts),

d. Adjust accounts payable (accrual basis ledgers only),

e. Make other adjusting entries (such as entries to adjust inventory, record cost of sales, reserve and write off uncollectible accounts receivables, etc.), and

f. Generate and review the general ledger

Learning Objectives:

Completion of this lesson will enable you to:

- Identify how raw data can help to prepare a complete and accurate general ledger and organized bookkeeping workpapers.
- Describe the basics of sales and use taxes.
- Determine how write-up services could impair the accountant's independence.

Reconcile Cash Accounts

The first step in processing accounting information is to reconcile cash balances. Ordinarily, that is accomplished by reconciling general ledger cash balances, at the end of the period, to bank statement balances at the end of the period. Since no entries for the current period have been recorded on the general ledger at this point in the process, however, the current general ledger cash balances are actually the general ledger cash balances at the end of the *preceding* period. Therefore, cash reconciliations consist of two steps: (a) adding or subtracting the current period cash activity to the general ledger cash balance at the end of the preceding period to obtain the general ledger cash balance at the end of the current period and (b) reconciling that balance to the bank statement balance at the end of the current period.

Bank Reconciliation Form. Accountants can use a "Bank Reconciliation Form" to roll forward general ledger cash account balances and reconcile them to bank statement balances as described in the preceding paragraph. A completed Bank Reconciliation Form is presented in Exhibit 2-1. Using the form, accountants can easily identify the company's cash transactions for the period as well as any errors that may have been made by the bank.

The left side of the form lists all of the cash activity during the period that the accountants should record on the company's general ledger. It begins with the general ledger balance at the beginning of the period and:

a. Adds current period deposits and any other activity that increased cash during the period (for example, interest income, checks written in a previous period that were voided during the current period, bank credit memos, and incoming wire transfers).

b. Subtracts current period disbursements and any other activity that decreased cash during the period (for example, bank charges, outgoing wire transfers, and bank debit memos).

The resulting amount is the general ledger balance at the end of the period.

The right side of the form lists all of the cash activity and adjustments that the bank has not recorded as of the bank statement date. It begins with the ending bank statement balance and:

a. Adds deposits in transit (that is, deposits made by the company during the period that have not cleared the bank as of the bank statement date) and any adjustments that the bank needs to make that would increase the bank statement balance.

b. Subtracts outstanding checks (that is, checks written during the period that have not cleared the bank as of the bank statement date) and any adjustments that the bank needs to make that would decrease the bank statement balance.

The resulting amount is the adjusted bank balance. It should agree to the general ledger balance at the end of the period that is computed on the left side of the form.

Record Cash Receipts and Disbursements

All of the cash receipts and disbursements during the period are identified during the bank reconciliation process. As explained above, they are the amounts that appear on the left side of the Bank Reconciliation Form. The cash receipts during the period are the amounts listed under "Deposits and Other Debits." The cash disbursements during the period are the amounts listed under "Disbursements and Other Credits."

Exhibit 2-1

Bank Reconciliation Form

Client: *Able Manufacturing Co.* Bank Account: *First Fidelity Bank-Operating Account*

Period: *June 20X3* Completed by: *M. Sanders* Date: *20X3*

Instructions: This form should be completed for each bank account. The left side of the form rolls forward the general ledger cash balance from the beginning of the period to the end of the period. Accordingly, all cash activity during the period that should be recorded on the general ledger should be entered on the left side of the form. The right side of the form reconciles the bank statement balance to the ending general ledger account balance. All transactions and adjustments that have not been recorded by the bank should be entered on the right side of the form.

GENERAL LEDGER BALANCE AT THE BEGINNING OF THE PERIOD		$ 10,268.38	BANK STATEMENT BALANCE AS OF *June 30, 20X3*		$ 8,544.70
DEPOSITS AND OTHER DEBITS			DEPOSITS IN TRANSIT (Attach list)	$ 2,000.00	
Deposits	$ 8,350.00		OTHER CREDIT ADJUSTMENTS NEEDED		
Interest Income	25.64		*Check no. 1248 written for $125.83*		
			but cleared the bank for 128.83	3.00	
TOTAL DEBITS	$ 8,375.64	8,375.64	TOTAL BANK CREDITS NEEDED	$ 2,003.00	2,003.00
DISBURSEMENTS AND OTHER CREDITS			OUTSTANDING CHECKS (Attach list)	$ 1,862.15	
Check nos. 1253–1278	$ 3,447.72		OTHER DEBIT ADJUSTMENTS NEEDED		
Service charges	10.75				
Wire transfers out	6,500.00				
TOTAL CREDITS	$ 9,958.47	(9,958.47)	TOTAL BANK DEBITS NEEDED	$ 1,862.15	(1,862.15)
GENERAL LEDGER BALANCE AT THE END OF THE PERIOD		$ 8,685.55	ADJUSTED BANK BALANCE		$ 8,685.55

Note:
The general ledger balance at the end of the period should equal the adjusted bank balance.

Cash Receipts. Accountants should record the cash receipts identified on the left side of the bank reconciliation either through journal entries or summary postings from special journals. For certain cash receipts, the entries needed are relatively straightforward. For example, interest income generally appears as one amount on the bank reconciliation and is recorded by debiting cash and crediting interest income. Other cash receipts may require further analysis before they can be properly recorded, however. For instance, cash deposits may appear as one amount on the bank reconciliation but actually consist of collections of sales, sales taxes, and accounts receivable.

To summarize cash receipts so that they may be properly recorded, accountants could prepare a worksheet totaling each type of deposit or, if cash receipt journals are used, total the entries made in cash receipts journals. Alternatively, cash receipts can be recorded using information contained on the "Cash Receipts Summaries." To illustrate, the cash deposits of $4,181.76 shown on the completed Cash Receipts Summary in Exhibit 1-2 would be recorded through the following journal entry:

Cash	$ 4,181.76	
Accounts receivable ($816 − $733)		$ 83.00
Layaway sales receivable		350.00
Sales		3,431.40
Tax exempt sales		60.00
Sales taxes payable		257.36

Cash Disbursements. To record checks written during the period, accountants should first code the check stubs—that is, determine the general ledger accounts to which the disbursements should be recorded and write the appropriate account numbers on each check stub or ask the client to perform this step. (Accountants in public practice should be careful not to assume the role of employee or management, thereby losing their independence with respect to the client. Normally, however, coding check stubs will not impair the accountants' independence so long as the client provides sufficient detail to clearly identify the nature of each transaction. This course further discusses independence issues surrounding write-up engagements later in this lesson.) To help ensure that the checks are properly coded, the accountant should:

- Be consistent from period to period.
- Use an updated chart of accounts list.
- Double-check department or cost center numbers.
- Ask for help (from the client) *before* coding, not after, if there is a question.
- Keep a log of all chart of account changes (most computer-based systems automatically provide this information).

After coding the check stubs, the disbursements should be recorded by debiting the account numbers on the check stubs for the appropriate amounts and crediting cash for the same amounts (or for the total of all disbursements).

Generally, accountants should not try to determine whether cash disbursements relate to purchases that were accrued in a prior period. Instead, it is more efficient to record all disbursements as if none had been accrued in a prior period and then reverse the prior period accrual during the current period. Adjusting the balance of accounts payable is discussed in greater detail under "Adjust Accounts Payable."

Other cash disbursements that were identified on the bank reconciliations should be recorded through journal entries or summary postings from special journals. For example, bank service charges may be recorded by preparing a journal entry that debits the appropriate expense account and credits cash.

Record Sales

Accountants should record sales based on the information contained in the Cash Receipts Summary. Thus, sales generally may be recorded when cash receipts are recorded.

Some accountants record sales by debiting accounts receivable and crediting sales for the total of all cash sales and sales on account. Then, they record cash receipts by debiting cash and crediting accounts receivable. As a result, they avoid having to determine separate amounts for cash sales and cash received on account. That approach generally should not be used, however, because under that method, accounts receivable is, in effect, a residual amount—the difference between total sales and total cash collected. Accordingly, an error in recording total sales will cause an error in recording accounts receivable. Using the Cash Receipts Summary reduces the risk of such errors by forcing the company to determine sales and other sources of cash receipts and reconcile the receipts to cash deposited.

Adjust Accounts Payable

If the general ledger is maintained on the accrual basis, accountants will need to prepare journal entries to adjust the balance of accounts payable. (As discussed previously, the information necessary to adjust accounts payable can often be obtained by summarizing the company's unpaid invoice file.) The following entries are generally made to adjust accounts payable:

a. An entry is made to reverse the beginning of the period balance of accounts payable. (As discussed previously, current period cash disbursements are charged to current period expense even if they were accrued in a prior period. Thus, the prior period's payable accrual should be reversed in the current period to avoid recording expenses twice.)

b. An entry is made to record the balance of accounts payable at the end of the period.

To illustrate that approach, assume that a company's only accounts payable at the beginning of the period was a $2,545 invoice for office supplies. During the current period, the $2,545 invoice was paid and additional office supplies of $1,220 were purchased on account. To record the transactions, the following entries would be made during the current period:

Office supplies	$ 2,545	
Cash		$ 2,545
To record cash disbursements.		
Accounts payable	$ 2,545	
Office supplies		$ 2,545
To reverse the prior period balance of accounts payable.		
Office supplies	$ 1,220	
Accounts payable		$ 1,220
To record accounts payable at the end of the period.		

The effect of the entries on the current period is to reduce cash for the $2,545 payment made, record a $1,220 expense for office supplies purchased during the current period, and record an accounts payable of $1,220 for office supplies purchased but not paid for at the end of the current period.

Other Adjusting Entries

Inventory and Cost of Sales. Generally, all inventory purchases during the period should be recorded as additions to inventory. Then, at the end of the period, the accountants should adjust inventory and record cost of sales using one of the following methods:

a. The general ledger inventory balance should be adjusted to the balance reflected in the company's perpetual inventory records. The adjustment should be made through a journal entry that debits cost of sales and credits inventory. Periodically (at least annually), physical inventories should be taken, and general ledger inventory balances should be adjusted to physical inventory amounts.

b. Cost of sales should be estimated using cost of sales percentages, and the general ledger cost of sales balance should be adjusted to that amount. The adjustment should be made through a journal entry that debits cost of sales and credits inventory. Periodically (at least annually), physical inventories should be taken, and general ledger inventory balances should be adjusted to physical inventory amounts.

Generally, the method described in item a. will produce the most accurate results since, by adjusting to perpetual inventory amounts, the actual items sold are charged to cost of sales. However, the method described in item b. (referred to as the gross profit method) will be used by most small to medium-sized companies because (a) the method can produce results that are similar to those produced by the method described in item a. (if reasonable cost of sales percentages are used), and (b) many small to medium-sized companies do not have the resources to maintain perpetual inventory records. To illustrate using the gross profit method, assume the following:

- ABC Company's sales during the current period totaled $165,000.
- The company estimates, based on its past history and current pricing structure, that cost of sales during the current period was 65% of total sales.

The adjustment needed at the end of the period would be computed as follows:

Sales	$ 165,000
Estimated cost of sales percentage	× 65%
Adjustment needed	$ 107,250

The following journal entry would record the adjustment:

Cost of sales	$ 107,250	
Inventory		$ 107,250

To record current period cost of sales.

In reality, different profit margins may be earned on each component of inventory. If profit margins vary significantly between components of inventory, accountants may need to apply different cost of sales percentages to different types of sales. For example, if item A costs 45% of its selling price and item B costs 75% of its selling price, cost of sales would be determined by multiplying sales of item A by 45% and sales of item B by 75% and totaling the results.

Accounts Receivable Reserve. If the general ledger is maintained on the accrual or GAAP basis, accountants will need to prepare an entry to record a loss when all or a portion of a receivable is estimated to be uncollectible. The loss generally is recognized by debiting bad debt expense and crediting the allowance for doubtful accounts. The allowance account is a balance sheet asset account that carries a credit balance (referred to as a contra-asset account), which is typically offset against accounts receivable in the financial statements. (If the books are maintained on the income tax basis, the reserve method for computing and deducting accounts receivable may not be used.

Generally, at the end of the period, the accountant should estimate uncollectible accounts using either the percentage of sales method or the aging method. The following is a brief discussion of each method:

- *Percentage of Sales Method.* The percentage of sales method is often used when a company has a large number of uniformly-sized accounts with a stable market and customer base. Under this method, uncollectible accounts are estimated by applying a predetermined "bad debt" percentage to each month's sales. For example, if credit sales are $300,000 in the current month, bad debt expense in the current month would be $7,500 using a 2.5% bad debt estimate. The percentage usually is determined based on the trend of bad debt expense over the past few years. Each month, a similar entry is made. At year end, a more detailed analysis of uncollectible accounts is made and the allowance account is adjusted upward or downward.
- *Aging Method.* The aging method generally is used when individual accounts receivable are not uniform in amount and sales activity fluctuates widely. Under this method, the balance for the allowance account

is recomputed each month by applying a predetermined percentage to each aging category per the aged accounts receivable report. The percentages will vary from one company to the next depending on credit terms, market conditions, and collection experience. The calculated bad debt estimate is then compared to the allowance for doubtful accounts general ledger balance. The balance and related bad debt expense is then increased or decreased to agree to the calculated balance.

Writing off Uncollectible Accounts Receivable. If the general ledger is maintained on the accrual or GAAP basis, specific accounts are charged against the allowance account when management believes further collection efforts are futile. For example, if the company ceases its efforts to collect a $2,500 receivable, the accountant should make the following journal entry to write off the account:

Allowance for doubtful accounts	$ 2,500	
Accounts receivable		$ 2,500

If the general ledger is maintained on the income tax basis of accounting, accountants may not use the reserve method for computing and deducting bad debts on receivables. Instead, the accountant must use the specific charge-off method. Under that method, specific accounts are charged to bad debt expense when management has determined that the balance is worthless. For example, if the company has determined that a $2,500 receivable is worthless, the accountant should make the following journal entry to write off the account if the records are maintained on the income tax basis of accounting:

Bad debt expense	$ 2,500	
Accounts receivable		$ 2,500

Gain or Loss on Fixed Asset Sales. When a fixed asset is sold, the accountant might initially record the total sales proceeds by simply crediting a fixed asset gain/loss account or miscellaneous income account in the general ledger for the amount of the proceeds. (The entry generally is recorded when the accountant is recording a company's cash receipt activity.) If so, an adjusting entry is needed to remove the fixed asset's costs and accumulated depreciation from the general ledger and record the proper gain or loss.

The appropriate gain or loss is calculated by comparing the sales proceeds with the asset's net book value (original cost less accumulated depreciation). A gain results if the sales proceeds exceed the net book value, and a loss occurs if the sales proceeds are less than net book value. To properly calculate the gain or loss, the accountant must ensure that depreciation has been calculated through the date of sale. To illustrate the calculation of the gain or loss on a fixed asset sale, assume the following facts:

Sales proceeds		$ 5,000
Net book value:		
Original cost	$ 9,000	
Accumulated depreciation at sale date	(4,600)	4,400
Difference—net gain		600
Income initially recorded in general ledger		5,000
Income adjustment needed		$ (4,400)

In the preceding example, income is overstated by $4,400 because the $5,000 sales proceeds were initially recorded to miscellaneous income. The adjusting journal entry needed to properly record the transaction is as follows:

Accumulated depreciation	$ 4,600	
Miscellaneous income	4,400	
Fixed assets		$ 9,000

The journal entry properly writes off the fixed asset and accumulated depreciation amounts and recognizes the appropriate gain of $600 ($5,000 − $4,400).

Gain or Loss on Fixed Asset Trade-ins. When a company acquires a fixed asset by trading in another fixed asset, the accountant might initially record only the additional cash paid, if any, at the trade-in date by debiting the fixed asset account in the general ledger. If so, the accountant must decide whether an adjusting journal entry is needed to properly reflect the accounts.

FASB ASC 845-10 (formerly APB Opinion No. 29) addresses accounting for exchanges of nonmonetary assets, such as property and equipment. An exchange of nonmonetary assets should be recorded based on the fair value of the assets involved, and a gain or loss should be recognized on the transaction, unless any of the following three conditions exists:

a. Neither the fair value of the asset received nor the asset surrendered can be reasonably determined.

b. The exchange transaction facilitates sales to customers.

c. The exchange transaction lacks commercial substance. An exchange lacks commercial substance if the future cash flows of the entity are not expected to change significantly as a result of the exchange.

If any of those conditions exist, the exchange transaction should be measured based on the recorded amount of the asset surrendered and not on the fair values of the assets exchanged. However, the recorded amount should be reduced if there is an indicated impairment of value. To be considered an exchange subject to the provisions of FASB ASC 845-10 (formerly APB Opinion No. 29, as amended), the transferor of a nonmonetary asset must have no substantial continuing involvement with the transferred assets. In other words, the transferor must have transferred the usual risks and rewards of ownership of the asset.

An exchange of nonmonetary assets should generally be measured using the fair value of the assets involved in the exchange. If a company receives an asset in a nonmonetary exchange, the company should record the cost of the asset acquired using the fair value of the asset surrendered. However, if the fair value of the asset received is more clearly evident, it should be used to record the asset received.

Prepaid Asset Amortization. Small businesses often pay certain expenditures in advance, such as property and casualty insurance, property taxes, and advertising. Such expenditures that benefit more than one month should be recorded as prepaid assets when paid and amortized over the appropriate number of months covered by the expenditure. For example, an accountant should initially record a $24,000 insurance prepayment as follows:

Prepaid insurance	$ 24,000	
Cash		$ 24,000

Assuming the policy covers a 12 month period, the accountant would record an expense of $2,000 ($24,000 ÷ 12) in each of the following 12 months as follows:

Insurance expense	$ 2,000	
Prepaid insurance		$ 2,000

If a company has several types of prepaid expenses, it is often helpful to prepare a schedule that shows the monthly amortization amount and ending asset balances.

Depreciation. The cost of an asset that will benefit several accounting periods should be depreciated (that is, charged to expense) over the useful life of the asset. Generally accepted accounting principles basically recognize two methods of computing depreciation:

- *Straight-line.* The cost, less any salvage value that can be realized, at the end of the asset's useful life is allocated evenly over the estimated useful life.

- *Accelerated.* The cost is allocated disproportionately over the useful life so that the early years are charged with most of the cost.

Many small to medium-sized companies use depreciation methods and useful lives prescribed by tax laws even if they maintain their general ledgers on the GAAP basis of accounting. They do so because (a) it avoids the need to maintain separate depreciation schedules for book and tax purposes and (b) the results often are not significantly different than those achieved using GAAP depreciation methods and lives.

Annual depreciation expense should be allocated to interim periods. Normally, the allocation to interim periods is made on a straight-line basis. Thus, if a one-month period is being processed, one twelfth of the annual depreciation expense would be recorded. Similarly, if processing is done on a quarterly basis, one fourth of the annual expense would be recorded. Generally, depreciation expense is recorded through a journal entry that debits an expense account (such as depreciation expense, overhead, etc.) and credits accumulated depreciation.

The accountant should adjust the monthly or quarterly depreciation expense calculation for fixed asset additions, disposals, and other changes during the year. However, as a time-saver, some accountants do not adjust for those items until year end. While it may save valuable time, waiting until year-end to adjust depreciation expense for asset additions and disposals is appropriate only if the effect of the adjustment is immaterial.

Accountants generally use computer spreadsheets or maintain manual worksheets to track fixed assets and calculate depreciation. When a company has numerous depreciable assets, however, that method may be cumbersome and time consuming. In such cases, the accountant should consider using fixed asset software to make depreciation calculations. Generally, such software not only calculates GAAP depreciation, but makes separate tax depreciation calculations as well.

Marketable Securities. Under generally accepted accounting principles, debt or equity securities that are held for trading purposes or are available for sale should be recorded at their fair values. Consequently, if the general ledger is maintained in accordance with generally accepted accounting principles, a journal entry may be necessary to adjust the securities to their fair values as follows:

- *Securities That Are Held for Trading Purposes.* The journal entry would debit or credit the asset account for the increase or decrease in value and record an offsetting amount to current period income or expense.

- *Securities That Are Available for Sale.* The journal entry would debit or credit the asset account for the increase or decrease in value and record an offsetting amount to equity (unless the decline in value is considered to be other than temporary, in which case the offsetting amount would be recorded to current period income or expense).

As a practical matter, most small to medium-sized businesses will adjust marketable debt or equity securities to fair value only at year-end. Adjustments generally will not be made during interim periods unless significant changes in fair value occur.

Interest Expense. Whenever a business makes a note payment, the payment must be allocated between principal and interest. The method of allocation generally depends on the type of note instrument. Two types of notes are frequently encountered by small businesses:

a. *Term Notes.* Term notes often have a fixed principal and interest payment schedule and a stated maturity date. Interest rates may either be fixed or variable. An amortization schedule usually can be prepared showing the principal and interest portion of each payment throughout the life of the note. Using that information, the accountant can prepare the necessary journal entries to allocate payments between principal and interest.

b. *Lines of Credit.* Lines of credit generally do not require regular principal payments. Instead, principal payments are required whenever specified assets (referred to as the borrowing base) fall below a predetermined minimum. Interest is usually paid monthly based on a variable interest rate. The lender typically sends a bill detailing the principal and interest portion of any note payments the company is required to make.

To save time on monthly write-up engagements, some accountants determine (using the amortization schedule) the interest expense on a company's term note for the entire year and allocate the annual interest expense to interim periods on a straight-line basis. Thus, if a one-month period is being processed, one twelfth of the annual interest expense would be recorded. Similarly, if processing is done on a quarterly basis, one fourth of the annual expense would be recorded. (That method should not be used, however, if it would materially distort monthly interest expense.) For example, assume that the annual interest expense on a company's term note is $5,000. Note payments are made to the bank on a monthly basis. During April, the company makes a principal and interest payment of $1,050. The accountant records the cash disbursement for the note payment as follows:

Note payable	$ 1,050	
Cash		$ 1,050

Assuming that the accountant is recording the interim interest expense based on the straight-line method described above, the accountant then records interest expense of $417 ($5,000 ÷ 12) for the month of April (and in each month thereafter) as follows:

Interest expense ($5,000 ÷ 12)	$ 417	
Note payable		$ 417

Other Adjusting Entries. Periodically, accountants may need to make adjustments to correct errors in previous postings to the general ledger. Such adjustments should be made through journal entries in the current period, not by correcting and reprinting the general ledger of a prior period. Restating a prior period general ledger can create much confusion, particularly if the original general ledger for that period is not destroyed or if financial statements or other financial reports were issued using information from the original general ledger. GAAP requires accountants to restate prior-period *financial statements*, however, if the statements are reissued or presented in comparative form with current-period statements.

Journal entries may also be necessary, for example, to record payroll information and to accrue the employer's portion of payroll taxes.

Generate and Review the General Ledger. Once the proposed journal entries have been posted, the accountant should generate and review a preliminary general ledger. The review process includes scanning the ending balances and the entries posted to each general ledger account to detect unusual entries or unexpected ending balances. Ideally, the review should be performed by an accountant who is familiar with the general ledger accounts. Otherwise, the possibility of identifying an incorrect entry or an unreasonable ending balance may be low.

Although the effectiveness of the review generally depends on the reviewer's abilities and experience, some common "red flags" that may indicate a problem in a specific account include the following:

- *Debit versus Credit Balance.* Some accounts naturally carry debit balances (assets and expenses) and others carry credit balances (liability, equity, and revenues). If one of the accounts is unexpectedly in a debit or credit position, there may be a problem.

- *Debit versus Credit Postings.* Similar to the above, some accounts normally receive debit entries (expense accounts) and others receive credit postings (revenues). If credit entries were posted to an expense account or debit entries were posted to a revenue account, further investigation may be warranted.

- *Unusually Large or Small Amounts.* Most accounts have a normal monetary range of transactions. Unusually large or small amounts may indicate coding or data entry errors.

- *Unexpected Posting Source.* Some accounts primarily receive postings from specified journals. For example, entries to accounts receivable typically come from the sales and cash receipts journals. Entries to salaries and labor accounts typically come from the payroll journal. If entries from other journals are noted, the entries may have been misposted.

- *Beginning and End of Period Balances.* Balance sheet account balances are often comparable from one period to the next. If the ending balance for an account differs significantly from the balance at the beginning of the period, a problem could exist.

- *Absence of an Entry.* Most accounts have one or more types of journal entries that are regularly posted to them each month. If one of the entries is missing, the accountant may need to investigate the omission.

When performing the general ledger review, the reviewer can make "review comments" on a separate sheet of paper questioning any unusual items noted. Once all problems and/or unusual items have been identified, the accountant can follow-up on those items. The review comments generally leave room for a response after the item has been investigated so the accountant can document his or her resolution of the matter.

If any errors are detected during the general ledger review (such as miscodings, missed entries, etc.), the accountant should prepare an adjusting journal entry to correct those items. After preparing the correcting entries, the accountant must then post the entries and generate another general ledger. That process continues until the accountant generates a final general ledger that meets his or her approval.

Processing Controls

Most computerized bookkeeping systems have built-in controls to ensure that the total debits entered equal the total credits entered. Such controls do not guard against incorrectly entering or classifying amounts, however. Therefore, accountants should consider the following additional controls when processing accounting information:

a. Prepare an adding machine tape of all debit entries and agree that amount to the total debits processed by the computer.

b. Agree ending general ledger cash balances to ending bank reconciliation balances.

c. Agree ending general ledger balances to totals of related subledgers. (For example, the ending general ledger accounts receivable balance should equal the total balance of the accounts receivable subledger.)

d. Agree ending general ledger balances to supporting workpapers. (For example, the ending balance of cost of sales should equal the amounts shown on workpapers used to compute cost of sales, and the ending balance of payroll tax liability accounts should equal the amounts due on payroll tax returns.)

e. Review postings to general ledger accounts to determine that transactions were recorded in the proper general ledger accounts.

Documenting Journal Entries. Accountants can review and analyze general ledger accounts more easily if all journal entries are properly documented. Thus, journal entries should include the following:

- Reference number. (Each journal entry should be assigned a unique reference number so that it can be easily identified and traced back to supporting documents. One method that is often used is to assign each journal entry a four-digit number. The first two digits of the number signify the month the entry was made. The last two digits signify the numerical order of the entry. For example, the eighth entry made in October would be numbered 10-08.)

- General ledger account numbers debited and credited and the amounts of the debits and credits.

- Description of the reasons for making the journal entry.

Many businesses have standard recurring journal entries from month-to-month. Examples of such journal entries include depreciation expense, interest expense, etc. Since the account numbers (and sometimes the amounts) are the same each month for those standard journal entries, the accountant can complete a form for each journal entry and photocopy it for use in subsequent months as a time-saver. The photocopies are often placed in the journal entry binders for the appropriate month.

Many software packages allow users to set up recurring journal entries. Most software packages also allow for the automatic reversal of specified journal entries. This feature is useful for monthly accruals that require reversal in the following period before a new accrual entry is entered into the system. If desired, accountants can print the journal entries and retain the entries with other supporting documentation. Accountants should ensure that the recurring journal entries (as well as the automatic reversal, if applicable) are set up properly to avoid errors.

Workpaper Documentation. Accountants should maintain workpapers documenting all journal entries made and procedures performed. Therefore, at a minimum, the accountants' workpapers should generally include the following:

- Engagement letter (if the bookkeeping procedures are performed by a CPA firm),
- Journal entries,
- Documents supporting all journal entries (such as bank reconciliations, depreciation schedules, loan amortization schedules, etc.),
- Memos discussing unusual and significant matters encountered, and
- General ledger and related special journals and subsidiary ledgers.

Many accounting firms develop a standard method of organizing workpapers in which workpapers are placed in specific files. For example, firms often maintain the following files for each write-up client:

- *Permanent File.* This file contains documents that are permanent in nature. Such documents are those that are either updated and reviewed annually or provide client information that generally does not require a monthly review. Examples include the engagement letter, the "Client Information Form," general client correspondence (e.g., client letters documenting special fee arrangements), and permanent client documents (e.g., lease agreements and loan agreements).
- *Write-up File.* This file contains the documents and workpapers that support the general ledger. Generally, the workpapers included in the write-up file include a current chart of accounts, journal entries and supporting documentation, and the "Data Processing Checklist." The file may also contain the period's general ledger, financial statements, and supporting subsidiary ledgers. Due to their bulk, however, those records are often maintained in separate files.

  Normally, each client's write-up file contains workpapers supporting the work performed during several periods. For example, if a write-up is performed monthly for a client, that client's write-up file may contain workpapers supporting all of the monthly write-ups performed during the year. If more than one write-up period's workpapers are included in the file, each period's workpapers should be filed together with the most recent period appearing first.
- *Payroll Files.* The payroll file includes payroll-related workpapers and documents, such as "Employee Payroll Information Sheets," "Payroll Information Transmittals," copies of payroll tax returns with supporting schedules, and other applicable payroll forms.

Special Considerations for Year-end Processing

Many small to medium-sized businesses do not have the need or financial resources to have extensive financial information prepared during interim periods. For interim periods, they ask their accountants to provide only the basic accounting information necessary to manage the business and to satisfy creditors or other outside parties. Thus, during interim periods one or more of the following situations may occur:

a. Accounting records are maintained on the cash basis of accounting. Receivable and payable accruals are not made.

b. Inventory balances are estimated using the gross profit method.

c. Annual depreciation expense is estimated at the beginning of the year and is not revised unless a significant change in depreciable assets occurs.

d. The amounts of certain costs and expenses are estimated and assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include inventory shrinkage, allowance for bad debts, the cash surrender value of life insurance, allowance for quantity discounts, discretionary year-end bonuses, profit-sharing contributions, and income tax expense.

At year-end, however, more accounting information generally is processed either to meet the demands of outside parties or to convert the general ledger from the cash basis to the accrual basis for financial or tax reporting. As a result, year-end processing may involve the following additional procedures:

a. Accounting records are converted from the cash basis to the accrual basis.

b. Physical inventories are taken and the accounting records are adjusted to physical inventory balances.

c. Depreciation accounts are adjusted to actual amounts for the year.

d. The amounts of certain costs and expenses are adjusted to actual amounts for the year.

Closing the Books. After all transactions and adjustments for the year have been recorded, the general ledger is *closed* (that is, all income and expense accounts are reduced to zero and their balances transferred to equity). Most general ledger software packages perform the year-end closing automatically before processing of the first period of the next year is started. In manual general ledger systems, however, the year-end closing is accomplished by making a closing journal entry. To illustrate, assume that a company's income and expense accounts had the following balances at the end of 20X1:

Income	
Sales	$ 165,500
Interest	4,100
Expenses	
Cost of sales	77,000
Salaries	45,000
Payroll taxes	4,200
Advertising	1,500
Auto expense	994
Depreciation	5,235
Utilities	6,700
Insurance	4,500
Office supplies	2,200
Interest	4,350

The closing entry needed at year-end would be as follows:

Sales	$ 165,500	
Interest income	4,100	
Cost of sales		$ 77,000
Salaries		45,000
Payroll taxes		4,200
Advertising		1,500
Auto expense		994
Depreciation		5,235
Utilities		6,700
Insurance		4,500
Office supplies		2,200
Interest expense		4,350
Retained earnings		17,921

To close 20X1 income and expense accounts.

SELF-STUDY QUIZ

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

23. Use of a "Data Processing Checklist" can be efficient because it:

    a. Omits certain processing procedures.

    b. Guides less experienced accountants during the bookkeeping procedures.

    c. Bypasses the need for all processing procedures to be performed.

    d. Must be customized for each client.

24. Lori is training a new paraprofessional to convert transaction information to a general ledger. Which of the following is **not** a step Lori is likely to include in her training?

    a. Reconcile cash accounts.

    b. Record cash receipts and disbursements.

    c. Adjust accounts payable.

    d. Assign account numbers.

25. In recording cash disbursements, which of the following statements is **not** true?

    a. Accountants must determine whether cash disbursements relate to purchases that were accrued in a prior period.

    b. Accountants should record all disbursements as if none had been accrued in a prior period and then reverse the prior period accrual during the current period.

    c. Coding check stubs will impair an accountant's independence, so the client must be assigned this task.

26. Mary is adjusting the accounts payable for a company that uses the accrual basis of accounting. The correct entries for her to make are:

    a. An entry to reverse the beginning of the period balance of accounts payable and an entry to record the balance of accounts payable at the end of the period.

    b. An entry to reverse the ending period balance of accounts payable and an entry to record the balance of the beginning period balance.

    c. Debit expense and credit accounts payable.

    d. Credit expense and debit accounts payable.

27. What method of adjusting inventory is used by most small companies?

    a. Physical count.

    b. Gross profit.

    c. General ledger.

    d. Perpetual inventory.

28. When adjusting the accounts receivable reserve, accountants use the ____________ method when a company has a large number of uniformly-sized accounts with a stable market and customer base.

    a. Aging.

    b. Profit margin.

    c. Doubtful account.

    d. Percentage of sales.

29. When adjusting for depreciation, which of the following is **not** a true statement?

    a. Waiting until year-end to adjust depreciation expense for asset additions and disposals is appropriate even if the effect of the adjustment is significant.

    b. Annual depreciation expense should be allocated to interim periods.

    c. Accountants generally use computer spreadsheets or maintain manual worksheets to track fixed assets and calculate depreciation.

    d. Many small to medium-sized companies use depreciation methods and useful lives prescribed by tax laws even if they maintain their general ledgers on the GAAP basis of accounting.

30. Rank the following journal entries from least correct to most correct.

    i. Debit Office Supplies; Credit Cash; include reference number; omit the general ledger account numbers debited and credited; include the amounts of the debit and credit; omit a description of the reason for making the entry.

    ii. Debit Office Supplies; Credit Cash; omit reference number; omit the general ledger account numbers debited and credited; include the amounts of the debit and credit; omit a description of the reason for making the entry.

    iii. Debit Office Supplies; Credit Cash; include reference number; the general ledger account numbers debited and credited; along with the amounts and a description of the reason for making the entry.

    a. iii, ii and i.

    b. i, ii and iii.

    c. ii, i and iii.

31. Many accounting firms develop a standard method of organizing workpapers in which workpapers are placed in specific files. Which file contains the documents and workpapers that support the general ledger?

    a. Permanent.

    b. Write-up.

    c. Payroll.

SELF-STUDY ANSWERS

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

23. Use of a "Data Processing Checklist" can be efficient because it: **(Page 55)**

    a. Omits certain processing procedures. [This answer is incorrect. Use of a "Data Processing Checklist" prevents the omission of necessary processing procedures.]

    b. Guides less experienced accountants during the bookkeeping procedures. [This answer is correct. Using such a "Data Processing Checklist" can be particularly efficient since accountants (or paraprofessionals) do not have to rely on memory to determine the sequence of bookkeeping procedures.]

    c. Bypasses the need for all processing procedures to be performed. [This answer is incorrect. The reviewer uses a "Data Processing Checklist" to quickly determine whether or not all processing procedures have been performed.]

    d. Must be customized for each client. [This answer is incorrect. Although the types of transactions encountered may vary with each company, the basic steps necessary to process the transactions generally do not change. Generally, a "Data Processing Checklist" will apply to multiple clients.]

24. Lori is training a new paraprofessional to convert transaction information to a general ledger. Which of the following is **not** a step Lori is likely to include in her training? **(Page 55)**

    a. Reconcile cash accounts. [This answer is incorrect. The first step in this course's approach to processing accounting information is to reconcile cash balances.]

    b. Record cash receipts and disbursements. [This answer is incorrect. This is one of the steps for processing accounting information used by the approached suggested in this course, so it would likely be included in Lori's training. All of the cash receipts and disbursements during the period are identified during the bank reconciliation process.]

    c. Adjust accounts payable. [This answer is incorrect. If the general ledger is maintained on the accrual basis, accountants using this course's suggested approach for processing accounting information will need to prepare journal entries to adjust the balance of accounts payable.]

    d. Assign account numbers. [This answer is correct. Account numbers should be identified as part of establishing the bookkeeping system. This is not a step in converting transaction information to a general ledger.]

25. In recording cash disbursements, which of the following statements is **not** accurate? **(Page 58)**

    a. Accountants must determine whether cash disbursements relate to purchases that were accrued in a prior period. [This answer is correct. Generally, accountants should not try to determine whether cash disbursements relate to purchases that were accrued in a prior period. It is more efficient to record all disbursements as if none had been accrued in a prior period and then reverse the prior period accrual during the current period.]

    b. Accountants should record all disbursements as if none had been accrued in a prior period and then reverse the prior period accrual during the current period. [This answer is incorrect. According to the approach for processing accounting information that is suggested by this course, this method is a more efficient way to deal with this type of transaction.]

    c. Coding check stubs will impair an accountant's independence, so the client must be assigned this task. [This answer is incorrect. Normally, coding check stubs will not impair the accountant's independence so long as the client provides sufficient detail to clearly identify the nature of each transaction.]

26. Mary is adjusting the accounts payable for a company that uses the accrual basis of accounting. The correct entries for her to make are: **(Page 59)**

    a. An entry to reverse the beginning of the period balance of accounts payable and an entry to record the balance of accounts payable at the end of the period. [This answer is correct. Based on the approach suggested by this course, the proper entries consist of the following two step process: An entry is made to reverse the beginning of the period balance of accounts payable. Then, an entry is made to record the balance of accounts payable at the end of the period.]

    b. An entry to reverse the ending period balance of accounts payable and an entry to record the balance of the beginning period balance. [This answer is incorrect. Although the answer choice has selected the proper accounts affected by the adjusting entry, the entries described are not stated correctly.]

    c. Debit expense and credit accounts payable. [This answer is incorrect. This answer choice does not reflect the correct entry.]

    d. Credit expense and debit accounts payable. [This answer is incorrect. Current period cash disbursements are charged to current period expense even if they were accrued in a prior period. Thus, the prior period's payable accrual should be reversed in the current period to avoid recording expenses twice.]

27. What method of adjusting inventory is used by most small companies? **(Page 59)**

    a. Physical count. [This answer is incorrect. Physically counting inventory should be done periodically (at least annually). It is a process of performing inventory but not a method of adjusting inventory.]

    b. Gross profit. [This answer is correct. This method will be used by most small to medium-sized companies because (a) the method can produce results if reasonable cost of sales percentages are used, and (b) many small to medium-sized companies do not have the resources to maintain perpetual inventory records.]

    c. General ledger. [This answer is incorrect. The general ledger inventory balance is adjusted to the balance reflected in the company's perpetual inventory records. The adjustment should be made through a journal entry that debits cost of sales and credits inventory. However, this method is not the one used by most small companies to adjust inventory.]

    d. Perpetual inventory. [This answer is incorrect. Most small companies do not have the resources to maintain perpetual inventory records.]

28. When adjusting the accounts receivable reserve, accountants use the _____________ method when a company has a large number of uniformly-sized accounts with a stable market and customer base. **(Page 60)**

    a. Aging. [This answer is incorrect. The aging method generally is used when individual accounts receivable are not uniform in amount and sales activity fluctuates widely.]

    b. Profit margin. [This answer is incorrect. This is not a method of adjusting accounts receivable reserve.]

    c. Doubtful account. [This answer is incorrect. Although a doubtful account may cause a need for an adjustment to the accounts receivable reserve, it is not a method of performing this step.]

    d. Percentage of sales. [This answer is correct. According to the approach suggested by this course, the percentage of sales method is often used when a company has a large number of uniformly-sized accounts with a stable market and customer base. By applying a predetermined "bad debt" percentage to each month's sales, the amount of uncollectible accounts are estimated.]

29. When adjusting for depreciation, which of the following is **not** an accurate statement? **(Page 63)**

    a. Waiting until year-end to adjust depreciation expense for asset additions and disposals is appropriate even if the effect of the adjustment is significant. [This answer is correct. The accountant should adjust the monthly or quarterly depreciation expense calculation for fixed asset additions, disposals, and other changes during the year. Thus, interim adjustments are made.]

    b. Annual depreciation expense should be allocated to interim periods. [This answer is incorrect. This is an accurate statement. Normally, the allocation to interim periods is made on a straight-line basis.]

    c. Accountants generally use computer spreadsheets or maintain manual worksheets to track fixed assets and calculate depreciation. [This answer is incorrect. This is an accurate statement. However, if a company has numerous depreciable assets, fixed asset software can be used.]

    d. Many small to medium-sized companies use depreciation methods and useful lives prescribed by tax laws even if they maintain their general ledgers on the GAAP basis of accounting. [This answer is incorrect. This is an accurate statement. This method provides two advantages (1) the need to maintain separate depreciation schedules for book and tax purposes is avoided and (2) the results often are virtually the same as those achieved using GAAP depreciation methods and lives.]

30. Rank the following journal entries from least correct to most correct. **(Page 65)**

    i. Debit Office Supplies; Credit Cash; include reference number, omit the general ledger account numbers debited and credited; include the amounts of the debit and credit; omit a description of the reason for making the entry.

    ii. Debit Office Supplies; Credit Cash; omit reference number; omit the general ledger account numbers debited and credited; include the amount of the debit and credit; omit a description of the reason for making the entry.

    iii. Debit Office Supplies; Credit Cash; include reference number and the general ledger account numbers debited and credited, along with the amounts and a description of the reason for making the entry.

    a. iii, ii and i. [This answer is incorrect. Correctly documented journal entries allow accountants to perform their review and analysis procedures more easily. Of the journal entries described above, Entry iii is not the least properly documented.]

    b. i, ii and iii. [This answer is incorrect. Accountants can review and analyze general ledger accounts more easily if all journal entries are properly documented. Entry i is not the least properly documented.]

    c. ii, i and iii. [This answer is correct. Each journal entry should be assigned a unique reference number so that it can be easily identified and traced back to supporting documents. A complete entry would include all amounts, the account numbers involved, and a description of the entry so that the accountant can review and analyze it more easily.]

31. Many accounting firms develop a standard method of organizing workpapers in which workpapers are placed in specific files. Which file contains the documents and workpapers that support the general ledger? **(Page 66)**

    a. Permanent. [This answer is incorrect. The permanent file contains documents that are permanent in nature. Such documents are those that are either updated and reviewed annually or provide client information that generally does not require a monthly review.]

    b. Write-up. [This answer is correct. The write-up file contains these types of supporting documents and workpapers, if the organizational method described by this course is used. The file may also contain the period's general ledger, financial statements, and supporting subsidiary ledgers.]

    c. Payroll. [This answer is incorrect. The payroll file includes payroll-related workpapers and documents, such as "Employee Payroll Information Sheets," "Payroll Information Transmittals," copies of payroll tax returns with supporting schedules, and other applicable payroll forms.]

PAYING STATE SALES AND USE TAXES

Most states require businesses to pay taxes on sales of certain tangible personal property and services. The tax may take the form of either a consumer sales and use tax, a gross receipts tax, an occupation tax (based on sales), or an excise tax. The seller business is required to either collect the tax from the customer or pay the tax itself based on the business's gross sales. As a result, certain information must be accumulated and presented to the various states in the form of sales tax returns. Accountants often are asked to prepare sales tax returns for their write-up clients. This section provides information about the most common form of the tax—a consumer sales and use tax.

What Are Sales and Use Taxes?

Sales Taxes. Generally, sales taxes are taxes collected by the seller business at the time of sale based on the retail sales price. The seller business reports and remits the amounts collected to the state on a periodic basis.

Use Taxes. Use taxes are most often imposed when an item is purchased out of state but used in the state. Their purpose is to make sales taxes irrelevant to a business's purchase decisions. In contrast to a sales tax, the purchaser business voluntarily reports and pays use taxes directly to the state. For example, if the Acme Company, located in Texas, bought stationery from a local store, Acme would pay sales tax on the purchase. However, if Acme bought the stationery from a mail order discount office supplier in Illinois, the vendor may not collect sales tax. (Sales taxes are often not collected when the items sold are to be used out of state.) To prevent Acme from avoiding Texas sales taxes by purchasing all its supplies from out-of-state vendors, Texas imposes a use tax (equal to sales tax on in-state purchases) on Acme's out-of-state purchases. Use taxes are voluntarily reported by the purchaser business rather than collected by the vendor at the time of sale; so Acme would list the purchase and use tax amounts on its sales and use tax return.

Use taxes also apply when a business buys a product for a tax exempt purpose (such as for resale) and then changes its mind and uses the product for a non-tax exempt purpose (such as for its own operations).

Accountants should be familiar with the sales and use tax rules to assist their clients if they have questions or encounter problems. For many small businesses, administering a state sales and use tax is a straightforward process. However, for companies conducting business in several states, selling to a mix of wholesale and retail customers, or offering a diverse product line, sales and use taxes can become quite complex.

Recognizing Sales Tax Collection Duties

When a business sells goods and meets certain conditions in a state, it is required to collect sales taxes for the state. In addition, the business must (a) register to do business in the state, (b) register to collect sales taxes, (c) pay the state's franchise or capital taxes, and (d) pay the state's income and employment taxes. It is the responsibility of a business to recognize the state requirements. However, the accountants should periodically confirm that the business is aware of the appropriate state's regulations and provide assistance, if necessary.

Traditionally, a business had to have a physical presence in a state (a sales representative, a sales location, or an inventory of goods) before it was required to collect sales taxes. However, in recent years states have greatly expanded the activities that can create collection duties for a business. Such activities now include advertising, catalog distribution, consignments, warehousing and storing, and delivery of goods by private carriers within the state. There is some legal controversy over whether mail order and telephone sales create a collection duty. If questions about a client's collection duties arise, an accountant or attorney familiar with the state's requirements should be consulted.

Streamlined Sales Tax Project. Sales and use tax is determined by each individual state; thus, rules, forms, and rates vary considerably. The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize the collection and administration of sales and use tax. The Project's proposals will incorporate (a) uniform definitions within tax bases, (b) simplified audit and administrative procedures, and (c) emerging technologies to substantially reduce the burdens of tax collection.

The key features of the Streamlined Sales Tax System include the following:

- *Uniform Definitions within Tax Laws.* Legislatures still choose what is taxable and exempt but will use the common definitions for key items in the tax base.

- *Simplified Exemption Administration for Use- and Entity-based Exemptions.* Sellers are relieved of the "good faith" requirements that exist in current law and will not be liable for uncollected tax. Purchasers will be responsible for incorrect exemptions claimed.

- *Rate Simplification.* States will be responsible for the administration of all state and local taxes as well as the distribution to the local governments of the local taxes. State and local governments will use common tax bases and will be responsible for providing notice of rate and boundary changes. States will be allowed one state rate and a second state rate in limited circumstances.

- *Uniform Sourcing Rules.* The states will have uniform sourcing rules for all property and services.

- *Uniform Audit Procedures.* Depending on the technology model used, sellers who participate in one of the certified Streamlined Sales Tax System technology models will either have a limited scope audit or will not be audited at all.

- *Paying for the System.* To reduce the financial burdens on sellers, states will be responsible for implementing the Streamlined Sales Tax System.

The Streamlined Sales Tax Project suggests that states change their sales and use tax laws to conform to the simplifications as proposed by the Project. Therefore, the simplifications would apply to all sellers. Participation in the Streamlined Sales Tax System is voluntary for sellers who do not have a physical presence or "nexus" with a state (unless Congress chooses to require collection from all sellers for all types of commerce). A majority of the 45 states that collect sales tax and the District of Columbia are currently involved in the project. The project has two components, the Uniform Sales and Use Tax Administration Act ("Act") and the Streamlined Sales and Use Tax Agreement ("Agreement"). These two components enable states to enact legislation to provide the benefits of simplification to vendors in their state. In November 2002, thirty states and the District of Columbia approved the Agreement provisions. The Agreement approved in November 2002 took effect October 1, 2005. Currently, 21 states are participating in the system, but more are expected to join over time. More information on the project may be obtained from the project's Web site at **www.streamlinedsalestax.org**.

Identifying Taxable Transactions

Accountants usually rely on a business to accumulate the appropriate sales tax information because most businesses generate their own sales invoices. Therefore, it is important for a business to identify correctly the sales or use tax consequences of a transaction when it occurs, rather than after the fact. (By identifying the taxable transaction early, it is often easier for the business to summarize the information for processing.) The business usually must gather information concerning (a) sales to customers and (b) purchases by the business.

For sales to customers, the business should record the following information for each sale:

- *Date of Sale.*

- *Location Where the Sale Occurred.* The location determines which states, counties, or localities get paid the tax. The definition of where a sale occurs varies by state, with most states determining that sales occur at the destination where the product or service is delivered.

- *Sales Price of Goods or Services Sold.*

- *Taxable or Exempt Status of the Goods Sold.* Exemptions vary from state to state.

- *Tax Rate.* The tax rate usually varies by state, county, and locality.

- *Tax Collected from Customers.*

Businesses usually gather and document the information on the sales invoice.

For purchases, businesses should gather similar information. If the business's purchase was from an out-of-state vendor who collected less sales tax than would the home state, the business should identify the purchase as subject to use tax. Businesses usually gather and document the purchase information on the purchase invoice.

The accountants should encourage a business to correctly identify the sales or use tax consequences of a transaction when it occurs, rather than after the fact. As discussed previously, by identifying the taxable transaction early, it is often easier for the business to summarize the information for processing. In addition, any questions or problems regarding a particular transaction can be addressed before the accountant begins preparing the sales tax return.

State sales and use tax authorities assume that every sale or purchase is taxable unless specifically exempted from sales and use taxes. Therefore, the business bears the burden of identifying exempt transactions and obtaining proper documentation (often in the form of exemption certificates completed by the purchaser).

Exempt Transactions. Exemptions vary widely among the states. Exemptions may be full or partial, or they may take the form of nonstandard tax rates. In general, exemptions from sales taxes are based on one or more of the following:

- Product sold (for example, food and drugs, services, newspapers and periodicals, motor vehicles, and pollution control equipment).
- Use of product (for example, items purchased for resale or export or for use in agriculture, manufacturing, or industrial processing).
- Type of transaction (such as occasional sales).
- Nature of the buyer (for example, charitable or religious organization, government, or schools).

Exhibit 2-2 presents sales tax treatments (including exemptions) of certain business transactions. However, the exhibit presents only general state practices. The accountants or business should become familiar with the specific regulations of the states in which the business operates.

Exhibit 2-2

General State Sales Tax Treatment of Transactions

Transaction	Treatment
Agricultural equipment	Usually exempt
Bad debts	Usually an allowed deduction from the tax base or a tax credit, but restrictions apply
Barter and exchange	Usually taxable
Computer software	Usually "canned" software is taxable, custom software is not
Computer hardware	Usually taxable, but some states exempt it if used in manufacturing, production, or research
Containers, covering, and packing material	Usually exempt, when sold with the products to consumers
Delivery freight (FOB destination & paid by the seller as part of the sale)	Usually considered part of the sale and taxable (see also service charges)
Delivery freight (FOB origin & paid by buyer)	Usually not considered part of the sale and, thus, not taxable (see also service charges)

Transaction	Treatment
Discounts for immediate payment in cash	Sometimes deducted before sales tax applied
Discounts to trade members or based on quantity	Usually deducted before sales tax applied
Discounts for early payments	Usually not deducted before sales tax applied
Drop shipment sales	Treatment varies widely
Food & drugs	Usually exempt, although nonprescription drugs and prepared foods are usually taxable
Goods for resale	Usually exempt
Goods taken from resale inventory for business's use (for samples, equipment, gifts, or research)	Usually taxable
Installment and credit sales	Usually taxed, but timing varies by state. Many treat each payment as a separate taxable sale.
Interest and finance charges	Usually exempt if stated separately on the invoice
Internet sales	Most states require the collection of sales taxes on sales where possession of tangible goods takes place within the state. Usually, if sales taxes are not collected, the purchaser owes use taxes.[a]
Labels, tags, and signs	Usually exempt, when affixed to tangible personal property for sale at retail
Labor and service charges	Usually taxable
Leases and rentals	Generally taxable
Mail order sales	Treatment varies widely
Service charges (such as for installation and delivery)	Usually exempt, if stated separately on invoice and added after the sale
Stocks, bonds, notes, and insurance	Usually exempt
Trade-ins	Usually an allowed deduction from the tax base
Manufacturing equipment	Usually exempt
Materials (raw) used in agriculture, manufacturing, or industrial processing	Usually exempt
Materials (raw) used in research and development	Usually taxable
Medical services and supplies[b]	Usually exempt[b]
Newspapers and periodicals	Usually exempt
Occasional sales (sales of goods not sold in the normal course of business)	Usually exempt, but restrictions often apply
Office machinery	Usually taxable
Other services	Usually exempt
Personal services	Usually exempt
Pollution control equipment	Treatment varies
Products subject to state and federal excise taxes	Usually exempt
Professional services	Usually exempt

Transaction	Treatment
Purchase by a charitable or nonprofit organization	Usually exempt
Purchase by a contractor on a construction project	Treatment varies
Purchase by an educational institution	Usually exempt
Purchase by a government entity	Usually exempt
Purchase by public utility	Usually exempt
Return of merchandise	Usually an allowed deduction from the tax base. Some states require the refund to the customer of the full purchase price.
Sale of repossessed merchandise	Generally taxable

Notes:

[a] The taxation of Internet sales and access is currently the subject of great debate. The Internet Tax Freedom Act (ITFA) prohibits states from requiring remote sellers (i.e., retailers, including Internet sellers, without a physical store or warehouse or other presence in that state) to collect sales tax on sales in that state. The moratorium on Internet sales tax created by ITFA expired on November 1, 2003. However, in December 2004, the President signed the Internet Tax Non-Discrimination Act. The Act reinstitutes the moratorium on Internet access taxes and multiple and discriminatory taxes on electronic commerce, retroactive to its expiration and extends the moratorium through November 1, 2014. The Internet access sales tax charge differs from sales tax on Internet purchases. The issue of charging sales tax on Internet purchases is covered in the Streamlined Sales Tax Project as discussed earlier.

[b] Prescriptions for therapeutic devices may receive tax-exempt status.

*   *   *

Exemption Certificates. Exemptions that are based on the nature of the product sold often require no documentation other than the sales invoice. Exemptions that are based on the use of the product, transaction type, or the nature of the buyer generally require documentation in the form of an exemption certificate, that is, a special form completed by the purchaser.

Each state determines the wording of the exemption certificate. Some states allow the seller to print a statement using required language on the invoice for the purchaser to sign. Others go further and require a specific state-created form for each type of exemption. While no one form is accepted by all states, most states accept the Multistate Tax Commission's (MTC) form.

States place other conditions on exemption certificates. During an audit, states frequently do not allow the seller to obtain exemption certificates for previous sales. In fact, some states accept only certificates dated before the sale. (If the state does allow the business to obtain exemption certificates after the sale, the business should periodically review sales transactions and request customers to submit missing certificates.) All states require the seller to check the reasonableness of the claimed exemption; for instance, if a purchaser provides an agricultural exemption certificate, the seller should determine that the sold goods can reasonably be used in agriculture.

To comply with the state requirements on exemption certificates, the accountants might recommend that the business include sales taxes on the customer invoice unless the customer presents a sales tax exemption certificate before or at the sale. If the customer provides the business an exemption certificate within a specified time period, for example 30 days, the business can then refund the sales tax.

From the seller's point of view, exemption certificates generally fall into two categories:

- *Blanket Certificates.* Blanket certificates are issued by customers generally for two years based on the nature of the purchaser (such as a school) or the intended use of the product (such as for resale or manufacture). Blanket certificates are a convenience that keeps frequent customers from having to prepare an exemption certificate for each purchase. When dealing with blanket exemption certificates, the business should take special care to (a) review each new sales invoice for the reasonableness of the claimed exemption, (b) monitor the certificate's expiration date and obtain needed renewal certificates, and (c) ensure that an audit trail exists from the sales invoice to the customer's blanket exemption.

- *Unit Certificates.* Unit certificates are limited to a specific transaction, such as the use of the purchased goods on a specific government contract. The customer must provide a new exemption certificate for each purchase transaction.

When the business is the purchaser, it is important for the business to properly review purchase transactions to claim the sales and use tax exemptions to which the business is entitled. The business also should take care to claim exemptions properly; for example, a retail business should not use its reseller's exemption to avoid sales taxes on the office supplies the business consumes.

Many businesses forget to claim exemptions from use tax on qualifying out-of-state purchases. If a purchase qualifies for a tax exemption if it had been made in-state, it also qualifies for an exemption if made out of state. The business should leave a clear audit trail for tax exemptions claimed on use tax purchases. In states with strict rules on exemption forms, the business should consider preparing completed exemption certificates for each of the business's exempt use tax purchases.

Recording Tax Liabilities

To record sales and use tax liabilities, the accountants must obtain a summary of the taxable transactions identified by the business. The accountants must then calculate and record the tax liabilities for (a) sales taxes collected from the business's customers and (b) use taxes on the business's purchases. Most general ledger software packages have the capability to track sales tax and prepare sales tax returns. The following paragraphs describe those activities.

Sales Tax Liability. In practice, accountants generally use one of three methods to calculate and record the business's liability for sales taxes collected from their customers.

- *Gross Sales Method.* Using this method, the accountants include the sales tax in the amounts recorded as gross sales. When preparing the sales tax return, the accountants determine sales to report on the sales tax return by dividing recorded sales by one plus the sales tax percentage. The accountants then calculate the sales taxes owed and record the business's remittance as a debit to sales. To accurately use this method, the business must track sales by jurisdiction and tax exemption. This method also requires a month-end accrual adjustment to record the business's tax liability if accrual basis general ledgers or financial statements are prepared.

- *Gross Taxes Payable Method.* Using this method, the accountants record the total amount of sales taxes collected in a liability account (or separate accounts for separate locations). To prepare the sales tax return, the accountants calculate reportable taxable sales by dividing the total taxes collected during the period by the sales tax percentage. The accountants then charge the subsequent remittance of the sales taxes against the sales tax liability account. While widely used by small businesses, this method is generally appropriate only for businesses who encounter few tax exemptions. State auditors may require the business to (a) reconcile total sales in the accounting records with total sales reported on sales and use tax returns and (b) provide supporting sales invoices for each tax exempt sale.

- *Detailed Ledger Method.* Under this method, the accountants record the amount of sales taxes collected in a liability account (or accounts for separate locations) and list in a detailed record (sometimes called a sales tax ledger) the tax information from each invoice (location, gross sale, type and amount of exemptions claimed, amount subject to tax, tax rate, and sales tax due). The accountants complete the sales tax return using information in the sales tax ledger and charge remittances against the sales tax liability account. This method is appropriate for businesses that operate in many taxing jurisdictions, carry product lines with taxable and exempt products, and receive frequent customer claims for exemptions. A business might prefer this method because it provides a detailed audit trail. Since this method is time-consuming, the accountants should encourage the business to maintain the detailed records.

Regardless of the method used, the accountants will need to obtain the following information from the business:

- Non-exempt customer sales (customer sales not exempt from sales tax).
- Exempt customer sales (customer sales exempt from sales tax).
- Sales taxes collected from customers.

That information can be obtained from the "Cash Receipts Summary." (If the business has sales in various states or jurisdictions, the information should be summarized by the appropriate state or jurisdiction and submitted to the accountant for processing.)

The business or accountants should also:

- Determine that a clear audit trail exists for refunds of sales taxes (either when sales are canceled or when the customer presents an exemption certificate).
- Review transactions involving gain or loss on disposition of assets. Such transactions are often subject to sales taxes.
- Review canceled sales, returns, credit memos, or accounts receivable write-offs. Many states allow deductions from sales taxes for sales taxes on canceled sales, returns, or write-offs of accounts receivable. (Accountants should remind businesses of those items because many businesses are unaware of the deductions.)
- Review additions to plant and equipment accounts. Sales tax auditors often audit all such transactions for sales taxes paid and the propriety of exemptions claimed.
- Review general journal and adjusting entries for impact on the sales tax liability. Again, the business and accountants should ensure that a sufficient audit trail is available to prove to an auditor that no sales tax is due on the transactions. A sales tax audit assessment may result from the business's inability to explain the purpose of an entry to the sales tax liability account.

Use Tax Liability. Accountants should obtain a summary of transactions subject to the use tax so that the use tax liability may be recorded. To help the business identify transactions that might be subject to the use tax, accountants should:

- Inquire about the business's purchases from out-of-state vendors. Ask the business to identify purchases for which (a) no tax was paid and (b) a tax was paid to the vendor's state.
- Inquire about the business's withdrawals from inventory for goods used by the business (for samples, gifts, capital assets, research, etc.). Such withdrawals create a use tax liability.
- Review general journal and adjusting entries for impact on the use tax liability. Accountants should ensure that there is sufficient documentation available to prove to an auditor that no use tax is due on a particular transaction.

The "Use Tax Schedule" is a worksheet to record taxable purchases and calculate use tax. To use the schedule, accountants should record the transactions (obtained from the business) subject to use tax, indicate the nature and amounts of exemptions claimed by the business, calculate the net taxable amount, and record any out-of-state sales taxes paid on the purchase. The net taxable amount and the out-of-state taxes already paid should then be reported on the sales and use tax return.

In practice, many accountants do not record a liability for use taxes even when accrual basis general ledgers and financial statements are prepared; they simply expense the amounts when the sales and use taxes are paid.

However, if accrual basis financial statements and general ledgers are prepared and the use tax amounts are significant to the business, accountants should consider accruing the use tax.

Preparing Returns

When preparing sales and use tax returns, accountants should determine that:

- *Returns Are Filed Timely.* Even if the business has no activity, a return must be filed. A "Multistate Sales and Use Tax Schedule" can be used to schedule and track the filing of sales tax returns for businesses selling in various states.

- *Payments Are Coded Correctly.* If the accountants use a sales tax liability account, the entry recording the tax remittance should fully zero-out the related liability. Additional entries (such as one to record collection discounts discussed below) may be necessary to ensure that this happens.

- *Collection Discounts Are Recorded Correctly.* Many states offer a small discount if sales tax returns are filed on time. The difference between the gross tax liability and the remittance is usually credited to miscellaneous income.

- *An Audit Trail Exists.* Any adjustments (such as for receivables written off or for customer exemption certificates received after the sale) that create differences between the supporting records and the amounts on the sales and use tax return should be clearly documented.

Record Retention

Like everything else involving sales and use taxes, every state has different rules on what records should be retained and for how long they should be retained. Records generally include the following:

- Sales documents (such as cash register receipts, credit card slips, or invoices),

- Exemption certificates,

- Support for use taxes and use tax credits,

- Sales and use tax returns,

- Journal entries affecting sales and use tax accounts, and

- Support for other transactions that might incur sales or use tax (essentially all nonpayroll accounting records)

State laws vary, therefore the accountant or business should confirm the particular documentation requirements and retention periods with the appropriate state tax authorities.

SELF-STUDY QUIZ

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

32. Which one of the following statements is **not** an accurate description of sales and use taxes?

    a. Generally, sales taxes are taxes collected by the seller business at the time of sale based on the retail sales price.

    b. Use taxes are most often imposed when an item is purchased out of state but used in the state.

    c. Use taxes do not apply when a business buys a product for a tax exempt purpose and then changes its mind and uses the product for a non-tax exempt purpose.

    d. Sales and use taxes can be quite complex for companies conducting business in several states.

33. The Pepmart Pharmacy sells drugs and sundries to the general public. Pepmart does not pay sales tax on the drugs sold. This sales tax exemption is based on which of the following?

    a. Product sold.

    b. Use of product.

    c. Type of transaction.

    d. Nature of the buyer.

34. One type of exemption certificate is the *blanket certificate*. When dealing with blanket exemption certificates from the seller' viewpoint, the business should take care to do all of the following, **except**:

    a. Review each new sales invoice for the reasonableness of the claimed exemption.

    b. Monitor the certificate's expiration date and obtain needed renewal certificates.

    c. Require the customer to submit an exemption certificate for each purchase.

    d. Ensure that an audit trail exists from the sales invoice to the customer's blanket exemption.

35. Accountants generally use one of three methods to calculate and record the business's liability for sales taxes collected from their customers. Which method do accountants use to record the total amount of sales taxes collected in a liability account?

    a. Gross Sales.

    b. Gross Taxes Payable.

    c. Detailed Ledger.

36. Wendy is recording her client's use tax liability. To identify transactions that might be subject to the use tax, she should do all of the following, **except**:

    a. Identify purchases for which sales tax has been remitted, but no use tax.

    b. Inquire about the business's withdrawals from inventory for goods used by the business.

    c. Identify purchases from out-of-state vendors for which tax was paid to the vendor's state.

    d. Review general journal and adjusting entries for impact on the use tax liability.

37. In general, records to be retained involving sales and use taxes include all of the following, **except**:

    a. Sales documents.

    b. Sales and use tax returns.

    c. Exemption certificates.

    d. All payroll accounting records.

SELF-STUDY ANSWERS

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

32. Which one of the following statements is **not** an accurate description of sales and use taxes? **(Page 74)**

    a. Generally, sales taxes are taxes collected by the seller business at the time of sale based on the retail sales price. [This answer is incorrect. Based on the general sales and use tax rules, this statement is accurate. The seller business reports and remits the amounts collected to the state on a periodic basis per the state's sales and use tax regulations.]

    b. Use taxes are most often imposed when an item is purchased out of state but used in the state. [This answer is incorrect. This statement is accurate based on typical sales and use tax rules. Their purpose is to make sales taxes irrelevant to a business's purchase decisions. In contrast to a sales tax, the purchaser business voluntarily reports and pays use taxes directly to the state since the item purchased will be "used" in the state.]

    c. Use taxes do not apply when a business buys a product for a tax exempt purpose and then changes its mind and uses the product for a non-tax exempt purpose. [This answer is correct. According to general sales and use tax rules, use taxes do apply when a business buys a product for a tax exempt purpose (such as for resale) and then changes its mind and uses the product for a non-tax exempt purpose (such as for its own operations).]

    d. Sales and use taxes can be quite complex for companies conducting business in several states. [This answer is incorrect. This is an accurate statement. For many small businesses, administering a state sales and use tax is a straightforward process. However, for companies conducting business in several states, selling to a mix of wholesale and retail customers, or offering a diverse product line, sales and use taxes can become quite complex.]

33. The Pepmart Pharmacy sells drugs and sundries to the general public. Pepmart does not pay sales tax on the drugs sold. This sales tax exemption is based on which of the following? **(Page 76)**

    a. Product sold. [This answer is correct. Though exemptions vary from state to state, one typical type of sales tax exemption is one based on the type of product sold (for example, food and drugs are common products exempt from sales tax).]

    b. Use of product. [This answer is incorrect. A sales tax exemption can be based on use of the product (for example, items purchased for resale or export or for use in agriculture, manufacturing, or industrial processing); however, in this scenario another answer choice is the basis for the exemption.]

    c. Type of transaction. [This answer is incorrect. A sales tax exemption can be based on the type of transaction (such as occasional sales); however, this scenario is an example of a sales tax exemption with some other exemption basis.]

    d. Nature of the buyer. [This answer is incorrect. Sales tax exemption can be based on the the nature of the buyer (for example, charitable or religious organization, government or schools); however, in this scenario another answer choice is the basis for the exemption.]

34. One type of exemption certificate is the *blanket certificate*. When dealing with blanket exemption certificates from the seller's viewpoint, the business should take care to do all of the following, **except**: **(Page 78)**

    a. Review each new sales invoice for the reasonableness of the claimed exemption. [This answer is incorrect. When dealing with blanket exemption certificates, the business should take special care to review each new sales invoice for the reasonableness of the claimed exemption under state requirements.]

b. Monitor the certificate's expiration date and obtain needed renewal certificates. [This answer is incorrect. Blanket certificates are issued by customers generally for two years based on the nature of the purchaser (such as a school) or the intended use of the product (such as for resale or manufacture). The business accepting the blanket certificate should monitor the certificate's expiration date and obtain needed renewal certificates.]

c. Require the customer to submit an exemption certificate for each purchase. [This answer is correct. Blanket certificates are convenient because they keep frequent customers from having to prepare an exemption certificate for each purchase. Businesses must comply with state requirements for exemption certificates.]

d. Ensure that an audit trail exists from the sales invoice to the customer's blanket exemption. [This answer is incorrect. When dealing with blanket exemption certificates, the business should take special care to ensure that an audit trail exists from the sales invoice to the customer's blanket exemption to ensure it is valid under state requirements.]

35. Accountants generally use one of three methods to calculate and record the business's liability for sales taxes collected from their customers. Which method do accountants use to record the total amount of sales taxes collected in a liability account? **(Page 79)**

a. Gross Sales. [This answer is incorrect. Using this method, the accountants include the sales tax in the amounts recorded as gross sales. When preparing the sales tax return, the accountants determine sales to report on the sales tax return by dividing recorded sales by one plus the sales tax percentage. The accountants then calculate the sales taxes owed and record the business's remittance as a debit to sales. To accurately use this method, the business must track sales by jurisdiction and tax exemption.]

b. Gross Taxes Payable. [This answer is correct. In practice, accountants using this method record the total amount of sales taxes collected in a liability account. To prepare the sales tax return, the accountants calculate reportable taxable sales by dividing the total taxes collected during the period by the sales tax percentage. The accountants then charge the subsequent remittance of the sales taxes against the sales tax liability account.]

c. Detailed Ledger. [This answer is incorrect. Under this method, the accountants record the amount of sales taxes collected in a liability account and list in a detailed record (sometimes called a sales tax ledger) the tax information from each invoice (location, gross sale, type and amount of exemptions claimed, amount subject to tax, tax rate, and sales tax due).]

36. Wendy is recording her client's use tax liability. To identify transactions that might be subject to the use tax, she should do all of the following, **except**: **(Page 80)**

a. Identify purchases for which sales tax has been remitted, but no use tax. [This answer is correct. Companies would not owe both sales tax and use tax on a product—it is an either/or situation. If sales tax has already been remitted on the purchase, than the company would not owe use tax.]

b. Inquire about the business's withdrawal from inventory for goods used by the business. [This answer is incorrect. Wendy does need to inquire about the business's withdrawals from inventory for goods used by the business (for samples, gifts, capital assets, research, etc.) to complete this task. Such withdrawals create a use tax liability.]

c. Identify purchases from out-of-state vendors for which tax was paid to the vendor's state. [This answer is incorrect. Wendy does need to inquire about the business's purchases from out-of-state vendors to fulfill this task. She should ask the business to identify purchases for which (a) no tax was paid and (b) a tax was paid to the vendor's state.]

d. Review general journal and adjusting entries for impact on the use tax liability. [This answer is incorrect. Wendy needs to review general journal and adjusting entries for impact on the use tax liability to complete this job. Accountants should ensure that there is sufficient documentation available to prove to an auditor that no use tax is due on a particular transaction.]

37. In general, records to be retained involving sales and use taxes include all of the following, **except**: **(Page 81)**

   a. Sales documents. [This answer is incorrect. Sales documents (such as cash register receipts, credit card slips, or invoices) should generally be retained under state rules.]

   b. Sales and use tax returns. [This answer is incorrect. Like everything else involving sales and use taxes, every state has different rules on what records should be retained and for how long they should be retained. Sales and use tax returns generally are items which should be retained.]

   c. Exemption certificates. [This answer is incorrect. Exemption certificates should generally be retained. However, state laws vary, therefore the accountant or business should confirm the particular documentation requirements and retention periods with the appropriate state tax authorities.]

   d. All payroll accounting records. [This answer is correct. Items that provide support for other transactions that might incur sales or use tax should be retained under typical state rules; essentially, this includes all nonpayroll accounting records. Payroll is not subject to sales or use tax.]

INDEPENDENCE ISSUES THAT SURROUND WRITE-UP ENGAGEMENTS

A frequent issue that arises when performing write-up services for a client is whether or not certain services could impair the accountant's independence. Generally, independence becomes an issue when, as part of the write-up engagement, the accountant generates financial statements. When external accountants prepare financial statements from general ledger information generated during a write-up engagement, then such financial statements become subject to the requirements of the Statements on Standards for Accounting and Review Services (SSARS). According to SSARS, when preparing financial statements for a client the accountant must, at a minimum, compile those financial statements in accordance with SSARS No. 1 (AR Section 100). When a CPA's independence is impaired, the accountant is only permitted to compile the financial statements for that client and must specifically disclose his or her lack of independence within the compilation report. (Note that when a CPA's independence is impaired, the CPA is precluded from issuing an *audit* or *review* report on the financial statements that they prepared for that client.)

SSARS Framework and Reliability Project

The Accounting and Review Services Committee (ARSC) issued an exposure draft of three proposed SSARSs—

- *Framework and Objectives for Performing and Reporting on Compilation and Review Engagements*
- *Compilation of Financial Statements*
- *Review of Financial Statements*

The exposure draft includes the following three major areas of change—

- Allow CPAs to perform a review when they are not independent because of internal control services that they have performed on behalf of management.
- Separate the compilation standards from the review standards.
- Harmonize the terms and concepts in the SSARS with the international standards and the review standards in the U.S. attestation standards.

Within those areas, the most significant changes from existing standards that would result from the issuance of the proposed standards are as follows—

- Use of the term *moderate assurance* versus *limited assurance*.
- Introduction of the terms *internal control service*, *review evidence*, *review risk*, and *materiality* to the SSARS literature.
- Requirement for a written, signed engagement letter for all compilations and reviews.
- Requirement to document significant, unusual matters considered by the accountant during the performance of the compilation procedures, including their disposition.
- Allowing the accountant to include a general description in the accountant's compilation report as to the reason(s) for an independence impairment.
- Expanded guidance with respect to the performance of analytical procedures in a review engagement.
- Requirement in a review that the accountant document management's responses to—
    - the accountant's inquiries regarding fluctuations or relationships that are inconsistent with other information or that differ from expectations by a significant amount.
    - significant matters covered in the accountant's inquiry procedures.

- Allowing the accountant to perform a review and issue a review report in the instances when independence is impaired due to the performance of internal control services.

- Changing the reporting language for both compilation and review reports.

The proposed SSARS are expected to supersede the majority of the existing SSARSs and would be effective for compilations and reviews of financial statements for periods beginning on or after December 15, 2010, with early implementation permitted. At the date of this course, ARSC needs to consider a large number of comment letters received addressing the exposure draft. ARSC's plan is to issue final SSARS in the fourth quarter of 2009. If issued as planned, the new SSARS would be effective for compilations and reviews for periods beginning on or after December 15, 2010, with early implementation permitted. If the new SSARS are adopted early, they will need to be adopted in their entirety and not piecemeal.

Authoritative Literature Relating to Independence

For many small businesses, the accountant may unknowingly be providing write-up services that impair his or her independence. Therefore, it is important for accountants to understand the various rules and regulations that govern independence. The following paragraphs discuss the authoritative literature relating to independence and provide some examples of client services or situations that might impair an accountant's independence.

The primary rules governing independence are found in the AICPA *Code of Professional Conduct* (Conduct Code). The accountant should read Rule 101 of the Conduct Code, interpretations of Rule 101, and independence rulings for guidance concerning independence. This guidance can be found in the *AICPA Professional Standards*, ET Sections 101 and 191. [*PPC's Guide to Quality Control—Compilation and Review* provide an "Independence, Integrity, and Objectivity Questionnaire" that covers each of the independence interpretations and rulings and may be ordered by calling (800) 323-8724 or at **ppc.thomsonreuters.com**.] Exhibit 2-3 presents a listing of common independence considerations along with their applicable reference to the AICPA *Professional Standards*. This listing is not intended to be all inclusive, but rather to assist accountants in finding information about the most common independence considerations.

Exhibit 2-3

Independence Rules

Independence Consideration	**AICPA Ref.**
Another CPA Firm's Participation	ET 191.142.–143
Cooperative Arrangement with a Client	ET 101.14
Employment with a Client	ET 101.04
Family Relationships	ET 101.02
Fee Issues	ET 101.04, ET 191.103–.104
Financial Institution Clients	ET 191.075–.076, ET 191.081–.082, ET 191.150–.151, ET 191.170–.171
Gifts or Entertainment	ET 191.226–.229
Governmental Clients	ET 101.12
Indemnification of a Client	ET 191.204–.205
Investments	ET 101.02, ET 101.10, ET 101.17, ET 191.138–.139, ET 191.162–.163, ET 191.184–.185
Lease Property	ET 101.02, ET 191.182–.183
Litigation	ET 101.08, ET 102.03, ET 191.192–.193
Loans	ET 101.02, ET 101.07, ET 191.134–.135, ET 191.196–.197, ET 191.220–.221
Nonprofit Organization Clients	ET 101.06, ET 191.027–.028, ET 191.031–.034, ET 191.061–.062, ET 191.128–.129, ET 191.186–.187
Referral	ET 102.03

Independence Consideration	AICPA Ref.
Retirement, Savings, Health and Welfare, or Similar Plan	ET 101.17, ET 191.041–.042, ET 191.119–.120, ET 191.214–.215, ET 191.222–.223
Services to Clients	ET 101.02, ET 101.05, ET 102.03, ET 191.003–.004, ET 191.017–.018, ET 191.021–.024, ET 191.031–.032, ET 191.037–.038, ET 191.144–.145, ET 191.164–.165, ET 191.198–.199, ET 191.206–.297, ET 191.222–.225
Significant Influence	ET 191.212–.213

*   *   *

Independence requirements also can be found in the SSARS, statements on auditing standards, and statements on standards for attestation engagements. While the authoritative literature governing these various types of engagements contains a great deal of discussion about the concepts of independence, identifying independence problems, and about resolving nonindependence situations, the basic concept of independence is the same regardless of the level of service or the type of engagement. Basically, accountants are independent if they are free from obligation to or interest in their clients.

Conceptual Framework for Independence. In January 2006, the Professional Ethics Executive Committee (PEEC) published a Conceptual Framework for AICPA Independence Standards (ET 100.01), which describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence. Revisions were made to Interpretation 101-1 at the same time.

No Independence Interpretations or Rulings. In situations where there are no independence interpretations or rulings that address an accountant's particular independence circumstance, the Interpretation 101-1 revisions require 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 must refer to the risk-based approach described in the Conceptual Framework for AICPA Independence Standards.

Required Documentation. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In instances where threats to independence are not at an acceptable level, thereby requiring safeguards, the following should be documented:

- The threats identified.
- The safeguards applied to eliminate the threats or reduce them to an acceptable level.

Unacceptable Risk. The Introduction to the Conceptual Framework for AICPA Independence Standards indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client.

Threats. Threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.
- *Advocacy threat.* Actions that promote an attest client's interests or position, such as representing a client in tax court.

- *Adverse interest threat.* Actions or interests between the accountant and the client that are in opposition, such as a threat of litigation by either party.

- *Familiarity threat.* Accountants who have close or longstanding relationships with attest clients.

- *Undue influence threat.* Attempts by an attest client's management to exercise influence over the accountant, such as pressure to reduce audit procedures for the purpose of reducing audit fees.

- *Financial self-interest threat.* Potential benefit to an accountant from a financial relationship with an attest client, such as excessive reliance on revenue from a single attest client.

- *Management participation threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

Safeguards. Safeguards are controls that mitigate or eliminate threats to independence. To be effective, safeguards must eliminate the threat or reduce to an acceptable level the threat's potential to impair independence. There are three broad categories of safeguards:

- *Safeguards created by the profession, legislation, or regulation.* Examples include continuing education requirements on independence and ethics, and external review of a firm's quality control system.

- *Safeguards implemented by the attest client.* Examples include a tone at the top that emphasizes the attest client's commitment to fair financial reporting, and policies and procedures that are designed to achieve fair financial reporting.

- *Safeguards implemented by the firm.* Examples include rotation of senior personnel who are part of the attest engagement team, and the involvement of another firm to perform part of an audit.

This over-arching principle in determining independence may cause legal liability concerns for accountants who will no longer be able to strictly use a rules approach to determining their independence. The provisions of the Conceptual Framework for AICPA Independence Standards became effective April 30, 2007. A copy of the Conceptual Framework and the revisions to Interpretation 101-1 can be found on the AICPA's Web site at **www.aicpa.org/members/div/ethics/index.htm**.

In addition, when performing an audit in accordance with the GAO's *Government Auditing Standards* (the Yellow Book), an auditor is required to adhere to the Yellow Book's independence standards. Accountants providing write-up services should be aware of those standards in order to determine whether their write-up services will impair their independence on other engagements. The Yellow Book independence requirements are discussed later in this lesson.

Impairment of Independence by Unpaid Fees

An accountant's independence can be impaired by unpaid fees. Specifically, Ethics Ruling No. 52 (ET 191.103–.104) states that an accountant's independence will be considered to be impaired if fees (billed or unbilled) for professional services rendered more than one year prior to the date of the accountant's compilation, review, or audit report remain unpaid when the current year's report is released. 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 engagement partner (or the in-charge accountant under the engagement partner's supervision) should have the primary responsibility for determining if there are unpaid fees that would impair the firm's independence. The write-up accountant should, however, periodically verify with the engagement partner as to whether fees (both billed and unbilled) for services provided more than one year prior to the date of the accountant's report have been paid. If they have not, then the firm is not independent with respect to that client.

Does Providing Write-up Services Impair an Accountant's Independence?

For a small business engagement, the most frequent concern about meeting independence requirements is the effect of providing general accounting or bookkeeping 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 a write-up services engagement, that impair his or her independence. The following paragraphs discuss the effects of accounting/write-up services on independence and specifically address Ethics Interpretation 101-3 (ET 101.05), *Performance of Nonattest Services*.

Performance of Nonattest Services. ET 92.01 defines an *attest engagement* as an engagement that requires independence. Audits, examinations, agreed-upon procedures engagements, reviews, and compilations are, therefore, attest engagements. With the exception of compilations, attest engagements cannot be performed if the accountant's independence is impaired; compilations can be performed provided the accountant's report discloses the lack of independence. Interpretation 101-3 (ET 101.5) describes the requirements that must be met in order for the performance of nonattest services for an attest client to *not* impair independence:

- *The Member Should Not Perform Management Functions.* Under the Interpretation, independence is considered to be impaired if an accountant (or his or her firm) performs management functions or makes management decisions for a client. However, the accountant may assist management in those functions or decisions.

- *The Attest Client Must Agree 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. Designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to be responsible for overseeing the services to be performed.

  b. Evaluate the adequacy and results of the services performed.

  c. Make all management decisions and perform management functions.

  d. Accept responsibility for the results of the services.

  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 Understanding Between the Member and the Client Must be Documented in Writing.* To help prevent any type of misunderstanding with the client, the Interpretation states that *before* performing the nonattest services for an attest client, the accountant must 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, and

  e. Any limitations of the engagement

  The Interpretation does not specify how the written understanding is to be documented, so the accountant has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an attest engagement. It is common in many small business engagements for the accountant to also provide nonattest services such as tax return preparation or bookkeeping services. Therefore, *PPC's Guide to Compilation and Review Engagements* includes sample engagement letters that contain sample documentation for instances when nonattest services are performed for compilation or review clients.

Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence regardless of whether the auditor complies with the other requirements of Interpretation 101-3 (ET 101.05). The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. The Interpretation specifically states that performance of the following general activities would impair an auditor's independence (that is, they would preclude the auditor from being independent):

- 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,
- Supervising client employees performing their normal recurring activities,
- Determining which of the auditor's recommendations should be implemented,
- Reporting to the board of directors on behalf of management,
- Serving as a client's stock transfer or escrow agent, registrar, or general counsel, and
- Establishing or maintaining internal controls, including performing ongoing monitoring activities for a client.

Exhibit 2-4 provides a table adapted from Interpretation 101-3 (ET 101.05) that lists various types of nonattest services an auditor may perform and addresses the impact of those services on the auditor's independence.

In addition, under Interpretation 101-3, 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. Interpretation 101-3 also addresses the impact of those services on the accountant's independence. According to the Interpretation, 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 of the Interpretation discussed previously (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 the board of directors and/or audit committee (if one exists) is fully informed of the engagement.

Exhibit 2-4

Impact on Independence of Performance of Nonattest Services[a]

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	• Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.	• Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents. • Make changes to source documents without client approval.
Nontax disbursement	• Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. • Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.	• Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Approve vendor invoices for payment.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Benefit plan administration[b]	• Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document. • Process transactions (e.g., investment/ benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member's electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium.	• Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence. • Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
Investment—advisory or management	• Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. • Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks. • Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (a) following the guidelines of the client's investment policy statement; (b) meeting the client's investment objectives; and (c) conforming to the client's stated investment styles. • Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction.	• Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. • Execute a transaction to buy or sell a client's investment. • Have custody of client assets, such as taking temporary possession of securities purchased by a client.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Corporate finance—consulting or advisory	• Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources. • Assist in drafting an offering document or memorandum. • Participate in transaction negotiations in an advisory capacity. • Be named as a financial advisor in a client's private placement memoranda or offering documents.	• Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Executive or employee search	• Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity.	• Commit the client to employee compensation or benefit arrangements. • Hire or terminate client employees.
Business risk consulting	• Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements.	• Make or approve business risk decisions. • Present business risk considerations to the board or others on behalf of management.
Information systems—design, installation, or integration	• Install or integrate a client's financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package). • Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system. • Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records. • Provide training and instruction to client employees on an information and control system.	• Design or develop a client's financial information system. • Make other than insignificant modifications to source code underlying a client's existing financial information system. • Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system.

Notes:

[a] This exhibit is adapted from AICPA Ethics Interpretation 101-3 (ET 101.05), "Performance of Nonattest Services," as amended July 2007.

[b] When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed.

*   *   *

Should Proposing Journal Entries and Preparing Financial Statements in Connection with an Audit be Viewed as Bookkeeping and, Therefore, Nonattest Services? Interpretation 101-3 includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, the Interpretation provides several examples of services that would be considered bookkeeping. Two of those examples, which are listed in Exhibit 2-4, are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client and (b) preparing financial statements based on information in the trial balance. Practice questions have arisen as to whether those examples mean that proposing journal entries and preparing financial statements in connection with a compilation or review should be viewed as bookkeeping and, therefore, nonattest services subject to the Interpretation. As a practical matter, small and midsize nonpublic entities typically view proposing journal entries and preparing financial statements as part of the attest engagement, and, based on implementation guidance provided in questions and answers published by the AICPA Professional Ethics Executive Committee (PEEC) during 2004 and 2005, it seems that PEEC did not intend for Interpretation 101-3 (ET 101.05) to require viewing those services as separate from the attest engagement.

Bookkeeping services are services that involve processing an entity's transactions or preparing an entity's accounting records. For example, preparing an entity's accounting journals and ledgers by entering information provided by management into QuickBooks® or other accounting software is a bookkeeping service because it involves preparing an entity's accounting records. Bookkeeping services that—

a. Constitute management functions, such as authorizing or approving purchase orders or preparing sales invoices, would impair independence.

b. Do not constitute management functions, such as recording disbursements approved by management, would not impair independence provided the accountant obtained the understanding with the entity required by the Interpretation. Failure to obtain the required understanding would impair independence. However, failure to comply with the Interpretation's requirement to document that understanding would not impair independence but would be a violation of Rule 202, *Compliance With Standards*, of the *AICPA's Code of Professional Conduct*. A violation under Rule 202 is much less severe than a violation under Rule 101. In peer review, a violation under Rule 202 may only generate an item for discussion versus a Rule 101 violation, which could result in a modified opinion.

Preparing financial statements as part of a compilation or review would not be considered a bookkeeping service. Preparing financial statements as part of the attest service does not involve processing the entity's transactions or preparing its accounting records.

Proposing adjustments of an entity's accounting records in connection with a compilation or review also would not be considered a bookkeeping service. To illustrate, assume that as part of the review of the financial statements of a small or midsize nonpublic entity the accountant proposes journal entries to capitalize improvements recorded as repairs expense and to charge to expense repairs capitalized as improvements; to record depreciation calculated using the accountant's depreciation software; to convert the carrying amounts of inventory and cost of sales from amounts determined using the first-in, first-out method to the last-in, first-out method based on the accountant's calculation of indexes and changes in layers; to recognize liabilities for subsequent disbursements; to record the valuation allowance for customer account balances; and to record the current and deferred income tax provisions. Those are adjustments of the accounting records prepared by the entity. Accordingly, they should not be viewed as bookkeeping services and, therefore, would not be subject to the Interpretation.

The number of journal entries proposed in connection with a compilation or review is not relevant to whether that is a bookkeeping service and, therefore, subject to the Interpretation. As a practical matter, however, the entity's accounting records may be in such poor condition that the accountant cannot perform sufficient procedures to determine the journal entries needed. To overcome the scope limitation, bookkeeping services may be performed to bring those inadequate accounting records into substantial completion so that the accountant can perform the required procedures.

To illustrate, assume that an entity changed accounting software during the year and did not have sufficient controls in place to ensure the proper transfer of accounting information and that since the conversion, totals of subsidiary ledgers have differed materially from the related general ledger account balances. In that situation, the accountant would be unable to perform sufficient procedures to determine the journal entries needed to issue either a compilation or review report. That scope limitation could be overcome by having the entity, members of the accountant's firm, or a bookkeeping service prepare adequate accounting records for the period from just prior to the conversion through year-end.

Accountants who are unable to make a judgment as to whether they are providing bookkeeping services are not prohibited from concluding that they are providing services subject to the Interpretation and following the Interpretation's requirements.

Additional Questions in Applying Interpretation 101-3 (ET 101.05). The following are questions that are likely to arise as accountants apply the requirements of the Interpretation.

- *Impact on Compilation and Review Services.*
  - *Question*—How does Interpretation 101-3 (ET 101.05) impact compilation and review services?
  - *Response*—If the accountant performs nonattest services for a compilation or review client, independence will be impaired if *any* of the following occurs:
    a. The accountant performs management functions or makes management decisions.
    b. The client is unwilling or unable to assume *all* of the responsibilities for: management decisions and functions; designating an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee any nonattest services performed for the client, such as bookkeeping services, payroll services, tax services, or profit-sharing plan services; evaluating the adequacy and results of, and accepting responsibility for, the services provided; and establishing and maintaining internal controls, including monitoring related ongoing activities.
    c. The accountant does not establish the understanding with the client regarding: the objectives of the engagement, the services to be performed, the client's acceptance of its responsibilities, the accountant's responsibilities, and any limitations of the nonattest engagement.

  If independence is impaired, the accountant may still issue a compilation report as long as the report is modified to indicate the lack of independence. In a compilation engagement in which the financial statements are intended for management-use-only, the engagement letter would need to be modified, in lieu of the report, to indicate the lack of independence. The following sentence should be added to either the report or the engagement letter, as applicable, to indicate the lack of independence.

  > We are not independent with respect to the entity.

- *Providing Routine Advice to Clients.*
  - *Question*—If a client calls the accountant and asks a technical question, would this be considered a nonattest service for which ET Interpretation 101-3 (ET 101.05) would apply?
  - *Response*—No, routine activities performed by the accountant, such as providing advice and responding to clients' technical questions as part of the normal client-accountant relationship, are not considered nonattest services for which ET Interpretation 101-3 (ET 101.05) would apply.

- *Inadvertent Noncompliance.*
  - *Question*—What if the accountant inadvertently fails to comply with the Interpretation's requirement to document in writing the accountant's understanding with the client?
  - *Response*—A failure to document the understanding with the client is not considered to impair a member's independence provided such understanding has been established. Rather, such a failure, regardless of whether it was isolated or inadvertent, would be considered a failure to comply with an ethics standard under Rule 202, *Compliance with Standards*.
- *Independence Rules of Other Regulatory Bodies.*
  - *Question*—If the accountant performs attest services for his or her client and the work is subject to oversight by other regulatory bodies (e.g., Government Accountability Office, Department of Labor, and Securities and Exchange Commission), how does the Interpretation apply?
  - *Response*—The requirements of the Interpretation must be met, along with any independence rules of the applicable regulatory body that are more restrictive than the requirements of the Interpretation. Failure to comply with independence rules of the regulatory body relating to nonattest services would constitute a violation of the Interpretation.
- *Assessing Whether an Individual Possesses Suitable Skill, Knowledge, or Experience*
  - *Question*—How does an accountant assess a client's designated employee possess suitable skill, knowledge, or experience as required by the Interpretation?
  - *Response*—It is not intended that the client employee possess a level of technical expertise equal to the accountant's. The client employee need only understand the nonattest services enough to be able to provide general direction for the services; understand the key issues the accountant identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the accountant's work. This may mean the accountant will need to educate his or her client in order to allow them to assume these responsibilities. For example, if the accountant performs routine bookkeeping services for an attest client, he or she could ensure compliance with the requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client should then be in a position to approve the journal entries and accept responsibility for the financial statements.
- *Nonattest Services Performed before the Client Becomes an Attest Client.*
  - *Question*—The accountant accepts a compilation or review engagement for a client for whom he or she has previously provided only bookkeeping services. Prior to accepting the attest engagement, the practitioner does not have a written understanding with the client under Interpretation 101-3. Has the practitioner violated the requirements of the Interpretation?
  - *Response*—No, the ET 101-3 documentation requirements does not apply to nonattest services performed before the client becomes an attest client. The accountant would be permitted to prepare the required documentation upon acceptance of the compilation or review engagement, provided the accountant is able to demonstrate his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client. As a practical matter, practitioners who are initially engaged to only provide nonattest services but expect to subsequently be engaged to also provide attest services should consider structuring the engagement so that performance of the nonattest services will not impair independence for the attest services.

Illustrative Examples. Independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions about independence but are not necessarily impairment problems. The following paragraphs provide several scenarios relating to accounting services in which accountants' independence might be impaired.

a. **Scenario:** A CPA accepts the responsibility of signing or cosigning a client's checks in emergency situations.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired since such activities are considered management functions. Having the authorization to sign or cosign checks on a client's bank account, even if such activity is never performed, impairs independence.

b. **Scenario:** A CPA performs payroll services for a client including preparing payroll tax forms and returns (for example, Form 941, Form W-2, etc.) and preparing semimonthly payroll checks. The CPA also cosigns each payroll check on behalf of an officer of the client.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired because having the authorization to sign or cosign checks on a client's bank account is a management function. However, preparation of payroll tax returns does not impair independence as long as the auditor does not have the authority to sign them. In addition, making electronic payroll tax payments does not impair independence provided the payments are made in accordance with U.S. Treasury Department or comparable guidelines and the client has made arrangements for its financial institution to limit such payments to the named payee.

c. **Scenario:** When performing monthly accounting services for a client, the CPA codes the check stubs (that is, determines the general ledger accounts to which the disbursements should be recorded and writes the appropriate account numbers on each check stub) based on the description included by the client on the check stubs.

   Is Independence Impaired? No, independence is not impaired. Normally, coding check stubs will not impair the accountant's independence as long as the client provides sufficient detail to clearly identify the nature of each transaction. Note that, in some cases, the accountant can determine the nature of a transaction based on who the check has been issued to (for example, the electric company, office supply company, etc.). However, the accountant should be careful not to assume the role of management, thereby losing independence with respect to the client.

d. **Scenario:** A CPA records journal entries in the client's accounting system.

   Is Independence Impaired? No, the accountant's independence would not be impaired provided that the client understands the nature and impact of the journal entries. For example, the accountant could provide the client with a printout of proposed journal entries accompanied by clear explanations, ask the client to review the printout, and then ask whether the client has any questions about the entries. Although not required, some accountants obtain the client's written approval of the proposed journal entries by, for example, signing or initialing the journal entries or on a separate journal entry approval form. If a representation letter is obtained (as in a review) such language might also be included in the representation letter.

e. **Scenario:** A CPA installs pre-packaged accounting software, such as QuickBooks, for his or her client and sets up the chart of accounts and financial statement format defaults.

   Is Independence Impaired? No, the CPA's independence is not impaired. In its *Background and Basis for Conclusions*, the Professional Ethics Executive Committee states that independence is not considered impaired, as this type of service does not constitute "designing" a system, provided the CPA does not create or change the source code(s) underlying the pre-packaged software.

The AICPA has an Ethics Hotline where members of the AICPA's Professional Ethics Team answer questions about independence and other behavioral issues. The toll-free number for the Ethics Hotline is (888) 777-7077 and the email address is ethics@aicpa.org.

Yellow Book Independence Requirements

When performing an audit in accordance with the GAO's *Government Auditing Standards*, (the Yellow Book), an auditor is required to adhere to the Yellow Book's independence standards. The Yellow Book addresses a wide range of auditor independence issues. The independence rules prevent auditors from performing certain nonaudit services. Some, but not all, write-up services described in this course may impair independence. Although Amendment No. 3 specifies certain nonaudit services that would and would not impair auditor independence, it acknowledges that it would be impossible to define every situation. Therefore, it uses a principle-based approach for determining that the auditor maintains independence in fact and appearance.

The GAO implementation guidance titled *Government Auditing Standards: Answers to Independence Questions* responds to questions related to the Yellow Book implementation time frame, underlying concepts, and application in specific nonaudit circumstances. The Yellow Book and the question and answer implementation guidance are available from the GAO's website at **www.gao.gov/govaud/ybk01.htm**.

The Yellow Book and the Q&A state that, if the audit firm maintains or prepares the entity's basic accounting records or maintains or takes responsibility for the entity's basic financial or other records that the firm will audit, the audit firm would not be independent to perform a financial statement audit of the entity. The Amendment and the Q&A list the following services as examples of services that would impair the firm's independence:

- Posting (whether or not coded by the entity) to the entity's financial records or to other records that subsequently provide data to the entity's financial records.
- Processing the entity's entire payroll, and payroll is a material amount to the subject matter of the audit. (The term *subject matter of an audit* refers to the financial statements on which an auditor's opinion is being expressed.)

The Yellow Book and the Q&A include examples of nonaudit services a firm can provide as long as it avoids situations that would violate either of two "overarching principles." The two overarching principles require that:

- Audit organizations not perform management functions or make management decisions.
- Audit organizations not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

The Q&A indicates in most instances that these services are considered by the GAO to be nonaudit services. The Amendment emphasizes that the services on the list are only examples. The examples include the following:

- Basic accounting assistance limited to services such as—
  - Preparing draft financial statements that are based on entity management's chart of accounts and trial balance and any adjusting, correcting, and closing entries that have been approved by the entity's management.
  - Preparing draft notes to the financial statements based on information determined and approved by the entity's management. (However, the draft financial statements and notes must be reviewed and approved by management, who must have adequate knowledge to evaluate and take responsibility for the result. In addition, the management representation letter should acknowledge auditor's role and management's review, approval, and responsibility for the financial statements and notes.)
  - Preparing a trial balance based on the entity's management's chart of accounts.
  - Maintaining depreciation schedules for which the entity's management has determined the method and rate of depreciation and salvage of the assets.
  - The Q&A discusses other situations relative to basic accounting assistance including, compilation services, supporting schedules, emergency services, assistance in implementing GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and assistance in reconciling bank accounts.

- Payroll services limited to services such as—
    - Computing pay amounts for the entity's employees based on entity maintained and approved time records, salaries or pay rates, and deductions from pay.
    - Generating unsigned payroll checks.
    - Transmitting entity approved payroll to a financial institution providing that the entity's management has approved the transmission and limited the institution to making payments only to previously approved individuals.
- Preparing routine tax filings in accordance with federal tax laws and rules and regulations of the Internal Revenue Service and state and local tax authorities and any applicable laws.

Accountants that provide write-up services to their clients that require a Yellow Book audit should determine whether those services impair their independence under the standards. If an accountant's independence is or would be impaired, the accountant and the client will need to choose which services the accountant will provide for the client. *PPC's Guide to Single Audits* contains further discussion of the 2007 Yellow Book and addresses the Yellow Book's requirements relating to nonaudit services.

SELF-STUDY QUIZ

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

38. What does The Conceptual Framework for AICPA Independence Standards published by the Professional Ethics Executive Committee (PEEC) describe?

    a. The primary rules governing independence.

    b. Statements on auditing standards and statements on standards for attestation engagements.

    c. The risk-based approach used by the PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.

39. There are numerous threats to independence. One example is the ____________ threat in which the accountant has a close or longstanding relationship with attest clients.

    a. Self-review.

    b. Adverse interest.

    c. Undue influence.

    d. Familiarity.

40. The Able Body accounting firm requires its accountants to meet continuing education requirements on independence and ethics. They are using which category of safeguards?

    a. Safeguards created by the profession, legislation or regulation.

    b. Safeguards implemented by the attest client.

    c. Safeguards implemented by the firm.

41. In order to **not** impair independence, which of the following requirements must be met in the performance of nonattest services?

    a. The member should perform management functions.

    b. The attest client must not perform certain functions.

    c. The understanding between the member and the client must be documented in writing.

42. All of the following general activities would impair an auditor's independence, **except**:

    a. Preparing source documents

    b. Having custody of client assets.

    c. Exercising authority on behalf of a client.

    d. Performing an actuarial valuation of a client's pension liabilities.

43. Warren handles payroll for his small business client. Which one of the following actions would impair his independence?

    a. Using payroll time records provided and approved by the client.

    b. Have custody of the client's payroll account.

    c. Generating unsigned paychecks.

    d. Transmitting client-approved payroll to a financial institution.

SELF-STUDY ANSWERS

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

38. What does the Conceptual Framework for AICPA Independence Standards published by the Professional Ethics Executive Committee (PEEC) describe? **(Page 90)**

    a. The primary rules governing independence. [This answer is incorrect. The primary rules governing independence are found in the AICPA *Code of Professional Conduct* (Conduct Code).]

    b. Statements on auditing standards and statements on standards for attestation engagements. [This answer is incorrect. The Statements on Standards for Accounting and Review Services (SSARS), contain statements on auditing standards and statements on standards for attestation engagements. They also contain independence requirements.]

    c. The risk-based approach used by the PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence. [This answer is correct. In January 2006, the PEEC published a Conceptual Framework for AICPA Independence Standards (ET 100.01), which describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.]

39. There are numerous threats to independence. One example is the ____________ threat in which the accountant has a close or longstanding relationship with attest clients. **(Page 90)**

    a. Self-review. [This answer is incorrect. The self-review threat is reviewing your own nonattest work, or that of your team, as part of the attest engagement.]

    b. Adverse interest. [This answer is incorrect. The adverse interest threat refers to actions or interests between the accountant and the client that are in opposition, such as a threat of litigation by either party.]

    c. Undue influence. [This answer is incorrect. The undue influence threat refers to 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.]

    d. Familiarity [This answer is correct. According to the Conceptual Framework, threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. The familiarity threat refers to accountants having the types of relationships described above.]

40. The Able Body accounting firm requires its accountants to meet continuing education requirements on independence and ethics. They are using which category of safeguards? **(Page 91)**

    a. Safeguards created by the profession, legislation or regulation. [This answer is correct. Safeguards are controls that mitigate or eliminate threats to independence. Safeguards created by the profession, legislation, or regulation include continuing education requirements on independence and ethics, and external review of a firm's quality control system.]

    b. Safeguards implemented by the attest client. [This answer is incorrect. Safeguards implemented by the attest client 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.]

    c. Safeguards implemented by the firm. [This answer is incorrect. Safeguards implemented by the firm include rotation of senior personnel who are part of the attest engagement team, and the involvement of another firm to perform part of an audit.]

41. In order to **not** impair independence, which of the following requirements must be met in the performance of nonattest services? **(Page 92)**

    a. The member should perform management functions. [This answer is incorrect. The member should not perform management functions. Under Interpretation 101-3, independence is considered to be impaired if an accountant (or his or her firm) performs management functions or makes management decisions for a client. However, the accountant may assist management in those functions or decisions.]

    b. The attest client must not perform certain functions. [This answer is incorrect. According to Interpretation 101-3, the attest client must agree 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.]

    c. The understanding between the member and the client must be documented in writing. [This answer is correct. To help prevent any type of misunderstanding with the client, Interpretation 101-3 states that *before* performing the nonattest services for an attest client, the accountant must document in writing his or her understanding with the client.]

42. All of the following general activities would impair an auditor's independence, **except**: **(Page 93)**

    a. Preparing source documents [This answer is incorrect. Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction is considered an activity that would impair an auditor's independence under Interpretation 101-3.]

    b. Having custody of client assets. [This answer is incorrect. Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence regardless of whether the auditor complies with the other requirements of Interpretation 101-3. Having custody of client assets is an example.]

    c. Exercising authority on behalf of a client. [This answer is incorrect. Interpretation 101-3 specifically states that performance of certain activities would impair an auditor's independence. Exercising authority on behalf of a client, such as authorizing, executing, or consummating a transaction, or having the authority to do so is an example.]

    d. Performing an actuarial valuation of a client's pension liabilities. [This answer is correct. An actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence under Interpretation 101-3 even if the amount was material.]

43. Warren handles payroll for his small business client. Which one of the following actions would impair his independence? **(Page 94)**

    a. Using payroll time records provided and approved by the client. [This answer is incorrect. The accountant's independence would not be impaired under Interpretation 101-3 by using payroll time records provided and approved by the client or processing the client's payroll.]

    b. Have custody of the client's payroll account. [This answer is correct. According to Interpretation 101-3, the accountant's independence is impaired by maintaining a client's bank account or otherwise having custody of a client's funds.]

    c. Generating unsigned paychecks. [This answer is incorrect. Based on the guidance found in Interpretation 101-3, an accountant's independence is not impaired by generating unsigned checks. However, accepting responsibility to authorize payment of client funds would impair independence.]

    d. Transmitting client-approved payroll to a financial institution. [This answer is incorrect. Independence would not be impaired under Interpretation 101-3 when transmitting client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (WUSTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. Which of the following statements about a bookkeeping system is most accurate?

    a. The basic steps necessary to record transactions usually vary significantly from company to company.

    b. A bookkeeping system *must* use a chart of accounts that provides for every conceivable transaction.

    c. Reconciling cash accounts in a bookkeeping engagement normally requires a roll forward of cash account balances from the beginning of the period to the end of the period.

    d. A bookkeeping system *must* be complex and need not consider the types of transactions into which the business enters.

21. The first step in the suggested approach for processing accounting information is to:

    a. Record cash receipts and disbursements.

    b. Record sales.

    c. Adjust accounts payable.

    d. Reconcile cash accounts.

22. Hank is ready to record cash disbursements. In order to be sure the checks are properly coded, Hank should do all because of the following, **except**:

    a. Be consistent from one period to the next.

    b. Use a chart of accounts that has been updated.

    c. Consult with the client after coding, if there is a question.

    d. Double-check numbers from the department or cost center.

23. A small business has an exchange of nonmonetary assets that facilitates sales to its customers. How should this exchange be treated under FASB ASC 845-10?

    a. It should be recorded based on the exchanged assets' fair value and a gain or loss on the transaction recognized.

    b. It should be measured based on the surrendered asset's recorded value, which would be reduced if the value was impaired.

    c. It should be recorded based on the fair value of the asset received in the exchange.

    d. Since the exchange is nonmonetary, no value needs to be recorded regarding the exchange.

24. What method of depreciation allocates the cost disproportionately over the asset's useful life so that most of the cost is charged to the early years.

    a. Straight-line.

    b. Accelerated.

    c. Allocation.

    d. Useful life.

25. Hartsmith Bookkeeping Firm is conducting a review of the preliminary general ledger for a client. From the answer choices below, select the choice that best indicates what has already occurred in the transaction processing cycle and the reason for the preliminary general ledger review.

    a. The books are about to be closed and all unusual account variances have been explained.

    b. Subsidiary journal entries are being compared to invoices for accuracy.

    c. Proposed journal entries have been posted and unusual account balances are being detected.

    d. The chart of accounts is being established on a new software platform and the client is new to the firm.

26. Which of the following controls **cannot** be used to determine whether amounts were incorrectly entered or classified?

    a. Prepare an adding machine tape of all debit entries and agree the total to the total amount of debits the computer processed.

    b. Agree the ending general ledger balances to related subledger totals.

    c. Agree the ending general ledger cash balances to the ending bank reconciliation balances.

    d. Agree the ending general ledger cash balances to journal entries.

27. Which procedure is usually performed only during year-end processing?

    a. Inventory accounts are adjusted to physical inventory amounts.

    b. Accounting records are converted from accrual basis to the cash basis.

    c. Depreciation accounts are eliminated.

    d. Income tax expenses are estimated.

28. After the year's transactions and adjustments have all been recorded, how is the general ledger "closed"?

    a. All information is deleted and a new year is begun.

    b. All income and expense accounts are reduced to zero by transferring their balances to owners' equity.

    c. All asset and liability accounts are reduced to zero by transferring their balances to income.

    d. All equity accounts are converted to the income statement.

29. Which of the following is **not** an accurate statement regarding sales tax collection?

    a. It is the accountant's responsibility to recognize the state requirements for sales tax collection.

    b. A business is required to collect sales taxes when it sells goods and meets certain conditions in a state.

    c. A business must register to do business in the state and register to collect sales taxes.

    d. A business must pay the state's franchise or capital taxes.

30. Which of the following is the name of an effort to simplify and modernize the collection and administration of sales and use tax?

    a. Simplified Exemption Administration

    b. Streamlined Sales Tax Project

    c. Uniform Sourcing Rules

    d. Rate Simplification Project

31. For sales to customers, which piece of information does a business **not** need to record?

    a. The location that the sale occurred.

    b. The tax rate.

    c. The time of day the sale occurred.

    d. The sales price of the goods or services sold.

32. When describing sales tax exemption certificates, which statement is most accurate?

    a. The business determines the wording of the exemption certificate.

    b. Most states will accept the Multistate Tax Commission form.

    c. During an audit, most states will allow the seller to obtain exemption certificates for previous sales.

    d. Few states require the seller to check the reasonableness of the claimed exemption.

33. Which of the following transactions is usually exempt from sales tax?

    a. Labor and service charges.

    b. Barter and exchange.

    c. Office machinery

    d. Professional services.

34. Frank is computing the sales tax liability for Royal Printing Company. Which one of the following items does he **not** need to obtain from the client?

    a. Purchases made by the business.

    b. Non-exempt customer sales.

    c. Exempt customer sales.

    d. Sales taxes collected from customers.

35. In which of the following scenarios, has an issue related to the preparation of sales and use tax returns been dealt with correctly?

    a. Princess Puffs has no sales and use tax activity, so no return is filed for the year.

    b. Shoe Match's sales and use tax liability account is finalized for the year and does not balance with the associated liability account.

    c. Write Stuff receives a discount for filing its state sales tax return on time, and credits it to the sales and use tax liability account.

    d. Cupcake Café keeps an audit trail for all receivables that are written off during the year.

36. Rick has a long-time client for which he performs write-up services. Under current authoritative guidance, which of the following can Rick provide his client since his independence is impaired?

    a. Issue an audit report on the financial statements he prepared.

    b. Perform a review of the financial statements he prepared.

    c. Compile financial statements as long as he discloses his lack of independence.

    d. Do not select this answer choice.

37. An *attest engagement* requires independence. Which of the following services is a nonattest service?

    a. Audit

    b. Examination

    c. Bookkeeping

    d. Reviews

38. For an accountant to perform an attest engagement, the client must agree to perform **all but which one** of the following:

    a. Evaluate the results of the services performed, as well as their adequacy.

    b. Defer management decisions to the accountant.

    c. Accept responsibility for the results of the services that were preformed.

    d. Designate an individual as responsible for oversight of the services performed.

39. Interpretation 101-3 states that performance of certain general activities impairs an auditor's independence. Which of the following is **not** one of those activities?

    a. Supervise client employees as they perform normal recurring activities.

    b. Serve as a stock transfer or escrow agent, registrar, or general counsel for client.

    c. Recommend a plan to improve a client's control processes.

    d. Report to the board of director's on management's behalf.

40. Which of the following services violates an accountant's independence under *Government Auditing Standards* (the Yellow Book)?

    a. Posting an entity's financial records.

    b. Preparing draft financial statements based on management's information.

    c. Preparing a trial balance based on management's chart of accounts.

    d. Preparing draft notes based on information from management.

GLOSSARY

Accrual Basis of Accounting: The method of recording transactions by which revenues and expenses are reflected in the accounts in the period in which they are considered to have been earned and incurred, respectively, whether or not such transactions have been finally settled by the receipt or payment of cash or its equivalent.

Assets: Are economic resources that have the following essential characteristics: (1) they represent probable future benefits that can contribute directly or indirectly to future net cash flows, (2) an entity can obtain those benefits and control others' access to it, and (3) the event giving rise to the entity's right or control of the benefits has already occurred. Examples of assets include cash, marketable securities, accounts receivable, inventories, and equipment.

Attest Engagement: An engagement that requires independence. Audits, examinations, agreed-upon procedures engagements, reviews, and compilations are, therefore, attest engagements.

Balance Sheet: The balance sheet (or statement of financial position) is a financial statement that reports an entity's assets, liabilities, and equity at a specific point in time.

Bookkeeping System: A system that provides controls to ensure that information about all of the company's transactions are captured and accurately recorded

Cash Basis of Accounting: The method of recording transactions based solely on cash receipts and disbursements (that is, cash in/cash out).

Cash Receipts System: A system used to record the receipt of cash from all sources.

Chart of Accounts: A listing of the accounts necessary to capture the appropriate financial information for the business.

Depreciation: The accounting process of allocating the cost of an asset to expense over the useful life of the asset.

Equity: Often referred to as net assets and is the residual interest in an entity's assets after deducting its liabilities.

Expenses: Are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from producing or delivering goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

General Ledger: A general ledger is a record containing all of an entity's asset, liability, equity, revenue, expense, gain, and loss accounts. It is the record from which the information necessary to prepare financial statements is obtained. Accordingly, it contains summary totals of all transactions entered in special journals (or books of original entry).

Income Statement: A financial statement that reports an entity's results of operations for a specific period.

Income Tax Basis of Accounting: The income tax basis of accounting is the method of accounting that an entity uses, or expects to use, to file its income tax return. It is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures.

Liabilities: Are economic obligations that have the following characteristics: (1) they represent present duties to one or more entities that will be settled by the transfer or use of assets at a specified date, on occurrence of a specified event, or on demand; (2) they obligate an entity, leaving it little or no discretion to avoid the future sacrifice of assets; and (3) the transaction obligating the entity has already occurred. Examples of liabilities include accounts payable, accrued expenses, notes payable, and revenues collected in advance.

Other Comprehensive Basis of Accounting (OCBOA): The financial statements of many small to medium-sized businesses will be prepared in conformity with an OCBOA (that is, a comprehensive basis of accounting other than generally accepted accounting principles).

Record Retention Policy: A policy for determining how long bookkeeping records are kept. The policy may vary depending on regulatory requirements, company (or CPA firm) policies, and the type of records. Obviously, the records should be kept so long as they serve a useful purpose or until all legal and regulatory requirements are met.

Revenues: Are actual or expected cash inflows that have occurred or will eventuate as a result of an entity's major or central operations.

Sales Tax Exemption Certificate: A certificate indicating the customer is exempt from sales taxes on transactions with various vendors.

Special Journals: Transactions are first recorded in special journals and then totaled periodically and recorded in the general ledger as one amount. Because entries in special journals come directly from documents that authorize the transactions, the journals are referred to as "books of original entry."

Statement of Cash Flows: A statement of cash flows has the following five basic elements: (1) cash flows from operations, (2) cash flows from investing activities, (3) cash flows from financing activities, (4) net change in cash during the period, and (5) supplemental disclosure of noncash investing and financing activities.

Streamlined Sales Tax Project: An effort created by state governments, with input from local governments and the private sector, to simplify and modernize the collection and administration of sales and use tax.

Subsidiary Ledger: Is used to keep track of various details that may relate to a specific general ledger account. When a subsidiary ledger is used, the related general ledger account functions as a control account and equals the total of all accounts maintained in the subsidiary ledger.

Unpaid Invoice File: Provides adequate control over unpaid invoices. Under such a system, each vendor invoice is approved when it is received and then placed in a "tickler" file according to the date that it should be paid.

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COMPANION TO PPC'S GUIDE TO WRITE-UP SERVICES

COURSE 2

MANAGING A WRITE-UP PRACTICE (WUSTG092)

OVERVIEW

COURSE DESCRIPTION:	This course offers guidance on designing a successful write-up practice. This course presents general information about obtaining and retaining clients and staff. The course takes the learner through the entire process, from engagement letter to report delivery. In addition, there is a discussion addressing quality control standards, disaster recovery and succession planning.
PUBLICATION/REVISION DATE:	December 2009
RECOMMENDED FOR:	Users of *Users of PPC's Guide to Write-Up Services*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting.
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Business Management & Organization
EXPIRATION DATE:	Postmark by **December 31, 2010**
KNOWLEDGE LEVEL:	Overview

LEARNING OBJECTIVES:

Lesson 1—The Elements of a Successful Write-up Practice

Completion of this lesson will enable you to:
- Recognize the characteristics of a successful write-up practice and describe the development process of planning for a firm.
- Identify methods to develop and retain qualified staff.
- Identify engagement continuation and termination factors.
- Discuss the use of engagement letters to help determine the client's needs and the intended use of the financial statements.
- Identify the considerations for preparing firm reports and correspondence.
- Describe the need for due date monitoring systems and implement billing and collecting procedures.

Lesson 2—Quality Control Standards, Disaster Recovery and Succession Planning

Completion of this lesson will enable you to:
- Recognize the quality control standards that contribute to a successful write-up engagement process.
- Determine the risks and responsibilities in an engagement.
- Identify the features of a disaster recovery plan and a succession plan for a firm.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
WUSTG092 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: The Elements of a Successful Write-up Practice

INTRODUCTION

The services provided during each write-up engagement may vary. For example, some engagements may only require bookkeeping services while others may require bookkeeping, payroll, and compilation services. Even if the same write-up services are provided for each engagement, the complexity of each engagement may vary depending on the client's size and industry and on the sophistication of the client's accounting system. This course discusses the administrative procedures that should be considered on all engagements regardless of their complexity or the services provided. The course also provides general considerations for managing a write-up practice. Although some of the issues discussed apply primarily to accountants in public practice (such as the discussions on engagement acceptance and continuance, engagement letters, marketing write-up services, billing and collecting write-up services, and professional liability insurance), many of the concepts discussed apply to accountants both in industry and public practice. The following topics are covered in this course:

- Developing a Successful Write-up Practice.
- How to Obtain and Retain a Qualified Staff.
- Accepting and Continuing an Engagement.
- What to Consider in an Engagement.
- Processing Reports, Tax Returns, and Correspondence.
- Implementing a Due Date Monitoring System.
- Billing and Collecting.
- When to apply Quality Control Standards to Write-up Engagements.
- Practice Issues in Write-up Engagements.
- Disaster Recovery Planning.
- Succession Planning.

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize the characteristics of a successful write-up practice and describe the development process of planning for a firm.
- Identify methods to develop and retain qualified staff.
- Identify engagement continuation and termination factors.
- Discuss the use of engagement letters to help determine the client's needs and the intended use of the financial statements.
- Identify the considerations for preparing firm reports and correspondence.
- Describe the need for due date monitoring systems and billing and collecting procedures.

DEVELOPING A SUCCESSFUL WRITE-UP PRACTICE

Characteristics of a Successful Practice

Successful write-up practices possess characteristics that distinguish them from others. Some of those characteristics are discussed in the following paragraphs.

Commitment. To be successful, a firm must commit sufficient financial, personnel, and other physical resources to its write-up practice. The nature and extent of the necessary resources depends on the types of write-up services the firm intends to provide and the types of clients and industries that the firm intends to serve. That does not mean that a substantial amount of resources must be committed, however. Since much of the work can be performed by paraprofessionals and entry level accountants, a write-up practice often requires less resources than an audit, tax, or consulting practice.

Leadership. Effective leadership is an essential ingredient for success. Although much of the write-up engagement may be performed by the professional staff or paraprofessionals, a partner should be involved in and ultimately responsible for each engagement. The involvement of a partner demonstrates the firm's commitment to the client. It also provides the personal contact that is necessary to maintain strong relationships with clients and to identify other services that clients may need.

Philosophy. A critical element of a successful write-up practice is its philosophy about write-up services. Are they viewed as routine bookkeeping engagements or as important services that can provide many opportunities for firm growth? The philosophy bears directly on the extent of the firm's commitment to its write-up practice. Elements of a successful firm's philosophy include a marketing orientation, adaptability, and a cooperative attitude among partners and staff.

Reputation. A successful firm must have a reputation within the community of being able to effectively meet the needs of its clients. Once developed, a firm's reputation can be one of its greatest assets for obtaining new clients. Achieving a good reputation requires strong marketing techniques as well as the ability to continually provide the needed services.

Planning for a Successful Practice

It has often been said that accounting firms that "fail to plan, plan to fail." This may be somewhat of an exaggeration, but, experience shows, firms that take the time to develop comprehensive business plans are usually more successful than firms that do not. At least firms that have gone through the planning process described in this lesson know where they want to go and how they intend to get there. Comprehensive business plans have the following three essential components:

- A strategic plan.
- A detailed budget.
- A succession plan.

Many small to mid-sized accounting firms believe that strategic planning is strictly for the larger firms. However, this lesson discusses the planning process that CPA firms of all sizes should periodically go through. This process is designed to help a firm grow by focusing on its strengths and overcoming its weaknesses. Only by going through a comprehensive planning process can a firm determine where it is now, where it wants to go in the future, and how it is going to get there.

In simple terms, a comprehensive planning system is designed to accomplish the following tasks:

a. Develop a firm's goals (strategic planning).

b. Quantify the financial impact of those goals (budgeting).

c. Define how the firm ensures continuity in key practice areas and plans for the transfer of ownership (succession planning).

d. Obtain commitment to achieve the firm's goals (individual performance planning).

e. Evaluate the success or failure of its plan (plan review).

By investing time in the planning process described in this lesson, accounting firms can usually improve their operations by focusing on where they want to go in the future and developing a detailed plan that will help them get there. Once a business plan has been developed and endorsed by the firm's partners and employees, it should then be updated continuously and revised as necessary.

There are two basic approaches to strategic planning: the top-down approach and the participative approach. In a top-down approach, the managing partner (or managing partners) develops the plan based upon his or her own perception of the goals, making all the decisions about the direction and strategies the firm will take to reach its goals. In a participative approach, all of the stakeholders participate in the development of the firm's goals, direction, and strategies. A plan developed using a top-down approach is limited by its lack of input from other partners, managers, and employees and therefore a firm could face a myriad of problems in implementing it. Because the participative approach is a collaborative one, it should be easy to gain general acceptance and commitment from all the members of the firm. The remainder of this lesson discusses the steps involved in developing a strategic plan assuming that the firm is using a participative approach.

The planning process an accounting firm should go through will generally vary little from one firm to the next. There are certain steps that all firms should perform regardless of size or areas of specialization. Those steps are summarized in Exhibit 1-1.

Exhibit 1-1

Overview of the Planning Process

I. Develop a strategic plan:

   A. Prepare a vision statement.

   B. Prepare a mission statement.

   C. Perform a SWOT analysis:[a]

      1. Solicit employee ideas.

      2. Solicit client feed back.

      3. Assess the firm's strengths.

      4. Identify the firm's weaknesses.

      5. Determine future opportunities.

      6. Identify threats.

   D. Establish objectives.

   E. Develop strategies that will help the firm accomplish its objectives.

   F. Formulate an action plan that will involve all partners and employees in the strategic plan.

II. Develop a budget based on the strategic plan.

III. Develop a succession plan.

IV. Assign individual performance goals to all partners and employees that are based on achieving the firm objectives.

V. Monitor the effectiveness of the business plan on an ongoing basis, and modify it as needed.

Note:

[a] The SWOT analysis is discussed further later in this lesson.

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Strategic Planning and Budgeting. Business planning is a continuous process, not just something that a firm does once a year. As discussed previously, the three essential components of an effective business plan are as follows:

a. *Strategic Plan.* A strategic plan can be described as a road map of where a firm wants to go during the next three to five years. In developing such a plan, the firm defines its current status and where the firm plans to go in the future. The firm then develops strategies and a detailed action plan that will help it achieve its long-term goals. On a quarterly basis, the firm should reassess the long-term goals contained in the strategic plan. In addition, the firm should make sure that the goals are still attractive and that the firm is on the right track for accomplishing those goals.

b. *Budget.* A budget is shorter in scope than a strategic plan—it usually covers only a one-year to three-year term rather than a three-year to five-year term. A budget translates a strategic plan into numbers against which a firm's future performance can be measured. It has been described as a tool that quantifies a firm's goals and serves as a yardstick for measuring its degree of success.

c. *Succession Plan.* A succession plan is a key element of the firm's overall strategic objectives. An effective succession planning process should encompass how the firm ensures that it has qualified employees for each key position in the firm, how it protects itself from potential damage that could result from the loss of key employees, and how the owners plan to transfer ownership of the firm when they retire. Like the strategic plan, the firm should periodically reassess the elements of the succession plan and make modifications as the firm changes its organization or objectives.

It is important to distinguish that while a strategic plan, a budget, and a succession plan are valuable tools for managing a firm, it is the strategic plan that ultimately drives the success of a firm. The budget can measure the financial success of a firm, but it does little to create success for a firm. An effective succession plan supports the strategic plan by providing the continuity needed for the firm to achieve its strategic objectives. Exhibit 1-1 presents an overview of the entire planning process. The main steps that are usually followed in developing a strategic plan are discussed in the following paragraphs.

<u>The Vision Statement.</u> The vision statement is a written commitment to the firm's goal to succeed. It sets the framework for strategic planning by creating a clear vision for the future of the firm. It is a description in words that conjures up a similar picture for each member of the firm of the destination the firm desires. The vision statement is a motivational tool, including phrasing and activities to which the organization aspires.

<u>The Mission Statement.</u> The mission statement answers three very important questions that a firm must address early in the planning process. Those questions are as follows:

a. What business are we in?

b. What business do we want to be in?

c. What do we want to achieve?

A simple answer to the first two questions might be public accounting. This is not descriptive enough to be useful, however, and it does not allow a firm to differentiate itself from other public accounting firms. Mission statements often focus on a firm's services, its clients, and its growth prospects.

The mission statement should be brief—perhaps just one sentence, but never more than one paragraph. A properly drafted mission statement should reflect the firm's business focus and provide both direction for the firm and motivation for its partners and employees.

The SWOT Analysis. Once the firm has developed its vision and mission statements, the next planning step is to thoroughly analyze its current operating conditions. This process is commonly called a SWOT analysis. SWOT is an acronym for strengths, weaknesses, opportunities, and threats. Strengths and weaknesses are internal firm characteristics. Opportunities and threats generally relate to factors outside the firm over which the firm has little control.

- A *strength* may be defined as a factor that contributes to a firm's competitive edge.
- In identifying a firm's *weaknesses*, the firm is searching for ways it does not measure up well competitively.
- Once the firm has identified its strengths and weaknesses, the next step in the planning process is to look outside the firm for factors that create *opportunities*. Areas worth considering include the firm's markets, its competitors, and the possibility of technological innovation. For instance, a competitor that has lost several clients recently because of fee and service disputes might create an opportunity for the firm to pick up new business. The importance of thoroughly evaluating a firm's opportunities cannot be overstated. The weaker a firm's competitors are, the more growth opportunities the firm will enjoy. An important key to success for an accounting firm is to know its competition.
- *Threats* represent potential external events that could adversely affect the firm's operations and profitability. Threats are often discovered in the same places as opportunities—in the marketplace, among the firm's competitors, from technological developments, and even from regulatory and governmental agencies. After listing all of the threats, the firm should compare the threats to the opportunities previously listed for any inconsistencies. The threats should then be prioritized.

Objectives and Strategies. The next step is to use the firm's strengths, weaknesses, opportunities, and threats discussed thus far to develop objectives and strategies. The real success or failure of the overall strategic planning process hinges on determining objectives, identifying strategies to help the firm achieve its objectives, and developing an effective action plan that will serve as marching orders for the firm's partners and employees. Objectives and strategies are discussed separately in this lesson, but in reality, they are often discussed together during planning sessions. It is hard to suggest an objective without also discussing possible strategies that will help the firm achieve the objective.

Objectives represent the general or high-level goals for improving the firm. Typically, objectives are motivated by profitable growth, however, the firm may also need to develop some defensive objectives. Best practices indicate a firm should have only four to six objectives.

Objectives indicate a firm's chosen direction, and strategies spell out in more details what results are expected. A well-written strategy should have the following characteristics:

- Attainability.
- Difficulty.
- Measurability.
- Controllability.
- Understandability.
- Time boundaries.

Strategies should not be too easy to reach nor should they be impossible to attain. They must be measurable over a specified period of time and within the controllability of the responsible partners and employees. Finally, they should be understandable. If the strategies are not clearly written, disagreements may occur over success or failure.

The world is constantly changing, partly due to technological innovations. CPA firms must keep up with technology, and the firm's response to technological innovations should be included in the strategic plan. The firm's vision of itself in the future should include the vision of how it will do business in terms of technology.

Once the strategies have been written and the financial and other implications have been assessed, the planners should prioritize the strategies. The rating system should be tied to risk and potential reward. Relatively safe projects that are likely to be highly profitable should obviously get the highest ratings. Riskier, less profitable strategies should be ranked lower.

Action Plan. After developing the firm's objectives and strategies, the next step is for the planning team to develop detailed action plans for each strategy that the firm wishes to pursue. Basically, action plans apply more detail to the top-rated strategies so that the projects become more manageable. Action plans serve several basic purposes, including the following:

- Individual responsibilities are assigned.
- Tasks can be prioritized and sequenced so that conflicts and delays will be minimized.
- Some tasks may surface that affect the related cost/benefit analysis.
- Monitoring the progress of the project is easier because due dates are established.

The Budgeting Process. A firm's budget can be described as the strategic plan put into numbers. As discussed earlier, the strategic plan is primarily the narrative part of the business plan that contains ideas, assumptions, strategies, strengths, weaknesses, goals, and other target information. The budget is the part of the business plan that contains the financial data and quantitatively reflects management's plans and direction for the firm.

It is difficult to develop a reliable budget without first going through the strategic planning process. By the same token, a firm can develop a good strategic plan, but it will be difficult for the firm to implement that plan without developing a budget. Both components of a comprehensive business plan are therefore important and should be analyzed in detail at least on an annual basis. In addition, as discussed later, it is recommended that a firm should periodically monitor the success of its business plan—usually on a quarterly basis.

Performance Management and Individual Performance Goals. At this point in the planning process, the firm has prepared or updated its strategic plan and completed its financial budget for the coming year. The firm has also developed vision and mission statements and a succession plan for key positions. The next step is usually to create a performance management system and to establish individual performance goals for each of the firm's partners and employees. By involving the entire firm in the work that needs to be done in setting and accomplishing its goals, the firm increases its chances of success. In order for the firm to achieve its vision and mission, owners must set goals and be accountable. Setting goals for owners and evaluating owner performance are key elements of the strategic planning process and the firm's management. It is also important that day-to-day operations are aligned with the firm's vision and mission and that its core values are defined and incorporated in the performance evaluation program. Overall, the firm's performance management process must be an integral part of the firm's strategic goals.

The firm should obtain personal commitments from all of its partners and employees that they will help the firm accomplish its goals. Specific tasks should be assigned to each partner and employee based on each person's skills, past successes, and other factors. Goals should be reasonable and attainable, both individually and as a whole. They should allow individuals to increase their capabilities and contribute to the firm. Once the partners and employees have accepted the responsibility for their assigned tasks, their performance during the coming year should be evaluated based partly on their ability to achieve their performance goals relating to the firm's business plan.

Employees usually respond well to financial rewards and personal recognition at the end of the evaluation period. The firm should therefore ensure that top performers are adequately rewarded. If some employees succeed in accomplishing their goals while others do not, and everybody is treated the same at review time, there will be no perceived incentive for anyone to strive for goal achievement. In fact, such treatment often creates a disincentive for those employees who are capable of accomplishing aggressive goals. Such employees may become discouraged and not operate at their full potential. Worse yet, such employees may leave the firm if they feel they have not been properly recognized for their accomplishments.

Monitoring the Effectiveness of the Business Plan. Business plans are intended to be working documents. If a firm spends the time necessary to develop a comprehensive business plan, it needs to use it in managing its future operations. It is just as important to the firm's success that the individuals who participated in creating the business plan periodically and regularly analyze whether the firm is on track to achieving the plan goals.

Best practices indicate that an accounting firm should review its strategic plan and any progress made in accomplishing its goals at least quarterly. This review should include the following:

a. Evaluation of year-to-date financial results.

b. Discussion of planned or potential activities related to the objectives defined in the firm's strategic plan.

c. Discussion of any issues that may have surfaced related to the retention of key employees and the effectiveness of the succession plan.

Occasionally, a quarterly review session reveals that an objective needs to be changed. Perhaps an expansion effort has gotten ahead of itself and requires more resources than originally planned. More likely, an objective will be behind schedule for one reason or another, requiring a change of plans. By making sure that changes are incorporated into the plan as they are needed, the firm can ensure that the plan remains an effective management tool throughout the year and into the future.

Expanding or Establishing a Write-up Practice

A firm should develop a comprehensive approach to expanding or establishing a write-up practice that considers its strengths and expertise and the need for the services that it can provide. Because write-up engagements often lead to other services, the firm's approach should include strategies to market all of its services. Generally, such a marketing plan includes the following steps:

a. Evaluate the firm's capabilities.

b. Analyze the competition.

c. Identify the target market.

d. Develop a marketing strategy.

e. Select specific marketing methods.

Evaluate Firm's Capabilities. The firm should assess its ability to deliver write-up services. Does the firm have adequate staff to deliver the services on time? Will the firm need to make a significant investment in computer equipment and software? The skills of the professional staff and paraprofessionals also should be assessed and additional training provided as needed. This course provides an excellent source for such training.

In addition, the firm should determine whether it possesses other unique capabilities. For example:

a. *Does the Firm Have Experience in a Particular Industry?* Clients have more confidence in a firm that is familiar with the unique accounting and reporting requirements of their industry. Also, the firm may have contacts within a particular industry that can result in a valuable network for referrals.

b. *What Other Services Can the Firm Provide in Addition to Write-up Services?* Clients often need more than just write-up services. For example, they may need the firm to perform tax-planning and prepare tax returns; review, audit, or provide agreed-upon procedures to financial information; assist in developing forecasts and projections; design compensation arrangements; or help them establish banking relationships and obtain financing. Selling write-up services to a prospective client is easier if the firm can demonstrate that it is capable of providing other services that may be needed in the future.

Analyze the Competition. A successful marketing plan should consider the nature and extent of competition. Questions to be investigated include the following:

a. What services are other firms providing?

b. For whom are they providing the services?

c. What rates are they charging?

d. Are there needs that are not being met?

The existence of competition should not necessarily be considered an impediment to entering the market. In some cases, just the opposite may be true. The existence of competing firms may indicate a need for such services. The key is to determine what services are being offered. The firm can then determine whether it can offer those same services more effectively, offer services that are not currently being offered, or both.

Identify the Target Market. The target market should be defined in detail. A marketing strategy has a better chance of being successful if the firm has a clear understanding and identification of its target market. Defining the target market precisely is a good method for developing a niche that can later be expanded. For example, the firm may decide to target a specific industry in which it has experience. As discussed earlier, the firm may develop a strong referral network within a particular industry that can provide excellent opportunities for practice expansion.

Develop a Marketing Strategy. A marketing strategy is a broad plan that forms the basis for selecting specific marketing methods. It should be tailored to a specific service definition and a specific market definition. It should also include goals that are expressed in measurable terms. For example, goals might be expressed in terms of the number of new clients or billable hours obtained within a definite time period. That gives the firm a yardstick by which to measure results. If possible, the strategy should contain approaches to market differentiation. That enables the firm to differentiate itself from its competitors. Market differentiation plays a significant role in attracting new clients.

Select Specific Marketing Methods. Marketing methods are specific techniques for initiating discussion with a prospective client about a potential engagement. The methods used should be consistent with the marketing strategy, the market definition, and the services the firm plans to offer. Methods should be evaluated in light of the firm's ability to use them properly, their appropriateness for the target market, and the cost/benefit associated with them. Reliance should not be placed on any one method; a combination of techniques is the most effective means of reaching the targeted market. Also, the firm should only use the methods with which it is comfortable and that are consistent with its professional image. The following are some of the more effective marketing methods:

- *Quality Service.* Firms must provide quality service to their clients if they expect to receive referrals from them. Quality write-up service involves not only providing error-free financial information, but also being accessible to clients, delivering services on time, being courteous, and charging fair prices for services rendered.

- *Referrals.* One of the most effective methods of obtaining new clients is through referrals. Obviously, referrals from existing clients can be particularly effective. Other professionals familiar with the firm's services, such as bankers or attorneys, also can be valuable sources for new engagements, however.

  Firms should feel free to ask for referrals rather than wait for them to occur. Often, clients or other professionals may not be aware of the firm's desire to expand or its ability to provide certain services. Firms should remember, however, that the referral system is a "two-way street." Those that provide referrals also expect to receive referrals.

- *Newsletters.* Newsletters can serve as an excellent vehicle for marketing the firm's services. They are an effective means of putting forth the firm's name to clients and other referral sources on a regular and continuous basis.

  Newsletters can be developed internally or can be purchased from outside sources. The disadvantages of developing a newsletter internally are (a) the cost of professional time used to design, write, and edit the publication is substantial and (b) there is a continuing problem of having enough published articles on hand to fill the pages. Thus, many firms purchase a newsletter from outside sources. With a purchased publication, the product is delivered to the firm ready to be mailed.

- *Websites.* Many firms have their own Internet websites. By creating a relatively inexpensive web presence, a firm can have access to millions of potential customers. A website provides a firm with fresh leads that, when combined with appropriate firm contact and follow-up, can potentially result in new clients.

- *Firm Seminars.* Presenting firm services to small groups of clients and prospective clients is a good marketing technique. Each seminar should have no more than 30 participants (15–20 is preferred) for optimal results. The seminar should ordinarily cover financial and tax topics that are of interest to the target market, either personally or professionally.

- *Joint Seminars.* Joint seminars, like firm seminars, are presentations of firm services to small groups of clients and prospective clients. They are ordinarily presented in cooperation with other professionals, such as bankers and attorneys, and cover a wide variety of topics that are of interest to the target audience.

- *Webinars.* The Internet has made the use of Webinars an effective way to conduct seminars. A Webinar is a live seminar delivered and attended entirely over the internet. According to *PC Magazine*, executives believe that a vendor who invites them to a Web conference is technologically savvy, respectful of their time and budget, and smart and efficient.

- *Speaking Engagements.* Delivering speeches leverages the accountants' time by putting the speaker in front of a large number of prospective clients. Accountants may have frequent opportunities to deliver talks on services the firm provides because many groups are generally eager for such presentations.

SELF-STUDY QUIZ

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

1. Flourishing write-up practices share common traits that set them apart from other firms. Firms pledge numerous resources to the firm to ensure its viability and success. The obligation of the resources demonstrates which of the following characteristic of a successful firm?

   a. Reputation.

   b. Commitment.

   c. Leadership.

   d. Philosophy.

2. Brown and Briddle, a local write-up firm, is completing its SWOT analysis. Which of the following would be identified as a strength for the firm?

   a. Langman, Chill and Durham, a competing write-up firm, has recently purchased and installed the latest accounting software.

   b. Brown and Briddle is unable to recruit new talent to the firm because the firm is not as established as its competitors.

   c. The partners of Brown and Briddle have several well-established clients that have been with the firm for the last few years.

   d. Clark Brothers, a competing firm against Brown and Briddle has recently increased their fee structure to their clients.

3. Which of the following accurately describes the budget?

   a. The budget is the strategic plan expressed financially.

   b. A reliable budget can be developed outside of the strategic planning process.

   c. The budget is not usually necessary in the implementation of the business plan.

   d. The budget is a part of the strategic plan.

4. Establishing individual performance goals is a step in the planning process. Which of the following is an accurate statement?

   a. An incentive program to recognize sales production is not necessary.

   b. It is best to treat everyone equally at review time.

   c. Success is best achieved if goals can only be obtained by a few top performers.

   d. Success is best achieved if all employees participate in the work that needs to be done to accomplish the firm's goals.

5. A successful marketing plan will include which of the following steps?

   a. Prepare a mission statement and develop a budget.

   b. Assess the firm's strengths and weaknesses.

   c. Monitor the business plan and establish objectives.

   d. Identify the target market and analyze the competition.

6. When selecting specific marketing methods, which of the following is the most accurate statement?

   a. Marketing methods should be chosen based on the firm's ability to use them properly.

   b. A firm should select one marketing method.

   c. Providing quality service to clients has no effect on the firm's marketing plan.

   d. Producing a client newsletter is best when developed internally.

SELF-STUDY ANSWERS

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

1. Flourishing write-up practices share common traits that set them apart from other firms. Firms pledge numerous resources to the firm to ensure its viability and success. The obligation of the resources demonstrates which of the following characteristic of a successful firm? **(Page 120)**

   a. Reputation. [This answer is incorrect. Reputation is an important characteristic of a successful write-up firm. The firm needs to have a good reputation within the community of being able to effectively meet the needs of its clients, but by definition, the reputation of the firm is the opinion of the general public toward the firm and does not obligate the resources to a firm to ensure its viability and success.]

   b. Commitment. [This answer is correct. To be successful, a firm must commit sufficient financial, personnel and other physical resources to a write-up practice to make sure that the work is completed timely and that all of the clients' needs are met. The nature and extent of the necessary resources depends on the types of write-up services the firm intends to provide and the types of clients and industries that the firm intends to service.]

   c. Leadership. [This answer is incorrect. Effective leadership is an essential ingredient of success, but leadership entails the process of social influence that the organizer of the firm can enlist the aid and support of others to accomplish a goal. Leadership does not obligate the resources of the firm, but with good leadership, the resources are used in the most efficient manner to complete the job.]

   d. Philosophy. [This answer is incorrect. A critical element of a successful write-up practice is its philosophy about write-up services. Elements of a successful firm's philosophy includes a marketing orientation, adaptability, and a cooperative attitude among the partners and staff of the firm. A philosophy does not bind the resources of a firm.]

2. Brown and Briddle, a local write-up firm, is completing its SWOT analysis. Which of the following would be identified as a strength for the firm? **(Page 123)**

   a. Langman, Chill and Durham, a competing write-up firm, has recently purchased and installed the latest accounting software. [This answer is incorrect. A technology development for a competitor would be classified as a threat for Brown and Briddle, not a strength. A threat is a component of the SWOT analysis. It represents potential external events that could adversely affect the firm's operations and profitability.]

   b. Brown and Briddle is unable to recruit new talent to the firm because the firm is not as established as its competitors. [This answer is incorrect. Not being able to recruit new talent to the firm would be considered a weakness for Brown and Briddle. It showcases a way that the firm does not measure up well with its competitors and is not a strength in the SWOT analysis.]

   c. The partners of Brown and Briddle have several well-established clients that have been with the firm for the last few years. [This answer is correct. Well-established clients give the firm a competitive edge in the market and is a strength for Brown and Briddle.]

   d. Clark Brothers, a competing firm against Brown and Briddle has recently increased their fee structure to their clients. [This answer is incorrect. A competitor increased their fee structure would be an opportunity for Brown and Briddle because it might cause a client of the competitor to analyze their current service and think about employing a new firm. Opportunity represents the "O" in SWOT.]

3. Which of the following accurately describes the budget? **(Page 124)**

   a. The budget is the strategic plan expressed financially. [This answer is correct. The budget contains the financial data and quantitatively reflects management's plans and direction for the firm.]

   b. A reliable budget can be developed outside of the strategic planning process. [This answer is incorrect. It is difficult to develop a reliable budget without first going through the strategic planning process, since the strategic plan helps set the firm's goals and plans that influence the financial budget.]

   c. The budget is not usually necessary in the implementation of the business plan. [This answer is incorrect. A firm can develop a good strategic plan, but it will be difficult to implement without first developing a budget. The firm will need the budget to measure the effectiveness of the strategic plan as it is put into motion.]

   d. The budget is a part of the strategic plan. [This answer is incorrect. The budget planning and strategic planning are separate processes, but each is dependent on the other. The strategic plan is the long range plans of the firm and the budget encompasses a shorter scope. The budget has been described as a tool that quantifies a firm's goals and serves as a yardstick for measuring its degree of success.]

4. Establishing individual performance goals is a step in the planning process. Which of the following is an accurate statement? **(Page 124)**

   a. An incentive program to recognize sales production is not necessary. [This answer is incorrect. Employees usually respond well to financial rewards and personal recognition since rewarded employees usually achieve their objectives.]

   b. It is best to treat everyone equally at review time. [This answer is incorrect. If some employees succeed in accomplishing their goals while others do not, yet everybody is treated the same at review time, there will be no perceived incentive for anyone to strive for goal achievement.]

   c. Success is best achieved if goals can only be obtained by a few top performers. [This answer is incorrect. Goals should be reasonable and attainable; they should allow individuals to increase their capabilities and contribute to the firm.]

   d. Success is best achieved if all employees participate in the work that needs to be done to accomplish the firm's goals. [This answer is correct. By involving the entire firm in establishing the goals, all of the participants will commit to the process. Everyone involved will want to strive for completion of the goals. The firm's purpose will become personal for every employee and each person will want to assist in achieving the firm's goals.]

5. A successful marketing plan will include which of the following steps? **(Page 126)**

   a. Prepare a mission statement and develop a budget. [This answer is incorrect. The mission statement is a step in the strategic plan and the budget is developed separately in the comprehensive planning process. Neither of these are included in the marketing plan.]

   b. Assess the firm's strengths and weaknesses. [This answer is incorrect. The SWOT analysis is performed as part of the strategic plan and is not part of the marketing plan.]

   c. Monitor the business plan and establish objectives. [This answer is incorrect. The business plan is monitored as a step in the overall planning process. Objectives are included in the strategic plan. A successful marketing plan does not include these steps.]

   d. Identify the target market and analyze the competition. [This answer is correct. Both of these are included in marketing planning. By defining the target market, a firm has a better chance of being successful. The competition should be investigated to know what services are provided and at what rates so that a marketing strategy can be developed.]

6. When selecting specific marketing methods, which of the following is the most accurate statement? **(Page 126)**

   a. Marketing methods should be chosen based on the firm's ability to use them properly. [This answer is correct. They should be consistent with the marketing strategy, the market definition and the services the firm plans to offer. The method should be comfortable for the firm and consistent with its professional image so the firm feels confident in their choice.]

   b. A firm should select one marketing method. [This answer is incorrect. Reliance should not be placed on any one method; a combination of techniques is the most effective means of reaching the targeted market.]

   c. Providing quality service to clients has no effect on the firm's marketing plan. [This answer is incorrect. Quality service can lead to referrals from satisfied clients, which is a method of marketing.]

   d. Producing a client newsletter is best when developed internally. [This answer is incorrect. Publishing a newsletter internally can be costly and difficult to produce on a consistent basis, since there can be a continuing problem of having enough published articles on hand to fill the pages.]

HOW TO OBTAIN AND RETAIN A QUALIFIED STAFF

To be successful, a CPA firm's write-up practice must be able to hire and retain competent staff. If client deadlines are consistently missed or staff work needs to be regularly corrected, a firm probably does not have a good chance of being successful. This lesson discusses procedures for recruiting, hiring, training, evaluating, and retaining write-up staff.

Recruiting

For most of 2008, the shortage of accounting professionals was a major issue for a majority of firms. However, as the economy has been declining, there has been a decrease in the number of available accounting positions, both in public accounting and industry accounting. This has lead to an overall reduction in hiring, especially by the bigger firms. This creates a great opportunity for smaller firms to recruit candidates that previously would have only considered working for one of the big four firms, a large national firm, or a regional firm. Nevertheless, qualified professionals are difficult to find and to attract because of the heated competition among employers for their skills. Increased competition for employees and fewer accounting graduates coming out of college each year have combined to make the accounting profession's staffing crisis more acute over time. As a result, recruiting has become as important as marketing to many firms.

Many people think of recruiting as interviewing and making offers. On the contrary, recruiting encompasses much more than that. To an accounting firm, recruiting should represent a comprehensive program covering the various steps that culminate in hiring a particular individual to fill an identified job position. Those steps should be part of an ongoing program, even when the firm is not actively looking to hire.

The Supply of New and Experienced Accounting Staff. The accounting industry started to experience a turn-around in capturing the interest of college students. The changes in the accounting world that resulted from Sarbanes-Oxley have often not been considered positive for the accounting industry. However, due to the high profile fraudulent reporting and alleged criminal activities of firms such as Enron and WorldCom, which ultimately led to Sarbanes-Oxley, a career in accounting has again become prestigious and alluring to a higher percentage of college and university students.

According to the AICPA's Private Companies Practice Section (PCPS), finding and keeping professionally qualified staff has consistently been the most significant concern for private accounting firms. Despite the recent rebound in the number of accounting students, getting and keeping staff remains a serious issue and skilled professionals are still in demand. And according to a recent Robert Half International Survey, staff and senior accountants are particularly in high demand. Recruiting new graduates is not the only focus for firms today as there continues to be a shortage of experienced staff. There does not appear to be one specific reason or cause for the shortage of experienced accounting professionals. Instead, the shortage is attributable to a combination of factors working simultaneously to aggravate the situation. Although not all-encompassing, a list of those factors includes the following:

- Fewer experienced accounting professionals available in the market.
- Increased competition for professionals from national and regional firms.
- Improved national and regional firm cultures.
- Defection of staff to industry and more graduates hired directly into industry.
- Young professionals starting their own businesses.
- Professionals temporarily leaving the workforce.
- Changing attitudes of professionals.
- A general unwillingness of young professionals to work in traditional work environments.

What Can Be Done? Because of the need for staff, many firms now have formal, ongoing recruiting programs for both new graduates and experienced professionals at all levels. In addition, to respond to the demand for qualified candidates, many firms are as competitive in the recruiting process as they are for prospective clients. Recruiting is much like marketing. When marketing, the firm tries to sell services to potential clients. When recruiting, the firm tries to sell the firm as a desirable place to work to potential employees. Like marketing, recruiting should be thought of as an ongoing function. To recruit successfully, the firm has to favorably compete with other employers. The firm should try to position itself to job candidates as the "employer of choice." In order to accomplish this task, it is important to understand what is important to the candidates.

What Are Job Candidates Seeking? The firm should evaluate what job candidates are looking for in an employer in key areas, such as the following:

- Benefits and incentive rewards.
- Personal development.
- Quality of life.

By determining what job candidates consider important in an employer, the firm can stress the positive aspects of how it addresses those areas.

Apart from salary, benefits and incentive rewards are typically two of the top factors that influence candidates to select one employer over another. As a result, it is important to be as competitive as possible in those areas. Flextime, casual dress, and hiring bonuses are a few of the more popular benefits that CPA firms have added to attract candidates.

Another important selection criterion for job candidates is how the job will affect their quality of life. A comprehensive staff retention program can enhance employee quality of life. The benefits of a staff retention program cannot be overemphasized. A functioning staff retention program both reduces existing staff turnover and serves as a powerful recruiting tool. It has considerable appeal to job candidates. In fact, it can be the decisive factor for some job candidates in selecting the firm over other employers. Firms have also increased vacation time and permitted more telecommuting in order to address quality of life issues.

Determining the Types of Candidates to Target. Before beginning the recruiting campaign, the firm needs to determine what type of candidates it wants to target. Job candidates come in many forms. They can be new graduates with little or no experience or highly experienced with specialized knowledge. The days of the "cookie-cutter accountant" are gone. To be successful, accounting firms should realize that a fundamental paradigm shift has taken place. There are no longer strict rules that define who a public accounting professional is or should be.

Before beginning the recruiting process, firms should identify the types of candidates who would most likely fit the profiled position. The types of possible job candidates a firm might target include the following:

- Recent accounting graduates.
- Experienced accounting professionals.
- Graduates who are not accounting majors.
- Older professionals.
- Retired professionals.
- Interns.
- Minorities.
- Paraprofessionals.

Delivering the Recruiting Message. To be effective, the firm should be creative and should deliver its recruiting message at every opportunity and in every available venue. The firm's commitment to recruiting directly affects its success in obtaining (and ultimately retaining) qualified staff. Fortunately, there are numerous sources for locating prospective employees. The following sources may be used to recruit candidates for most positions offered by CPA firms. The most appropriate source will vary with each position.

- *Soliciting Candidates through Advertisements.* Advertising in newspapers, business publications, trade journals, or school bulletin boards can be an effective method of reaching a broad range of potential applicants.

- *On-campus Recruiting.* Entry-level professional employees are often available through on-campus interviews. This technique is perhaps the most successful for obtaining qualified entry-level potential new employees. However, on-campus recruiting can be expensive because it often requires at least one member of the firm to spend a day conducting on-campus interviews at each college or university visited.

- *Using Employment Agencies and Search Firms.* Employment agencies or executive search firms may be helpful, particularly when firms are looking for experienced professional staff or staff with a particular expertise. Agencies and search firms may also be effective when firms lack the resources to screen many applicants or must quickly fill clerical positions.

- *Websites.* Many firms use their websites as recruiting tools. Because college students today are technologically savvy, the firm's use of technology may be an important job selection criterion. In addition to recruiting on its own website, a firm can list job openings on sophisticated recruiting websites.

- *Direct Contact Methods.* Positive direct contact with job candidates can tip the scale in the firm's favor. It is human nature for people to want to work with people they feel comfortable with. There is no substitute for direct contact in cultivating a positive impression about the firm. Direct contact usually occurs only after firms have identified key candidates. Unlike some other industries, accounting firms do not typically contact individuals personally before targeting them as desirable candidates.

- *Video.* In addition to using video as a marketing tool, some firms use it as a recruiting tool for prospective job candidates. Video can be a powerful medium, particularly for the college-aged audience. This can be a two-edged sword, however. Because they have typically spent years viewing cable and satellite television, that audience may be tough to impress. To be effective, the video must hold their interest. A poor quality or uninteresting video can potentially do more harm than good if it gives the viewer a negative impression of the firm.

- *Referrals.* Referrals from business contacts, clients, college professors, and other sources can be valuable resources for potential new employees. Such sources are often aware of individuals who are considering making an employment change. Additionally, firms may encourage current employees to refer friends or acquaintances for job openings. Presumably, employees know what the firm expects and will refer candidates with good work habits and other characteristics the firm seeks. Firms can encourage such referrals by providing staff with the tools they need as they come across individuals they would like to refer. Use of referral cards or an online form to report a prospect to the right person in the firm who will contact the referred candidate allows existing staff to more easily provide potential new employee recommendations. Consider implementing a monetary reward system for staff members who refer candidates that become part of the firm's staff, and make the rewards public. When other firm employees see the rewards being given, it will encourage more participation in the program.

- *Other Methods.* As discussed previously, many firms are now recruiting graduates who are not accounting majors. Talented and motivated candidates with business, English, communications, or other areas of expertise may possess important qualifications for being successful in the accounting profession.

- *Rehiring.* Some firms make a concentrated effort to keep in touch with their former employees in the hope that they will return—especially if the new job at a competitor firm proves disappointing. Former employees are known quantities, they are familiar with the firm's clients, and the firm probably has expended significant resources to train them. In addition, rehired workers generally are very loyal to the firm.

Recruiting Employees

A CPA firm distinguishes itself from the competition by the quality of its people—their desire, initiative, ability, creativity, and loyalty. The best firms tend to employ the best people. As a result, hiring and retaining the best employees available is one of the most important tasks facing a CPA firm.

The following paragraphs offer advice for setting up or modifying the firm's procedures for hiring inexperienced professional staff, experienced professional staff, and administrative personnel. It describes a process that can (a) efficiently locate the person that best fits the job requirements and (b) lessen the firm's legal risks. Specifically, the following paragraphs cover the following topics:

- Quality control considerations.
- Avoiding discrimination.
- Identifying staffing needs.
- Screening candidates.
- The interview process.
- Contacting personal references and former employers.
- Pre-employment testing.
- Evaluating the candidates.
- Suggested documentation.
- Rejecting a candidate.

Quality Control Considerations. Firms subject to peer review must establish policies and procedures for hiring that provide reasonable assurance that employees possess the appropriate characteristics to perform competently. Specifically, SQCS No. 7, *A Firm's System of Quality Control*, (QC 10.37) indicates that the firm should establish policies and procedures over the human resources quality control (QC) element designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to (a) assure engagements are performed in accordance with professional standards and regulatory and legal requirements and (b) enable the firm to issue appropriate reports. The policies and procedures established in this regard should address recruitment and hiring.

Avoiding Discrimination. *Discrimination* can be defined as making a difference in treatment or favor on a basis other than individual merit. For example, historically, minority groups have been discriminated against in the workplace merely because of their race. Numerous federal, state and local laws have been passed over the years that make it illegal to discriminate in the workplace. Generally, firms can comply with the various laws by using common sense when hiring. However, even well-intentioned firms can go astray (with disastrous consequences) if they do not fully understand the statutory requirements. Although discrimination is a consideration of the hiring process, the concept extends well beyond hiring to include promotions, terminations, layoffs, recalls, transfers, leaves of absence, compensation, training, and all other aspects of the employee/employer relationship. For further discussion on employment discrimination see *PPC's Guide to Managing an Accounting Practice*.

Identifying Staffing Needs. The firm should first evaluate its current and anticipated future staffing needs before hiring new employees. Anticipated needs should consider an honest evaluation of the firm's current staffing situation. In today's competitive environment, each staff vacancy represents an opportunity to identify exactly what types and numbers of positions are currently needed or may be needed in the near future. Evaluating staffing levels requires creative management and, if additional duties are assigned to remaining staff, the cooperation of the affected employees.

Developing a Staffing Plan. To support its hiring and recruitment process, the firm should develop a staffing plan. Staffing plans are driven by the strategy of the organization. A beneficial staffing plan requires a prediction of current and anticipated future staffing needs, an assessment of staff availability in the job marketplace (based on supply and demand), and a method for reconciling needs with availability. Staffing forecasts rely on data collection, analysis, and judgment. Conducting demand, supply, gap, and solution analyses, and following up with continuous evaluations, all contribute to the success of the plan. Future needs may be forecasted based on projected attrition rates, potential recruitment sources, hiring strategies, etc. Often, the data collected for a staffing plan is incomplete, but is still suitable for use to devise staffing plans and strategies. Attempting to collect more data at great effort and expense should be avoided in favor of using existing data to the fullest extent possible.

SQCS Requirements. As the firm addresses the personnel issues covered by the human resources element of the QC standard, the firm is able to determine the number and characteristics of the individuals needed to perform the firm's engagements. SQCS No. 7 (QC 10.39) states that effective recruitment processes help the firm select individuals of integrity who—

- Have the ability to develop the capabilities and competence necessary to perform the firm's work.
- Possess characteristics to enable them to perform competently. Such characteristics may include—
  - Meeting minimum academic requirements established by the firm.
  - Exhibiting maturity, integrity, and leadership traits.

Planning for the Firm's Personnel Needs. At least annually, firm personnel needs should be assessed by the individual responsible for staffing decisions (generally the partner, managing partner, or other individual assigned responsibility for recruitment and hiring). In determining the individual or group of individuals who will be involved in the recruitment and hiring process, the firm needs to remember that such individuals will be representing the firm and promoting its benefits against other prospective employers.

Among the criteria the firm may consider in performing a staffing assessment are the following:

- *Ability to Service Clientele.* The firm needs to evaluate the ability of its staff to provide quality services to its existing clients. Factors to consider include timely completion of engagements, needed expertise in specialized areas, and additional services that may be requested.
- *Anticipated Growth.* If the firm plans to pursue and promote growth of its client base, then the staffing required to support such growth needs to be considered and estimated.
- *Personnel Turnover.* In assessing staffing needs, turnover should be considered. Although the timing of staff attrition is difficult (if not impossible) to predict, firms should plan for turnover to occur as part of developing personnel needs.
- *Individual Advancement.* The ability of staff members to advance and assume greater responsibility depends, at least to a certain extent, on having qualified personnel to move into the job position left open by the advancement. Accordingly, the firm's advancement plans will often have an impact upon the need to hire a new staff person. Many of the considerations used in developing the firm's recruitment and hiring plan will be applicable in developing an advancement plan.
- *Anticipated Staff Workload.* Firms generally have at least one busy season with heavy workloads during the year that are followed by less busy times (and perhaps even occasional slack times) during other months. Various alternatives exist to handle changing workload demands, including (1) working planned overtime hours during the busy season and (2) hiring part-time or contract personnel. The approach and philosophy for handling busy season workloads has a major impact on hiring decisions.
- *Quality of Life.* Many candidates seeking employment today, especially younger candidates, value work/life balance. Firms with a work environment that does not allow some quality-of-life features may find it difficult to hire and retain younger employees.

- *Succession Plans.* Partner succession plans and succession plans for filling key positions within the firm need to be considered when designing both a hiring and advancement plan. If retirement of a key partner or manager is imminent, or if the loss of an employee in a key position could present a serious danger to the continuity of the firm, a special hiring need for an experienced professional will exist if the firm does not prepare an existing employee to fill that role.

Documenting the Recruitment and Hiring Plan. The degree of documentation used by a firm depends on the size of the firm and the complexity of its annual recruitment and hiring needs. Obviously, a sole practitioner with a small staff of paraprofessionals normally would not need to document a recruitment and hiring plan. However, as a firm grows in size and additional staff is required, the benefits of documenting such a plan become more apparent. Also, as part of its peer review, the firm will ordinarily be asked whether a recruitment and hiring plan was developed. Accordingly, firms are encouraged to annually document their considerations and plans for recruiting and hiring new staff. Documenting the hiring process is discussed later in this lesson.

Professional Staffing Alternatives. Many CPA firms need additional professional staff only during certain periods of the year. For example, a firm may need additional staff only to complete a special nonrecurring engagement. In those situations, adding full-time staff may not be warranted, and other staffing alternatives should be considered. The following are some alternatives to hiring full-time professional staff:

a. Part-time or temporary professionals.

b. Student interns.

c. Paraprofessionals.

In addition to using part-time and temporary professionals, there are other flexible work options such as flextime and telecommuting that are successfully being used by firms today. Providing flexible work arrangements can be a powerful staff retention strategy. Once the firm has invested in recruiting and training an individual, it has a stake in retaining that person—even if not as a full-time, on-site employee. Instead of losing valued staff, the firm should consider offering them flexible work arrangements. One Fortune 500 company reported that 85% of full-time employees who were prepared to leave the company stayed when offered flexible work arrangements. That illustrates just how effective offering alternative work arrangements can be in retaining staff.

In addition to working a part-time or temporary schedule, other options to provide staff opportunities for flexibility include the following:

- Flextime.
- Telecommuting.
- Compressed workweeks (such as four 10-hour days).
- Summer hours.
- Expanded time (such as shorter hours extended over more days).
- Job-sharing.
- Sabbaticals.
- Leaves.
- Contract labor.

Best practices for firms considering alternative work arrangements are to take a long, hard look at each option. Do not limit the firm to what has been done in the past or to what might appear to be feasible. Strategize about how each option might help to create a flexible model that meets the needs and expectations of firm staff.

Administrative Staffing Alternatives. Many CPA firms with write-up practices also need additional administrative staff. Some of the alternatives to hiring full-time administrative staff include the following:

- *Hire Part-time and Temporary Employees.* Many CPA firms with write-up practices meet administrative staffing needs by hiring part-time or temporary employees. In addition to meeting the firm's immediate needs, such employees can be a source for filling future permanent staff positions.

- *Outsource Selected Administrative Functions.* Some firms utilize outside entities to perform certain administrative functions such as firm payroll processing. The outsourcing alternative is especially attractive if the firm can eliminate an administrative staff position by using outside entities.

Importance of Continuity in Part-time and Temporary Employees. Locating high quality part-time and seasonal professional staff can be difficult, and training new staff each busy season consumes valuable firm time and effort. Consequently, firms that use seasonal employees should try to develop a group of competent, reliable seasonal professional staff that will return to work for the firm each busy season. Firms should also consider providing selected seasonal staff the opportunity to continue working for the firm on a part-time basis throughout the year if the work load supports it.

Firms may now encounter an increasing number of full-time professional staff, both men and women, who make the choice to work part-time. A part-time or alternative career path can be either temporary or long-term in duration. An individual's desire to go to a part-time status may be driven by family demands, lifestyle issues, or a variety of other factors. Because of the importance of staff continuity and the value of maintaining talented professionals in the work force, firms should consider creative, flexible staffing alternatives. In doing so, firms should evaluate each staff request on a case-by-case basis and arrive at a formal understanding with the individual about the terms and conditions of the arrangement before making the change.

Part-time employees should be made to feel that they are an integral part of the firm. Firms should discourage full-time employees from thinking of part-time staff simply as temporary help who do not require any investment of time or energy.

Screening Candidates. The hiring process may produce a large number of applicants. Firms can narrow the field of candidates by screening applicants in a nondiscriminatory fashion to identify individuals who appear to possess the desired qualifications. To help with the screening process, background information should be requested from each candidate. Generally, that information may be gathered by requesting employment applications and resumes. The following paragraphs discuss the screening process using resumes and employment applications.

Resumes. Resumes generally are the firm's first introduction to the group of aspiring candidates. From them, the firm selects a handful of seemingly qualified individuals for follow-up. Unfortunately, a resume does not always properly reflect the applicant's attributes. Applicants naturally attempt to portray events as favorably as possible, and, in some cases, they exaggerate the truth. Because a resume is essentially a personal advertisement that will rarely reveal anything negative about its author, firms often find themselves in the position of making initial decisions about candidates from information that cannot be considered 100% reliable.

When evaluating resumes, firms should consider the following:

a. *Consider Removing Information Unrelated to the Job.* Unsolicited personal information often creeps into resumes, and, once known, becomes potentially discriminatory. For instance, a candidate who indicates 1980 as the year of high school graduation is over 40 years old and, consequently, is in a protected class. One solution to that problem is to have an individual who is familiar with the various discrimination criteria, but uninvolved in the resume culling process, sanitize all such information from the incoming resumes before decision makers review them. If the information is removed from consideration, alleging discrimination would be difficult—at least at this stage of the process.

b. *Read the Experience Section First.* Experience is what matters most when filling non-entry-level jobs. Firms often find that the best indicator of what applicants will do is what they have done elsewhere. Firms should start reading the resume at the most current experience and proceed to earlier jobs. Unexplained gaps between jobs should be investigated. By following that pattern, the firm gives greater attention to the more current (and usually more relevant) experience and better understands the applicant's career progression and chronology.

c. *Focus on Knowledge, Skills, and Abilities.* The firm should look for verifiable facts—titles, duties, dates, and salaries.

d. *Look for Signs of Success.* A steady career progression, with increasing responsibilities indicates achievement. Employment while in school, volunteer activities, or special work projects indicate a willingness to work hard. Other desirable signs include bottom-line orientation, career direction, job stability, and descriptions of specific job content.

e. *Ask the Following Three Questions*:

(1) Does the applicant meet the minimum job qualifications as stated in the job description and advertisements?

(2) Could the applicant meet the minimum job qualifications with additional training? Job qualifications usually span several areas; an employee may meet most qualification requirements but fall short in one or two areas. Firms should only ask this question if the applicant appears well qualified in most areas. In addition, this judgment should be applied consistently to all applicants.

(3) Does the applicant have desirable additional qualifications as stated on the job description?

The firm should not document its review on the resume itself; under some state laws, applicants may have the right to obtain a copy of resumes (or applications) they helped to prepare. A firm may use a "Candidate Screening Form" to document its evaluation. After the pool of potential candidates has been screened, the firm can then evaluate in more detail the candidates who pass the screening process.

Employment Applications. Using employment applications allows the firm to obtain answers to its uniform questions and secure as much relevant information about a candidate as is legally permitted. Generally, employment applications should be completed before any interviewing takes place. Exhibit 1-2 lists the type of information normally requested on employment applications.

Exhibit 1-2

Job Application Elements

Personal Data
- Name, address, and telephone number
- Other names used in prior employment
- Verification that candidate is at least 18 years old
- Verification that candidate is authorized to work in the United States
- Driver's license number (if needed to verify driving record)

General Data
- Position being applied for
- Date available to work
- Salary requirement
- Objection to overtime work
- Referral source, if applicable

Employment Data
- List of all prior employers (perhaps with a 10-year limitation)
- Addresses and telephone numbers of previous employers
- Job titles and dates of employment (with explanations of employment gaps)
- Duties and responsibilities
- Salary history

- Name and title of immediate supervisor
- Reason for termination
- Permission to verify employment data with each previous employer

Education Data
- List of all schools attended
- Degrees earned and course specialization

Special Skills Data
- Whether the applicant is a CPA
- Skills acquired on-the-job
- Honors received relevant to the position being sought
- Proficiency on various types of office equipment
- Computer literacy and specific software familiarity

Health Data
- Agreement to take a pre-employment drug test
- Agreement to take a post-employment physical examination

Personal References
- Name, address, telephone number, occupation, and how long known
- Relationships to other employees, if any

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Firms often use employment applications to convey important information to applicants. For example, the application may:

- State that the completion of an application does not guarantee employment.
- Stress that the firm is an equal opportunity employer and will use all information provided on the application in a nondiscriminatory manner.
- Address the consequences of misrepresenting any information on the application (that is, dismissal, if subsequently hired).
- Obtain consent to verify all information on the application.
- Inform the applicant that the firm is an "at will" employer and, therefore, reserves the right to modify or end employment relationships at any time for any reason.
- Direct the applicant to follow all firm policies and procedures, if hired.

The applicant's signature on the form provides evidence acknowledging that the statements made are true.

The Interview Process. After screening and selecting qualified candidates, the interview process may begin. The interview is probably the most important part of the hiring process. It also is the most strenuous, since much information must be gleaned from the candidate in a very short period of time. In some instances, the interview may be conducted in two parts—an initial interview designed to evaluate the candidate's appearance, communication skills, attitude, maturity, and interest in the position and another interview to obtain answers to additional questions and meet other firm personnel.

When conducting an interview, the interviewer should:

a. *Try to Make the Candidate Feel Important.* The interviewer can make the candidate feel important by telling the candidate the importance of the job. The interviewer should also thank the candidate for attending the interview.

b. *Help the Candidate Relax.* Focusing on a minor but job-related item during this interview phase helps create a nonthreatening atmosphere. For example, the interviewer may comment on the candidate's college minor. Do not introduce personal topics unrelated to the job, however. Such comments and questions, although intended to be helpful, may unintentionally expose the firm to claims of discrimination.

c. *Explain the Firm's Hiring Process.* Generally this includes telling the candidate what happens after the initial interview and informing the candidate of the estimated timetable for filling the position.

d. *Describe the Job Requirements to the Candidate.* Providing this information to the candidate is useful because a common understanding helps create a basis for communication.

The interviewer should ask the candidate open-ended questions (that is, questions that require more than yes or no answers). Such questions require the candidate to answer with some detail and enable the interviewer to gauge the candidate's verbal communication skills. Properly worded open-ended questions usually provide the interviewer with the best opportunity to learn how the candidate solves problems, makes decisions, and learns from experiences. All questions should be job-related so that problems with discrimination and privacy laws do not arise. The following are examples of questions that may be asked:

- Give a detailed explanation of what you do during a typical work day.
- How have your past job experiences prepared you for this job?
- How would your present employer describe your work habits?
- What subjects caused you the most problems in school and why?
- What kind of work best suits you and why?
- In your previous jobs, what kind of pressures did you encounter and how did you handle those situations?
- What personal qualities would you say have accounted for your success to date?
- Do you like working by yourself or in groups and why?
- What do you know about this firm?
- What are your short- and long-term career goals?

Some firms like to ask each candidate the same questions so that an equal basis exists for evaluating the candidates. The firms list several standard interview questions ahead of time on an interview question sheet. Using predetermined questions should not prevent the interviewer from asking additional questions that may arise during the interview. Additional questions should be noted on the candidate's interview question sheet.

The interviewer should prepare a written evaluation of each candidate interviewed. The evaluation should cover only topics that relate to the job description. For a bookkeeping position, those topics normally include the candidate's personal attributes (professional image, attitude, etc.) and the level of experience that the individual will bring to the job.

Contacting Personal References and Former Employers. Candidates will often provide listings of personal references or former employers that the firm may contact. Although such references may appear to be good sources of information about a candidate, the firm should keep the following in mind when contacting them:

- Personal references are hand-picked by the candidate. Thus, the firm should expect to hear mainly positive comments about the candidate.
- Many federal and state employment laws have been enacted to protect the rights of present and former employees. Often, employers are hesitant to provide detailed information on former employees for fear of becoming part of a possible future employment discrimination lawsuit.

Information requested from former employers should concentrate on the candidate's work habits, attendance record, dependability, personal qualities, and other job-related matters. The information should confirm what has already been provided by the candidate. To be fair, the same questions should be asked for all candidates when making inquiries to personal references and former employers.

Most firms conduct reference checks by telephone. Many attorneys, however, strongly recommend that reference checks be conducted in writing. Written reference checks encourage a response, help avoid learning irrelevant information, and help guard against asking questions that may be construed as discriminatory.

The hostile workplace events that have occurred since the early 1970's have prompted the need for more interviewing diligence. Firms may want to consider performing more than the basic reference checks. In addition to reference checks, firms may consider verifying employment history, including salaries, and performing criminal background checks. Additionally, performing a Social Security check provides every locality where the prospective employee has lived in the last seven years. A full pre-employment check is only necessary on those two or three final candidates the firm desires to know more about.

Pre-employment Testing. Some firms require job applicants to take a skills test to determine whether they possesses the necessary skill and knowledge to perform the job. For example, candidates for a bookkeeping position may be asked to take an accounting knowledge test. Other firms require such tests only if a candidate does not have enough work experience. If pre-employment tests are used, care should be taken to ensure that they are nondiscriminatory. Such tests should be given to all candidates and be relevant to the specific job. (For example, it may be considered discriminatory to administer an accounting skills test to some, but not all, applicants for a bookkeeping position. It also may be considered discriminatory to administer an accounting skills test to applicants for a position that requires no accounting skills.) A test may be used to evaluate the accounting skills of candidates for a bookkeeping position. Because testing is sometimes controversial and regulated both by the Equal Employment Opportunity Commission and individual states, employers should consult an employment law attorney before adopting any testing program.

Evaluating the Candidates. The most critical step in the recruitment and hiring process is evaluating prospective employees. Previous paragraphs have discussed attributes that many firms seek in candidates. During the evaluation stage, the individual in the firm responsible for hiring makes a judgment of whether or not the candidate possesses those attributes. In making this judgment, both objective considerations (grade point averages, college courses, prior work experience, aptitude tests, etc.) and subjective considerations (the individual's personal appearance and response to questions, how references respond, and the interviewer's *general perceptions*) are evaluated.

Suggested Documentation. Firms should review all hiring information after it has been gathered and accept or reject each candidate. The candidates that will be extended an offer should be contacted by telephone. After the candidate accepts the verbal offer, a written offer should be prepared that includes the following information:

a. The job title.

b. Whether the job is considered full or part-time.

c. Whether the job is exempt or nonexempt from minimum wage and overtime pay regulations.

d. Starting salary or wage.

e. Starting date.

f. Benefits the employee may initially qualify for.

g. Any special terms of employment.

h. Employment at will policy.

The firm should send two copies of the offer to the candidate: one to sign and return to the firm indicating acceptance of the offer and another for the candidate's files.

Best practices are to maintain a job file for each position that is recruited. The file should contain the following:

a. Copies of job advertisements.

b. All resumes and employment applications received.

c. All interview evaluation forms completed.

d. Documentation of all information gathered through references and former employers.

e. Copies of letters sent to unsuccessful candidates.

f. Copy of the letter sent to the successful candidate (The original letter, and any other information received or gathered on the successful candidate, also should be placed in that individual's personnel file.)

Since employment laws vary by state, the firm should contact an employment law attorney to see how long the job file should be kept before it is destroyed.

Rejecting a Candidate. One of the firm's most difficult tasks when hiring is telling certain applicants that they are not being hired. Not only is the task unpleasant, it may open the firm to discrimination claims from rejected applicants. Consequently, the firm should treat rejected applicants professionally and courteously, while protecting the firm's interests. The firm should do the following:

- *Document the Reasons the Firm Chose the Successful Candidate.* The firm should not document the reasons on the application or resume, but the documentation can be filed with those documents.

- *Document Separately the Business Reasons Why Each Applicant Considered Ineligible for Hire Was So Labeled.* The firm should not document the reasons on the application or resume, but the documentation may be filed with those documents.

- *Promptly Tell Rejected Applicants and Candidates When the Job Has Been Filled.* The firm may use letters or telephone calls to inform the rejected individuals.

- *Avoid Talking about the Applicant's Weaknesses.* If pressed, the firm should state the successful candidate appeared to be a better match to the job requirements.

- *Be Courteous and Professional.* Most people will respond similarly.

Training and Professional Development of Staff

A CPA firm must have properly trained staff to provide efficient write-up services to clients. Most of the training received by the write-up staff is on-the-job training. The amount of formal continuing professional education (CPE) provided to non-CPA write-up staff varies with each firm.

Quality Control Requirements. SQCS No. 7 indicates that continuing professional development has a significant impact on the ongoing competence of the firm's personnel because it facilitates maintaining their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific CPE and other professional development activities that enable them to fulfill their assigned responsibilities, such as passing the Uniform CPA Examination. In addition, such training will satisfy applicable CPE requirements of the AICPA and regulatory agencies.

The firm may provide the necessary training resources and assistance to facilitate the development and maintenance of firm personnel's required capabilities and competence. The firm may use an external source that is suitably qualified for that purpose if the firm lacks the technical expertise, or training resources, or for any other reason.

CPE Requirements. Members of the AICPA are subject to minimum CPE requirements. The requirements, which are described in Section 2.3.3 of the AICPA's Bylaws (BL 230.01 and 230R), state that all AICPA members must complete 120 hours of CPE over a three-year reporting period.

Firms applying for membership in the AICPA Division for CPA Firms agree to a certain level of CPE as a condition of membership. A basic membership requirement of the AICPA Division of CPA Firms is that every professional employed by a member firm must obtain 120 hours of qualifying CPE every three years.

State Boards of Accountancy and State CPA Societies. Most state boards of accountancy also have some form of CPE requirements for licensing. Most state CPA societies also have some form of CPE requirement for their members. Although many state requirements are similar to those of the AICPA, they do vary from state to state. For instance, for licensing, some states require that the individual must complete a stated number of CPE hours in accounting and auditing per reporting period. In addition, some state boards specify the maximum number of CPE hours that can be obtained in a particular delivery mode such as self-study, and some state boards do not allow any credit for certain delivery modes (for example, articles and publications). Some states require a stated number of CPE hours in ethics on a recurring basis and may stipulate that the ethics courses taken be approved by the state board of accountancy. Compliance with a state board's requirements will satisfy the AICPA requirement if certain conditions are met. However, the reverse is not necessarily true. Paragraph IB of the AICPA's *Policies for CPE Membership Requirement* (CPE Section 10 of the AICPA *Professional Standards*) cautions that AICPA standards may not necessarily be sufficient to meet requirements for continued state licensing or certification or for state society membership. Firms should contact their state boards and societies for specific requirements.

Are Write-up Staff Subject to CPE Requirements? All states require CPAs in public practice to meet minimum CPE requirements. Thus, all CPAs on the write-up staff (regardless of whether they are members of the AICPA) must obtain CPE.

Determining whether non-CPAs on the write-up staff must obtain formal CPE is more difficult. Because state CPE requirements extend only to those licensed to practice public accounting, state CPE requirements do not apply to non-CPAs. In addition, the AICPA's CPE requirement applies only to AICPA members. However, a requirement for membership in the AICPA Division of CPA Firms is that all *professionals* employed by a member firm meet certain CPE requirements. Thus, whether non-CPAs must obtain formal CPE depends on (a) whether the firm is a member of the AICPA Division of CPA Firms and (b) whether non-CPAs are classified as professionals.

The following literature addresses the issue of whether non-CPAs are considered professionals:

a. The AICPA's CPE requirement applies only to AICPA members. The AICPA's *Statement on Standards for Continuing Professional Education Programs* applies to CPAs, which it defines in footnote 1 as "all persons who are licensed and/or regulated by boards of accountancy."

b. *Government Auditing Standards* (the Yellow Book) states that CPE requirements apply to specialists who perform as members of the audit team, even if they are not CPAs.

In addition, AICPA Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*, requires assigned personnel to have the necessary capabilities, competence, and time to perform engagements in accordance with professional standards and regulatory and legal requirements and to ensure that the firm issues reports that are appropriate in the circumstances. Accordingly, the firm's personnel are required to have a sufficient level of continuing professional development to maintain their knowledge and capabilities. The standard states that the firm's policies should emphasize that all levels of firm personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned and to satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.

Planning the Firm's Professional Development Activities. At least once a year, the person responsible for professional development should assess the firm's professional development needs and plan the professional development program. In smaller firms, a partner (or even the managing partner) may be responsible for professional development in the firm. However, as the firm grows, this responsibility is often assigned to another individual because someone else can perform the duties if given proper training, supervision, and authority to implement the plans. Regardless of who is responsible, a thorough knowledge of the various CPE requirements affecting the firm, as well as a thorough understanding of the special needs of the firm to appropriately serve its clients, is essential. Planning the firm's professional development program is important if the firm is to accomplish the following:

- *Provide Quality Professional Services.* Competent staff who stay abreast of the technical guidance necessary to perform their engagements are essential to a firm's ability to provide quality professional services. A properly planned professional development program helps the staff maintain such ability.

- *Identify Individual Engagement Training Needs.* Staff with specific training needs should be identified and training techniques designed to meet those needs (i.e., a staff member who lacks good documentation techniques may be assigned to work under a supervisor who is experienced in this area).

- *Control CPE Costs.* The CPE needs of the staff can be assessed and met more cost-effectively through planning. Such planning can also help achieve a proper mix of in-house and outside programs that best meet the needs of the firm and its personnel.

- *Develop Specialists or Experts.* A firm's needs for specialists or experts should be considered. Special courses or reference materials that are needed should be identified, and steps should be taken to fulfill those needs. Some firms may have a need for managers, partners, and experienced staff with professional certifications in addition to the CPA certification.

Create a Professional Development Plan for Each Professional in the Firm. Planning for a firm's CPE and professional development activities means more than having a policy that requires all professionals to earn 40 hours of CPE each year. To be effective, planning should include developing a professional development (PD) plan for each individual in the firm. The *Statement on Standards for Continuing Professional Education Programs* suggests, but does not require, that CPAs develop a learning plan. The Statement's glossary defines a *learning plan* as "structured processes that help CPAs guide their professional development" and further states that learning plans include the following:

- A self-assessment of the gap between current and needed knowledge, skills, and abilities.

- A set of learning objectives arising from this assessment.

- Learning activities to be undertaken to fulfill the learning plan.

Other factors to be considered when planning an individual's PD needs to include the following:

- The individual's personal PD desires, i.e., what CPE courses or seminars the individual wants to attend, what skills the individual would like to develop, any specialized industry areas that the individual would like to focus on, etc.

- The firm's assessment of both the individual's PD needs and the firm's particular needs to stay technically current in a special accounting area or to expand into a new service area.

- The CPE requirements of the AICPA, state boards of accountancy, the GAO, and other regulatory agencies. Those requirements pertain not only to obtaining the minimum CPE hours for each staff, but also ensuring that the professional development courses qualify for CPE credit.

- Encouraging personnel at each staff level to participate in PD activities such as completing external professional development programs, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups.

Planning the PD needs of each staff member is time consuming. Consequently, this type of planning may be viewed as an onerous and unnecessary task by sole practitioners and small firms, especially if CPE decisions in those firms have been made on an ad hoc basis. While establishing PD plans for each professional is time consuming, it represents the most effective method to ensure that staff members obtain the appropriate CPE to enable them to fulfill their assigned responsibilities and to satisfy applicable CPE requirements of the AICPA, state boards of accountancy, and other regulatory agencies. It is in the firm's best interest to oversee each staff members' PD program following firm guidelines and in subjects that are relevant to each individual's responsibilities. Additionally, as previously mentioned, coordination of CPE activities at the firm level can greatly reduce total CPE costs. Firms may choose to develop the PD plan for new staff and then discuss the plan with them, using the opportunity as a means to teach new staff how to develop their PD plan in subsequent years. Even when staff is preparing the PD plan, firm management should review and discuss the PD plan as necessary and give final approval.

Document the Professional Development Plan. Some firms elect to document the professional development planning process in a memo or minutes to a partners' meeting. Normally, partner meeting minutes would indicate in general terms that PD planning has occurred. This documentation approach can be effective for sole practitioners or small firms with only a few professional staff members. When larger firms, however, do not have evidence of a written PD plan for each professional in the firm, peer reviewers will normally ask how the firm went about determining CPE needs for each professional. Such a process may require the peer reviewer to interview each staff member in the firm to discuss how that individual's CPE needs were determined and met.

An alternative documentation approach is the preparation of an annual CPE planning worksheet for each individual in the firm. Staff may prepare their individual CPE plan and submit the form to management for discussion and approval. This approach has the advantage of allowing the person responsible for overall CPE planning to formally document the overall PD plan and to fine tune the plan for cost savings or other purposes.

Assessing Professional Capabilities and Competencies. SQCS No. 7 expands a firm's responsibility for the assessment of capabilities and competencies, making it a significant aspect of the firm's quality control. It defines *capabilities and competencies* as "the knowledge, skills, and abilities that qualify personnel to perform an engagement." SQCS No. 7 refers to several ways in which an individual's unique capabilities and competence are developed, which include—

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Mentoring relationships with more experienced staff members.

SQCS No. 7 also states that "a firm's quality control policies and procedures should provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities." Generally, an engagement partner gains the necessary competencies through the methods listed previously, but particularly through relevant and appropriate experience in engagements performed in the accounting and auditing practice.

The AICPA has developed an online tool for CPAs to assess their professional competency by identifying an individual's strengths, learning opportunities, and areas where growth is needed. Competency models are available for various specialty areas and each model assesses the individual's level of proficiency in the particular functional specialty, broad business perspective, leadership qualities, and personal attributes. New competency models are added regularly to ensure that the tool remains up-to-date. The AICPA Competency Self-Assessment Tool (CAT) is available free of charge to AICPA members. This tool can be accessed at **www.cpa2biz.com/CPE-Conferences/CAT.htm**. Firms should consider having all professional staff utilize this tool to assist in identifying individual training opportunities.

A complete discussion of how individuals, including engagement partners, develop capabilities and competencies is beyond the scope of this course. However, a comprehensive discussion, including illustrations of general competencies for the competency categories of the CAT, can be found in *PPC's Guide to Quality Control*.

Evaluating Staff Performance

SQCS No. 7 (QC 10.55) states that a firm's quality control policies and procedures should provide that personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be expected to assume.

Through the use of performance evaluation, compensation, and advancement procedures, the firm gives due recognition and reward to the development and maintenance of competence and commitment to ethical principles.

To develop and maintain employee competence and commitment to ethical principles (including a commitment to quality), firms may take the following steps:

- Ensure that the firm's expectations regarding performance and ethical principles are clearly communicated to personnel.

- Provide personnel with performance evaluations and counseling specific to their individual progress and career development.

- Ensure that personnel understand—

  - The quality of an individual's performance and adherence to ethical principles directly affects compensation and advancement to positions of greater responsibility.

  - An individual's failure to comply with the firm's policies and procedures may result in disciplinary action.

Write-up staff should receive performance evaluations periodically. Performance evaluations also serve several other purposes. They—

- Inform employee of strengths and weaknesses noted during past job performances.

- Set goals for future job performance.

- Establish a basis for periodic salary adjustments.

- Allow feedback about employee concerns and morale.

- Provide the firm with a defense against employment discrimination claims.

Frequency of Evaluations. Write-up staff provide bookkeeping and other related services to assigned clients on a continuous basis throughout the year. Thus, it may not be practical to conduct formal performance evaluations after each engagement. Instead, it may be more productive to conduct evaluations at regular intervals throughout the year, such as quarterly, semi-annually, or annually.

Firms should not wait until the next scheduled performance evaluation to point out exceptional or unacceptable performances, however. Such instances should be discussed with the staff member when they occur to provide encouragement or to correct the deficiencies noted. Immediate feedback is also important for employee morale since staff members are always interested in knowing how they are doing. Generally, the feedback is communicated verbally, although in some instances it may be preferable to also document the communication in writing by placing a memo in the staff member's personnel file. Firms should take special care to document conversations involving employee performance weaknesses, deficiencies, or repeat problems. A lack of adequate documentation of those conversations can potentially put firms at risk if an employee discharge is necessary in the future.

Input from Supervisors and Clients. Before conducting formal performance evaluations with staff members, the evaluator should obtain information about staff performances from supervisors that are familiar with the staff members' work. The information can be obtained verbally or through written evaluations completed by the supervisor.

The evaluator may also receive information about the write-up staff from clients. Information received from clients usually is more informal than that received from supervisors. Generally, client feedback is received verbally over the telephone or during informal meetings. Verbal feedback from clients should be summarized in a memo for inclusion in the staff member's personnel file.

Documenting the Performance Evaluation. Prior to conducting the performance evaluation, the evaluator should prepare a written evaluation of each staff member based on information obtained from supervisors and clients. The written evaluation should then be discussed with the appropriate staff member during the performance evaluation.

Generally, the written evaluation should document the staff member's strengths and weaknesses. The evaluation should not dwell on the weaknesses noted but, instead, use them as a means of offering suggestions for improving future performance. At the conclusion of the evaluation, the evaluator should document the staff member's comments and reactions to the review.

Retaining Staff

The public accounting profession is constantly changing, and the need for experienced, highly technical staff is more critical than ever. Years ago, a common practice was to hire new inexperienced staff, train them, get a few years of hard work from them, and then expect them to leave. Today, most firms cannot afford that strategy. It is too expensive to hire and train staff only to lose them in a few years. In 2005, a consultant to the accounting industry stated the cost of losing a professional young staff person is $75,000, including the cost of executive search fees for the replacement, re-training, and the loss of morale. Also, with the increased use of computer technology, there is less lower-level staff work to do. More work is now of a technical or analytical nature, requiring experienced and knowledgeable personnel. Retention of quality staff, therefore, is vital to a firm's success.

In today's environment, lifestyle choices and job satisfaction are major factors that employees consider when deciding whether or not to stay with a firm. Adequate compensation and benefits are obviously important and necessary, but the firm's culture is often just as important to an employee. The firm's culture significantly impacts an employee's overall perception of the firm and, in the long term, can often be the reason an employee chooses to stay with the firm or to go elsewhere.

The firm's culture should communicate the message to employees that they are valuable and deserving of respect. While definitely not all-inclusive, some of the cultural benefits a firm can provide are:

- *Positive Work Environment.* Overall working conditions may be the single most significant factor that contributes to an employee's level of job satisfaction. Few people enjoy being in a negative or oppressive work environment. Firms should strive to establish a work environment that encourages employees to want to perform to their potential. Firms should particularly work to maintain a positive environment during busy season as deadlines approach and tensions mount. If the firm management style promotes employee insecurity, hostility, or intimidation, employee morale will probably always be low, even if employees are well compensated.

- *Emphasis on Personal Development.* If the firm seeks to retain high-quality staff, it should develop those individuals and provide opportunities for their continued professional growth throughout their careers. Since professional staff are required to receive a certain number of CPE hours each year, the firm should ensure that those CPE hours are meaningful and relevant to the extent possible. Taking CPE just to satisfy the hour requirement wastes the firm's opportunity to increase both staff quality and job satisfaction. The firm should attempt to provide staff with courses that improve their individual skills, such as developing an industry expertise, increasing knowledge in a particular area, or providing management or other skills as appropriate.

- *Recognition of Performance.* One of the most positive things a firm can do to increase staff job satisfaction is to recognize individuals for outstanding performance. Recognition does not have to be public, nor does it have to be expensive. A partner giving an employee a "pat on the back," a simple thank-you for a job well done, can have a tremendous impact on that employee's attitude and loyalty to the firm. All too often, accountants forget to reward positive performance; the old philosophy that "no news is good news" prevails. Firm partners should take every opportunity to reinforce positive performance. The benefits to the firm can be great. Regular and frequent feedback is particularly important to the latest generation of young professionals.

- *Emphasis on the Individual as Part of a Team.* All staff members should first be treated respectfully as individuals. They should also be treated as part of the group, as members of a team that works together to achieve a common goal. Employees need to feel that they are a part of things, that their efforts make a positive contribution to the firm as a whole. If the firm recognizes staff retention as a strategy for developing future partner candidates, promoting the team concept can be very effective. Some firms are now adopting a formal team approach to serve certain industries or specialties. Other firms are informally utilizing the team concept to motivate staff and management to communicate and work together better.

- *Open Communication.* In order to maintain job satisfaction for any length of time, employees must feel free to communicate with management. It takes little effort to promote the firm as having an open door policy, but it does require effort and sometimes patience to genuinely practice the policy. Employees need to be able to communicate their needs and problems openly and without fear of repercussions. Some firms are now soliciting staff input on an ongoing basis to improve client service and firm administration. Other firms designate a mentor for each new staff member who helps facilitate communication with management. For open communication to truly exist in a firm, partners must be willing to hear the truth. The truth may not always be pleasant, but hearing and accepting the truth will often make the firm stronger.

- *Information about the Firm.* From a staff perspective, some firms appear to operate under a veil of secrecy. Many firms do not disseminate financial information to the staff, or even provide more general information such as firm goals and plans for the future. Since communication is one of the top reasons that employees leave a firm, not communicating with all employees should be reconsidered. While it is necessary to maintain confidentiality in areas such as partner compensation, certain other firm information can and should be communicated to the staff. The staff will perceive it as a demonstration of trust. Just as a firm invests in its staff, its staff members also invest in the firm's future by working to achieve firm profitability and to eventually become partners. The staff wants to know what is going on and how it will impact their jobs. As a result, those staff members deserve to be told basic information that will allow them to have some degree of security about the firm's financial stability. Firms should share as much financial and other information with the staff as possible. At a minimum, the staff should be told whether the firm is profitable and whether there are opportunities for growth in the future. Additionally, the staff should know about the firm's strategic plan and how each individual contributes to the firm's plan. The firm's most talented staff will usually choose to leave the firm at some point if a career path is not apparent.

The issue of staff retention is extremely important for firms today. Understanding the motivations and lifestyle objectives of those staff can help the firm position itself to retain the talent it has spent a significant amount of time and money cultivating. Firms can obtain further information about dealing with staff in the workplace and receive a free one-page monthly newsletter on related issues from **www.rainmakerthinking.com**. Additional guidance on staff retention may also be found in *PPC's Guide to Managing an Accounting Practice*.

SELF-STUDY QUIZ

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

7. Recruiting qualified staff is best described as:

   a. Selective since there is an abundance of qualified candidates.

   b. Just as important as marketing.

   c. Interviewing and making offers.

   d. Difficult since college students are not interested in the accounting profession.

8. Select from the following choices the best definition of discrimination.

   a. Using a skills test to determine whether an employee or potential employee possesses the necessary skill and knowledge to perform the job.

   b. Requesting information from former employers concerning a job-candidate's work ethic

   c. Making a hiring judgment.

   d. Using a basis other than individual merit to make a difference in treatment.

9. Lori is the HR director of a local write-up services firm. She has been reviewing the jobs that have signed engagement letters and anticipating the other engagements from previous years that have not been confirmed yet, to make sure the firm will have enough staff to cover the workload during their "busy" season and deciding if any new hires need to be made. She considers her current staff stable and competent. In her staffing assessment, what factor is Lori concerning herself with?

   a. Predicting staffing expected to cover growth of the firm.

   b. Predicting the staff's workload during a particular time period.

   c. Accommodating the schedule for expected turnover in the firm.

   d. Making sure the firm will be able to assist all of their clients.

10. Which of the following is correct regarding the application process?

    a. An application should be filled out when an employee completes the interview process and only if the employer is serious about hiring them.

    b. Information on the application can be verified by the prospective employer with the consent of the applicant.

    c. The application should assert that its completion is not a guarantee of employment.

11. Documentation is part of the hiring process and must be taken seriously by the firm. In which of the following scenarios has the manager used documentation properly in the hiring process.

    a. Frank has made a decision on a candidate to fill the open position at the firm. He calls and extends and offer to the candidate, he accepts and Frank tells him when his first day of work will be.

    b. Kim, the HR director creates a job file for each open position in the firm, and keeps all of the paperwork accumulated on the candidates considered for the position.

    c. The documentation that was sent to Karen, a new hire of Bank and Brooks, contained the information on the job, including the starting date, job title and benefits, but the starting salary was not included.

12. When rejecting a job candidate, a firm should do which one of the following?

    a. Inform a rejected applicant the job was filled after the chosen candidate has been on the job for 90 days.

    b. Inform the rejected applicant what job requirements he was lacking.

    c. Document separately the business reasons why ineligible applicants were so labeled.

13. Martin, a relatively new CPA in the firm of Peavy, Pacey and Egerton has been asked to perform a self—assessment of the gap between current and needed knowledge, skills and abilities. This request is an indication that the firm is attempting to do which of the following?

    a. Evaluate Martin's performance as a staff member.

    b. Provide the firm with a defense against employment discrimination claims.

    c. Create a professional development plan for Martin.

    d. Inform Martin of his strengths and weaknesses noted during past job performances.

14. Which of the following is **not** included in SQCS No. 7 as a method in which an individual's competency can be developed?

    a. Professional education.

    b. Training and continuing professional development.

    c. Creating a positive work environment.

    d. Work experience.

15. What is one of the most positive things a firm can do to increase job satisfaction among staff?

    a. Recognize individuals for outstanding performance.

    b. Share the firm's financial information.

    c. Provide professional development opportunities.

    d. Adopt the team approach.

SELF-STUDY ANSWERS

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

7. Recruiting qualified staff is best described as: **(Page 134)**

   a. Selective since there is an abundance of qualified candidates. [This answer is incorrect. There is a shortage of qualified professionals.]

   b. Just as important as marketing. [This answer is correct. Qualified professionals are difficult to find and attract because of competition among employers, therefore, as much attention should be focused on recruiting as on marketing.]

   c. Interviewing and making offers. [This answer is incorrect. Recruiting is much more than interviewing and making offers. It should encompass an ongoing plan to attract and hire qualified individuals.]

   d. Difficult since college students are not interested in the accounting profession. [This answer is incorrect. A career in accounting has become prestigious and alluring to a higher percentage of college students.]

8. Select from the following choices the best definition of discrimination. **(Page 137)**

   a. Using a skills test to determine whether an employee or potential employee possesses the necessary skill and knowledge to perform the job. [This answer is incorrect. This is the definition of pre-employment testing. It allows a firm to determine whether an applicant possesses the necessary skills to perform the job. Care should be given to ensure all tests are relevant and specific to the job so that they are nondiscriminatory.]

   b. Requesting information from former employers concerning a job-candidate's work ethic. [This answer is incorrect. This is the definition of checking personal references. The same questions should be asked for all candidates that references are confirmed to keep the process fair.]

   c. Making a hiring judgment. [This answer is incorrect. Making a hiring judgment is part of the candidate evaluation process and is not discrimination. Every firm with a position to fill must select the candidate that possesses the attributes the firm is seeking.]

   d. Using a basis other than individual merit to make a difference in treatment. [This answer is correct. Many groups are protected from discrimination under federal law. Firm leaders cannot make statements that could be construed as discriminatory concerning individuals in any protected category.]

9. Lori is the HR director of a local write-up services firm. She has been reviewing the jobs that have signed engagement letters and anticipating the other engagements from previous years that have not been confirmed yet, to make sure the firm will have enough staff to cover the workload during their "busy" season and deciding if any new hires need to be made. She considers her current staff stable and competent. In her staffing assessment, what factor is Lori concerning herself with? **(Page 138)**

   a. Predicting staffing expected to cover growth of the firm. [This answer is incorrect. When a firm is trying to pursue and promote growth of its client base and make sure they had enough staff to cover this growth, then they are predicting staffing for growth. Lori is trying to make sure she has staff for confirmed work, not new work.]

   b. Predicting the staff's workload during a particular time period. [This answer is correct. When a firm is concerning themselves with the staffing needs during a particular time period, they are anticipating their staffing workload to make sure they have enough staff to handle the client's needs. Various alternatives exist to handling the changing workload demands, including (1) working planned overtime hours during the busy season and (2) hiring part-time or contract personnel. The

approach and philosophy for handling busy season workloads has a major impact on hiring decisions.]

c. Accommodating the schedule for expected turnover in the firm. [This answer is incorrect. When assessing staffing needs, turnover should be considered so that there will be enough staff to cover the work, but Lori is working on the current workload using the current staff that she feels is stable, so this is not the assessment that Lori is trying to complete.]

d. Making sure the firm will be able to assist all of their clients. [This answer is incorrect. Firms should also assess the ability of its staff to provide quality services to its existing clients. Lori is already considers her current staff stable and competent, so that is not her concern when assessing her current needs.]

10. Which of the following is correct regarding the application process? **(Page 142)**

a. An application should be filled out when an employee completes the interview process and only if the employer is serious about hiring them. [This answer is incorrect. An employment application should be completed before any interviewing takes place. Information that is pertinent to the interview process is contained in the application and would help an interviewer have a more complete interview with the candidate.]

b. Information on the application can be verified by the prospective employer with the consent of the applicant. [This answer is incorrect. An important feature of the employment application is that is provides the employer with the consent to verify the information provided in the application. The prospective employer cannot confirm the information without the prospective employee's consent since it violates the applicant's privacy.]

c. The application should assert that its completion is not a guarantee of employment. [This answer is correct. Applications should include a statement that conveys to the applicant that the completion of the application does not guarantee employment with the prospective company. This statement will ensure that there is no misunderstanding between the prospective employer and applicant about the status of the position with the company.]

11. Documentation is part of the hiring process and must be taken seriously by the firm. In which of the following scenarios has the manager used documentation properly in the hiring process. **(Page 144)**

a. Frank has made a decision on a candidate to fill the open position at the firm. He calls and extends an offer to the candidate, he accepts and Frank tells him when his first day of work will be. [This answer is incorrect. While Frank started the process correctly by calling and extending the offer verbally, he should follow up with a written offer for the candidate so that there will not be any misunderstanding between the hiring manager and the candidate.]

b. Kim, the HR director creates a job file for each open position in the firm, and keeps all of the paperwork accumulated on the candidates considered for the position. [This answer is correct. Best practices indicate that a job file for each recruited position should be maintained. Paperwork should be kept on successful and unsuccessful candidates for legal purposes. Employment laws vary by state, so a firm should contact an employment law attorney to see how long the job files should be kept before they are destroyed.]

c. The documentation that was sent to Karen, a new hire of Bank and Brooks, contained the information on the job, including the starting date, job title and benefits, but the starting salary was not included. [This answer is incorrect. The documentation should include the starting salary or wage so that there is no confusion on the part of the newly hired employee.]

12. When rejecting a job candidate, a firm should do which one of the following? **(Page 145)**

    a. Inform a rejected applicant the job was filled after the chosen candidate has been on the job for 90 days. [This answer is incorrect. A rejected applicant should be notified promptly once a candidate has been selected so that the applicant is not left wondering about a response from the firm.]

    b. Inform the rejected applicant what job requirements he was lacking. [This answer is incorrect. The firm should avoid talking about the applicant's weaknesses because it could put the firm in a compromising position with the applicant. If necessary, the firm should state the successful candidate was a better match to the job requirements.]

    c. Document separately the business reasons why ineligible applicants were so labeled. [This answer is correct. The reasons for not hiring an applicant should be documented but should not appear on the application or resume. Documenting reasons on applications could inadvertently create a discrimination situation.]

13. Martin, a relatively new CPA in the firm of Peavy, Pacey and Egerton has been asked to perform a self-assessment of the gap between current and needed knowledge, skills and abilities. This request is an indication that the firm is attempting to do which of the following? **(Page 147)**

    a. Evaluate Martin's performance as a staff member. [This answer is incorrect. Evaluation of performance indicates an assessment on tasks already performed. The question refers to current and needed knowledge which emphases future needs rather than what has already been accomplished.]

    b. Provide the firm with a defense against employment discrimination claims. [This answer is incorrect. This is what a performance evaluation would accomplish. The question is describing a needs assessment.]

    c. Create a professional development plan for Martin. [This answer is correct. One step in creating a professional development plan is a needs assessment. This assessment could be self-assessed.]

    d. Inform Martin of his strengths and weaknesses noted during past job performances. [This answer is incorrect. The question is emphasizing an assessment of knowledge needs that would help Martin perform in the future and this answer choice clearly states past job performance.]

14. Which of the following is **not** included in SQCS No. 7 as a method in which an individual's competency can be developed? **(Page 148)**

    a. Professional education. [This answer is incorrect. Professional education is mentioned in SQCS No. 7 as a method for developing competency.]

    b. Training and continuing professional development. [This answer is incorrect. Continuing professional development, including training is mentioned in SQCS No. 7 as a method for developing competency.]

    c. Creating a positive work environment. [This answer is correct. A positive work environment will contribute to an employee's level of job satisfaction but it is not included in SQCS No. 7 as a method for developing an individual's competency.]

    d. Work experience. [This answer is incorrect. Work experience is mentioned in SQCS No. 7 as a method for developing competency.]

15. What is one of the most positive things a firm can do to increase job satisfaction among staff? **(Page 150)**

    a. Recognize individuals for outstanding performance. [This answer is correct. Personal recognition of a job well done can have tremendous impact on the employee's attitude and loyalty to the firm.]

    b. Share the firm's financial information. [This answer is incorrect. Although being informed of the company's financial condition is important, this is not the most compelling method of increasing job satisfaction. Not sharing information is due mainly to confidentiality issues.]

c. Provide professional development opportunities. [This answer is incorrect. This is important to employees and helps in retention of staff, but it does not have the biggest impact on job satisfaction because the majority of employees would rank other factors higher.]

d. Adopt the team approach. [This answer is incorrect. Staff members should first be respected as individuals and then treated as part of a group working to achieve a common goal. Employees need to feel that they are part of things, but they need to know that their contributions are noted.]

ACCEPTING AND CONTINUING AN ENGAGEMENT

An element common to all engagements is the decision to accept a new client or to continue to serve an existing client. One of the most important considerations in such a decision is the firm's desire to avoid association with a client that has a poor or questionable reputation for honesty or business ethics. A firm should not accept work from clients that would be detrimental to the firm's image.

Continuation Factors

Firms should review a list of write-up engagements at least annually to determine whether such engagements and/or client relationships should be continued. The following are some of the factors firms should consider when evaluating whether to continue to provide services to an existing write-up engagement:

a. Timely payment of fees.

b. The firm's relationship with the client's management or owners.

c. Significant changes in one or more of the following:

   (1) Independence relationships.

   (2) Perceived integrity of management.

   (3) Directors or key management.

   (4) Legal counsel.

   (5) Financial condition.

   (6) Litigation.

   (7) Nature of business.

   (8) Nature or scope of engagement.

   (9) Risk associated with a particular engagement.

   (10) The firm's professional competence (expertise).

Terminating Services

Both objective and subjective reasons exist for terminating services to a client. In some instances, a client's actions provide specific reasons for no longer continuing the relationship. In other instances, the decision is based on more subjective factors. Each firm must determine its own continuation policies. The following factors may cause firms to consider terminating services to a write-up client:

a. Committing illegal acts or unethical practices.

b. Failing to pay fees when due.

c. Consistently not following advice.

d. Being uncooperative with firm personnel, including:

   (1) Failing to return phone calls.

   (2) Being rude to staff.

e. Continuing financial difficulties.

f. Misleading firm personnel.

g. Not providing complete data.

h. Intentionally providing false tax return information.

i. Failing to pay taxes when due—especially payroll taxes.

j. Constantly complaining about fees and service.

k. Changes in the perceived integrity of the client.

l. Dramatically decreasing the scope of the engagement.

When a firm decides to end a relationship with a client, the actual firing should be handled tactfully. If not, bridges may be burned and hopes of a future relationship could be lost. The client should be notified in writing. In addition, the following steps are generally recommended:

- *Do Not Sue the Former Client.* One of the more common causes of litigation against accountants is fee disputes. Accordingly, malpractice insurance underwriters strongly recommend against suing a client over unpaid fees.

- *Do Not Withhold Any of the Client's Records.* Any workpapers, journals, ledgers, checkbooks, canceled checks, or similar items that belong to the client should be returned upon termination. It is a violation of professional ethics (and in some jurisdictions, a violation of law) to withhold those items.

WHAT TO CONSIDER IN AN ENGAGEMENT

Determining the Client's Needs

Accountants may provide bookkeeping, payroll, or financial statement preparation services during a write-up engagement. They may not provide all of those services for each write-up client, however. The size of the client, its stage of development, the sophistication of its accounting system, the needs of banks and creditors, and many other factors provide indications of the types of services that may be appropriate. Generally, the accountants can obtain information to tailor the write-up engagement to meet the client's needs by discussing each service with the client. Because as clients grow their needs change, accountants should periodically evaluate the write-up services provided.

Meeting clients' needs is one of the most important attributes of a successful practice. Accountants should be alert for opportunities to provide other services in addition to write-up services. Accordingly, accountants should view write-up services as part of an overall engagement to provide a complete package of services for their clients. Those that view write-up services as a separate engagement often let opportunities such as financial planning slip away.

Considering the Intended Use of the Financial Statements

Introduction. Statement on Standards for Accounting and Review Services (SSARS) No. 1, (as amended) allows accountants to provide management-use-only financial statements *without issuing a compilation report*. In addition, SSARS No. 1 modifies the definition of *submission of financial statements*. A complete discussion of the submission of financial statements as defined by SSARS No. 1, as amended, is beyond the scope of this course.

Accountants who elect to submit management-use-only financial statements without issuing a compilation report will also have to determine the clients for which they may provide such services. Factors such as the definition of management and third parties, the adequacy of management's knowledge, and the intended use of the financial statements will affect the accountants' ability to submit management-use-only financial statements without a report in specific client situations.

Third-party-use versus Management-use-only Financial Statements. If the financial statements are, or can reasonably be expected to be used by a *third party*, management-use-only financial statements are not appropriate for the client. The SSARS considers *third parties* to be all persons, including those charged with governance, who are not members of management.

Who Is Management? SSARS No. 1, as amended by SSARS No. 17 (AR 100.04), defines *management* as—

> The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

SSARS No. 1, as amended by SSARS No. 17 (AR 100.04), defines *those charged with governance* as—

> The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases, management has this responsibility). In some entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform the management functions as defined above.

Consequently, boards of directors who are not members of management are considered to be *third parties*. In addition, members of management who do not meet the definition of management are also considered to be *third parties*. Management-use-only financial statements may only be issued if all intended users are members of management. Management-use-only financial statements are not appropriate for *internal use only* (that is, for use by all individuals within an organization).

In addition, SSARS No. 1 (AR 100.25) requires that when the compiled financial statements are prepared for management-use-only, the accountant should document an understanding with the client that includes a statement that management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. Thus, management-use-only financial statements may only be issued if all intended users (a) are members of management and (b) possess the requisite knowledge to understand the limitations of the financial statements. Clearly, this limits management's ability to share the financial statements with others within the organization.

Ultimately, it is up to the accountants to determine if they are comfortable with the level of management's knowledge and understanding of the possible limitations of management-use-only financial statements. From a practical standpoint, however, best practices indicate that management should represent to the accountants in the engagement letter that all intended users are *members of management* who possess the requisite knowledge. (*PPC's Guide to Compilation and Review Engagements* contains illustrative engagement letters that include language to this effect.) As long as the intended users appear reasonable and nothing comes to the accountants' attention to contradict management's representations, the accountants can rely on management's representation and perform a compilation of management-use-only financial statements.

Intended Use of the Financial Statements. Accountants should consider the reasons for which the client intends to use the financial statements. This might be done based on the accountants' knowledge of and past experience with the client, as well as based on discussions with the client as to how they intend to use the financial statements. SSARS No. 1 requires a client representation that management-use-only financial statements are not intended for third-party use. SSARS No. 1 provides that, absent any contradictory information that comes to their attention, accountants may rely on those representations without performing any further procedures.

Accountants should not, however, ignore information that would suggest that the financial statements might be used by third parties. For example, if accountants have compiled financial statements for the client in years past to meet certain provisions in a loan agreement, they might question whether such requirements are still in effect before agreeing to submit management-use-only financial statements. Accountants might also question the need for third-party-use financial statements if the client has entered into a new lending relationship during the current year. If obvious facts suggest that the financial statements might be used by third parties (despite management's representation to the contrary), accountants should compile and report on the statements in accordance with SSARS No. 1.

Accountants' Responsibilities When Management-use-only Financial Statements Are Distributed to Third Parties. SSARS No. 1 states that accountants who become aware that management-use-only financial statements have been distributed to third parties should—

- Discuss the situation with the client and request that the financial statements be returned.
- If the client does not comply with that request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third-party use, preferably in consultation with his or her attorney.

As discussed in the preceding paragraph, SSARS No. 1 places a responsibility on accountants who discover that management-use-only financial statements have been distributed to (and, presumably, are being used by) third parties. Distributing management-use-only financial statements to third parties is a violation of the terms of the engagement. However, the illustrative engagement letter in Appendix D of SSARS No. 1 does not explicitly impose on management a restriction on distribution; rather, it addresses only management's intended use of the financial statements. For that reason, accountants can add additional language in the engagement letter to clarify that management also agrees not to distribute the financial statements to third-party users.

Because unauthorized distribution is a contractual problem, accountants first discuss with their attorneys what action, if any, to take when they discover that management-use-only financial statements have been distributed to third parties. Factors or alternatives that might be discussed with an attorney include (but are not limited to) the following:

a. An evaluation, if possible, of any damages that might have been, or may be, incurred because of the use by a third party.

b. Whether to notify the client that the accounting firm is aware of unauthorized distribution of the statements.

c. Whether to notify third parties that received the statements that the distribution was unauthorized.

d. Whether to continue to provide services to the client.

To reduce exposure to unauthorized distribution, accountants should obtain an engagement letter (signed by management) that contains specific language about the restricted use of the financial statements.

Engagement Letters

Authoritative literature does not require accountants to obtain engagement letters for write-up engagements. A proposed SSARS would require accountants to establish an understanding with management regarding the services to be performed for *each* engagement. This understanding would need to be communicated in the form of an engagement letter and signed by both the accountant and management. However, SSARS No. 1, AR 100.20–.23, requires an engagement letter when compiled financial statements are not expected to be used by a third party and a compilation report will not be issued. Also, SSARS No. 1, AR 100.05, states that accountants should establish an understanding (preferably in writing) with the client when the engagement involves other unaudited financial statements of a nonissuer. The understanding should include the following items:

a. A description of the nature and limitations of the services.

b. A description of the report the accountants expect to render.

c. A statement that the engagement cannot be relied on to detect errors, fraud, or illegal acts.

d. A statement that the accountant will inform the appropriate level of management of any fraud or material errors and evidence or information that comes to his or her attention that fraud or an illegal act may have occurred (unless the illegal acts are clearly inconsequential).

Even if financial statements are not prepared (for example the write-up engagement involves preparation of a general ledger only), following the guidance in SSARS No. 1, AR 100.05 can be beneficial. Obtaining an engagement letter for all write-up engagements is recommended. Engagement letters are advantageous to both the client and the accountants because they:

a. *Help Avoid Client Misunderstandings.* In today's environment, an engagement letter is needed for both existing and new clients. To avoid misunderstandings, the engagement letter describes in detail the services to be rendered, the fee, and the other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountants and the client.

b. *Help Avoid Staff Misunderstandings.* Placing a copy of the engagement letter in the workpapers provides the staff of the accounting firm with an authoritative reference to supplement their oral instructions. That eliminates confusion and misunderstandings about the type of engagement to be performed, the date and period covered by financial statements, and the nature of the report expected to be rendered.

c. *Reduce Potential Legal Liability.* Many adverse consequences may result from failing to obtain a written engagement letter. In the case of services that are new to the client, it is particularly important to obtain engagement letters as protection against misunderstandings and the lawsuits that may result.

d. *Improve Practice Management.* Ordinarily, the engagement partner should review the engagement letter before it is presented to the client. A timely review may be the vehicle that permits the partner to amend the terms of the engagement, approve the proposed fee and payment schedule, and set up guidelines to minimize possible collection problems.

e. *Clarify Contractual Obligations.* Engagement letters are evidence that a contract is created when an accountant agrees to render services and a client agrees to pay for them. The engagement letter should contain a clear-cut delineation of the duties and responsibilities of the client and of the accountants.

Most clients will not find the engagement letter offensive if presented and explained in person. If the accountants determine that it is not advisable to request that the client sign an engagement letter, however, they should, as an alternative, develop the understanding orally and mail a letter of confirmation. If a confirmation letter is not mailed, the accountants may wish to document the oral communication in a note or memo to the engagement workpapers.

Most accountants recognize the merits of using engagement letters, but some find that their clients resist them. The following steps can be employed to overcome client resistance and avoid damage to client relations:

a. Explain that engagement letters are obtained for all write-up engagements; the client should not think this engagement is unique.

b. Explain the reasons for an engagement letter and that it also benefits management.

c. Review the letter with the client personally. Explain that the engagement letter is intended to help the client fully understand exactly what the accountant is doing. It lists any limitations of the accountant's services so that the client will not allow important functions to fall between the cracks.

Obtaining an engagement letter for each monthly financial statement that a firm compiles is not necessary. One engagement letter can be drafted to cover financial statements issued for a period of time, such as a year. It is also possible to use one engagement letter to cover all services to be provided. The engagement letter lists the services available, provides a place to indicate the frequency of each service (monthly, quarterly, annually, or as requested), and covers the other items required by SSARS No. 1 at AR 100.05. As an alternative, the accountants can use individually drafted engagement letters similar to those illustrated in SSARS No. 1 (AR 100.05, Appendixes C and D).

Obtaining Knowledge of the Client and Its Industry

SSARS No. 1, AR 100.08, requires accountants that issue compilation reports to possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates. A "Client Information Form" can be used to document compliance with that requirement.

Enhancing the Engagement's Efficiency

The repetitive nature of most write-up engagements provides opportunities for the firm to provide write-up services more efficiently. Best practices indicate the following for improving a write-up engagement's efficiency:

- *Develop a Work Program.* Many firms develop or purchase work programs or checklists that can be used to document the procedures performed on write-up engagements. The programs list the steps that most firms would want their accountants to follow in completing the bookkeeping function, preparing the trial balance, and/or drafting the financial statements. The type of program that should be used depends on the accounting or tax services to be provided. For example, if an engagement involves only bookkeeping services followed by the preparation of a trial balance (i.e., no financial statements are generated) the accountant might use a checklist such as a "Data Processing Checklist." If compiled financial statements are prepared, a "Financial Reporting and Disclosure Checklists" might be used.

- *Plan the Engagement for the Entire Year.* It is generally more efficient to plan a monthly write-up engagement as a single, year-long engagement rather than as twelve separate engagements. In other words, plan the engagement once instead of twelve different times. Determine and document the checklists, services, and forms that should be completed throughout the engagement for the entire year.

- *Develop a Due Date Calendar for Each Engagement.* Due dates are important for write-up engagements, particularly in the area of taxes. To help monitor due dates and determine staff scheduling requirements, many firms maintain a calendar listing an engagement's due dates for tax returns, tax deposits, or other matters. Further discussion of due date monitoring systems appears later in this lesson.

- *Determine What Information and Documents Will Be Needed Each Month.* It is important to convey to the client what information and documents will be needed each month. Some accountants provide transmittal forms to be returned with their clients' information. The forms serve as memory joggers for their clients to help ensure that all information is provided. It can be very inefficient for the accountant if clients fail to provide the necessary monthly information.

SELF-STUDY QUIZ

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

16. According to the text, what is the most important consideration when making a decision about continuing a relationship with a client

    a. The amount of fees collected from the client.

    b. The firm's desire to avoid association with a client of questionable reputation.

    c. The client's ability to understand the information produced by the firm.

17. Which of the following actions should **not** be taken when terminating a client?

    a. Notify the client in writing.

    b. Return the client's records.

    c. Sue the client for unpaid fees.

18. A company's management-use only financial statements can be provided to:

    a. A bank loan officer.

    b. A potential investor.

    c. The company's operations manager.

    d. The company's property insurer.

19. If a client distributes management-use-only financial statements to a third party without the permission of their accountants, what action should the accountant take first?

    a. Discuss the situation with their attorney.

    b. A complete audit of the financial statements.

    c. Call the client and request that the financials be returned.

20. Tom's client refuses to sign an engagement letter. Which step should Tom take to help him overcome his client's resistance?

    a. Tell the client that services cannot be provided without a signed engagement letter.

    b. Tell the client he is unique and that an engagement letter is necessary in this situation.

    c. Review the letter with the client personally.

    d. Assign the client to another accountant within the firm.

21. Which of the following statements is most accurate in regards to enhancing an engagement's efficiency?

    a. Purchase of a work program will enable the firm to keep track of any engagement.

    b. It is best to plan monthly write-up services as twelve separate engagements.

    c. Maintain a calendar listing an engagement's due dates.

    d. Contact the client for missing information.

SELF-STUDY ANSWERS

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

16. According to the text, what is the most important consideration when making a decision about continuing a relationship with a client? **(Page 159)**

    a. The amount of fees collected from the client. [This answer is incorrect. Although the timely payment of fees was mentioned as a factor in deciding whether to terminate a client, the amount of fees paid was not and it is not the most important consideration.]

    b. The firm's desire to avoid association with a client of questionable reputation. [This answer is correct. A firm should not accept work from clients that would be detrimental to the firm's image or call into question its business ethics.]

    c. The client's ability to understand the information produced by the firm. [This answer is incorrect. Although the client should understand the information provided, not understanding is not a reason for terminating the relationship.]

17. Which of the following actions should **not** be taken when terminating a client? **(Page 160)**

    a. Notify the client in writing. [This answer is incorrect. A client should be sent a termination letter for legal purposes.]

    b. Return the client's records. [This answer is incorrect. The client's records should not be withheld and failure to return them is a violation of professional ethics.]

    c. Sue the client for unpaid fees. [This answer is correct. One of the more common causes of litigation is fee disputes. Insurers strongly recommend against suing a client over unpaid fees since it could lead to more involved legal matters.]

18. A company's management-use only financial statements can be provided to: **(Page 161)**

    a. A bank loan officer. [This answer is incorrect. A banker is outside the business and, therefore, a third party.]

    b. A potential investor. [This answer is incorrect. Management-use-only financials cannot be shared with a third party.]

    c. The company's operations manager. [This answer is correct. This individual would be considered a member of management in charge of a principal business function.]

    d. The company's property insurer. [This answer is incorrect. An insurance company is a third party and not eligible to receive management-use-only financials.]

19. If a client distributes management-use-only financial statements to a third party without the permission of their accountants, what action should the accountant take first? **(Page 162)**

    a. Discuss the situation with their attorney. [This answer is incorrect. A discussion with the accountant's attorney about the action to be taken against the client might be appropriate if the client does not respond to other actions taken by the firm since the unauthorized distribution is a contractual problem.]

    b. A complete audit of the financial statements. [This answer is incorrect. The accountant is not obligated to do an audit of the financial statements, since this was not was contracted in the engagement letter with the client. An evaluation of any damages that might be incurred by the use of the report by the third party might be in order, though.]

c. Call the client and request that the financials be returned. [This answer is correct. It is a good idea to notify the client that the firm is aware of unauthorized distribution of the financial statements and request that they be returned to minimize the exposure to the management-use only financials.]

20. Tom's client refuses to sign an engagement letter. Which step should Tom take to help him overcome his client's resistance? **(Page 163)**

    a. Tell the client that services cannot be provided without a signed engagement letter. [This answer is incorrect. Even if not providing services without a signed engagement letter is firm policy, making such a direct statement may sound threatening to the client. There is a better answer choice.]

    b. Tell the client he is unique and that an engagement letter is necessary in this situation. [This answer is incorrect. Explain that engagement letters are obtained for all write-up engagements and that his engagement is not unique.]

    c. Review the letter with the client personally. [This answer is correct. Explain that the engagement letter is intended to help the client fully understand exactly what the accountant is doing.]

    d. Assign the client to another accountant within the firm. [This answer is incorrect. Assigning the client to another accountant within the firm would be the correct action if the client has a major dislike of the accountant. However a reassignment is no guarantee that the client will sign the engagement letter. There is a better answer choice.]

21. Which of the following statements is most accurate in regards to enhancing an engagement's efficiency? **(Page 164)**

    a. Purchase of a work program will enable the firm to keep track of any engagement. [This answer is incorrect. No one program will cover all engagements.]

    b. It is best to plan monthly write-up services as twelve separate engagements. [This answer is incorrect. It is more efficient to plan a monthly write-up engagement as a single, year-long engagement.]

    c. Maintain a calendar listing an engagement's due dates. [This answer is correct. Listing due dates, particularly for taxes, on a calendar is the best way to monitor due dates so that no important due dates are missed.]

    d. Contact the client for missing information. [This answer is incorrect. It is best to send the client a transmittal letter upfront requesting all information and reviewing it upon receipt so that an understanding of expectations is established between the client and the firm.]

PROCESSING REPORTS, TAX RETURNS, AND CORRESPONDENCE

Often, the only physical evidence of the long hours and hard work that a firm spends providing its professional services are the reports (for example, accountant's report attached to compiled financial statements), tax returns, and correspondence that it issues. Consequently, care should be taken to ensure that those products project the firm's professional image. For example, each report, letter, and other document should be proofread to ensure that it contains no "typos" or other errors. (Word processing software such as Microsoft's Word has spelling and grammar tools that can be helpful in identifying those types of errors in documents. However, such tools are not 100% accurate.) It also should be prepared using a high quality paper, attractive typestyle, and, if appropriate, bound in the firm's report cover.

This portion of the lesson presents considerations for preparing the firm's reports, tax returns, and correspondence. It discusses producing the reports, obtaining the necessary signatures, and delivering the finished product. It does not discuss the quality control procedures that the firm should follow to ensure the appropriateness of the reporting format or the accuracy of the firm's conclusions.

Producing Reports, Tax Returns, and Correspondence

Developing the Firm's Style. Authoritative literature provides little guidance on matters of form or style. Thus, in practice, many approaches are used, most of which are no more right or wrong than others. Typically, a firm's style evolves over time by addressing questions as they arise. As a result, inconsistencies develop, making the training of new clerical staff and staff accountants time-consuming and expensive.

Developing a style guide that documents specific, standardized style policies for all correspondence and reports is recommended. The style guide should address topics such as salutations, closings, margins, spacing, indentation, continuing page headings, capitalization, punctuation, format for numbers and dates, underscoring, words used, unique spellings, etc. Doing so provides the following advantages:

- It frees up the time previously needed to resolve format questions. Since disputes often must be resolved by individuals with higher billing rates, cost savings and added efficiency usually result.
- It provides a reference for new clerical personnel, thus reducing the amount of training time (including supervisory time).
- It promotes more efficient use of a firm's talents by enabling the professionals who draft and review the financial statements and other documents to concentrate on content and to leave the detailed format considerations to the word processing staff.
- It helps ensure that all documents consistently convey the same pleasing, professional appearance.

Style and form considerations are a matter of firm preference. The firm should focus on developing a style that is logical, consistent, easy to apply, attractive, and, most importantly, does not distract from the material being presented. Firms may use standardized correspondence and reporting templates that conform to the firm's style preferences to increase consistency in the appearance of documents.

Producing the Documents. The firm also should consider developing specific procedures for producing reports and tax returns. Doing so helps ensure that the firm's standards are met when the documents are processed, proofed, reproduced, and bound. For most firms, producing the report or tax return at the end of an engagement includes the following steps:

- *Submitting the Initial Draft of the Document for Word Processing.* The initial draft of the document is typically prepared by a member of the firm's professional staff and then submitted electronically for word processing. Simply providing the document to the clerical staff and asking them to return the draft and typed document upon completion may be sufficient for many small to medium-sized firms. However, larger firms that produce a high volume of documents may need more formal procedures. Such firms may find it necessary to require employees to sign a report control log when documents are submitted and returned so that the word processing staff has a record of each document and its status. In addition, many firms use a "Report Control Form" to keep track of who processes, proofreads, corrects, reviews, and signs each report.

- *Processing the Document.* The firm should make its word processing staff aware that the documents they create convey the firm's image. Staff members should make sure that each document follows the firm's style policies (even if the original draft did not). They should also make sure that the overall format of typed documents is attractive (that is, pages are well balanced, columns are appropriately aligned, pages do not break awkwardly, etc.). Finally, they should understand that finished documents must contain no errors. Documents that do not meet the firm's standards should be corrected until they do. In today's computerized environment, a lot of the actual input, formatting, and typing has been greatly reduced. Tax preparation and trial balance software packages often have report writing capabilities, or the packages generate output that often can be imported directly to the word processing package being used to generate the report.

- *Proofreading and Footing the Document.* Someone should proofread the hardcopy document and recompute any calculations it may contain. All corrections should be clearly marked on the hardcopy document. Errors or unusual items noted in the original draft should be brought to the attention of the preparer and, if necessary, corrected on the hardcopy draft.

- *Correcting the Document.* The hardcopy document should be returned to the word processing staff for the correction of any errors noted while proofreading and footing the document (or to make any other revisions considered necessary). As mentioned previously, finished documents should contain no errors.

- *Obtaining the Necessary Signatures.* The firm should adopt a policy describing who may sign reports, tax returns, and other correspondence. Generally, only a partner may sign accountants' reports, and the partner signs them using the firm's name rather than his or her own. Tax returns should be signed by the preparer using his or her name, as required by the Internal Revenue Service. (The firm's name should also appear in the signature block of the return.) Correspondence may be signed by any member of the firm, although many firms allow only managers and partners to sign documents presented on the firm's letterhead.

- *Assembling the Document.* Assembling the document involves making the appropriate number of copies, binding the document(s) if necessary, and preparing envelopes.

Many firms document each step of the production process by attaching a routing slip or report control form to the folder containing the report drafts and requiring the appropriate individuals to sign it as each step is performed. A firm may also monitor the progress of documents through the production process by maintaining a production control log. The log, which should be kept by the firm's word processing staff (or word processing department), records the status of each project from the time it is submitted for processing until it is delivered to the client.

Delivering the Finished Product

Generally, tax returns and reports should be delivered to the appropriate client personnel in person by the engagement partner, manager, or primary client contact. However, most firms allow exceptions to that practice for recurring engagements such as monthly write-up engagements or routine tax return preparation services. Many firms also deliver the final bill with each report to shorten the collection cycle and improve cash flow. If a client has been slow in paying its bills in the past, however, the firm might even consider holding off delivering its report until the client pays the final bill. This is because once the client has the report in hand, the firm loses a certain amount of collection leverage.

Presenting the final work product is an important element of the overall engagement. To enhance the presentation, many firms give their clients reporting packages, of which the actual work products (such as the financial statements and tax return) are only a part. For example, a reporting package may include summarized financial information in the form of graphs or tables, key financial ratios, or an executive summary highlighting the information most important to the client. A small gesture such as presenting an understandable, visually appealing reporting package can often strengthen the firm's position as a business advisor in the client's eyes.

Establishing Correspondence Guidelines

Like the manner in which the firm answers the telephone, how the firm communicates in its written correspondence reflects the image of the firm. Forms of written correspondence include formal and informal letters, emails, faxes, and memos. The firm should establish correspondence guidelines that set a standard for the firm's written communications and provide guidance on the forms of correspondence to be used in specific situations.

Technology has had a major impact on the way in which firms communicate. The immediate nature of email, instant messaging, and faxing creates an opportunity for poorly written or inaccurate communications to be misunderstood by the reader and to reach people other than those to whom they are intended. It is important that the firm understand the dangers posed by email correspondence.

The firm's correspondence policy should address formats and formalities, give guidance on the appropriate medium based upon the circumstances of the correspondence, and define filing and retention requirements. It should also address the use of standard forms such as the firm's letterhead, fax cover sheets, and email templates. The firm should also establish guidelines for approvals of and signatures for correspondence.

Formal Correspondence. Even though technology has significantly reduced the volume of formal correspondence, formal letters remain very important for communicating with business organizations, clients, and other external parties. Some guidelines for formal letters include:

- Always use the firm's letterhead.
- Use formal letters for:
  - Any communications in which the firm or its employees express professional opinions.
  - Proposals.
  - Engagement letters and any other correspondence that confirms or clarifies services, business issues, and relationships.
  - Transmittal letters for reports and other client material.
  - Offers or changes to terms of employment.
  - Legal correspondence of any nature.
- Always use the recipients' full names, titles, and credentials.
- Require that a partner or manager review all formal correspondence.
- Establish a signature policy, e.g., requiring all formal correspondence to be signed by a partner or senior manager.
- Establish a standard format for the basic elements of the letter including margin size, font style and size, indentation, spacing, headings for second pages, etc.
- Use printed second sheets, preferably with a firm watermark.
- Establish a filing and retention policy for formal correspondence.

Informal Correspondence. Informal correspondence includes informal letters, email, memoranda, and faxes used for communications among familiar individuals or of an informal nature. Notes and memoranda often contain important documentation of issues, opinions, or other matters that require some kind of attention. Some guidelines for informal correspondence include:

- Use the firm's letterhead, personal stationery, or plain paper for informal letters. Partners and persons in key administrative positions often have their own personal stationery.

- Do not require the use of the recipients' titles, surnames, or credentials in informal communications.

- Establish a policy for who may sign informal firm communications.

- When faxing, always include a fax cover sheet with the firm's name, address, fax number, telephone number, the sender's name and title, the subject of the fax, and the number of pages. The fax cover sheet should also include a confidentiality disclosure. Applicable rules for formal correspondence should be followed when faxing formal letters.

- Establish a policy for obtaining and maintaining fax confirmations and fax sending and receiving logs.

- Establish a filing and retention policy for informal correspondence.

Establishing an Email Policy

Email, like letters, can be formal or informal; when in doubt, it is safer to be more formal, especially because email is vulnerable to interception. It is important that all members of the firm use caution when writing emails because it is so easy to send a hastily, poorly written email that does not appropriately communicate the intended message. Email creates an electronic document that is stored on the firm's, the recipient's, and, in some cases, the internet service provider's network. It is possible for deleted email messages to be restored, which further increases the possibility that the message could reach unintended recipients. Both the firm and the sender could be held liable for damages resulting from unlawful or harmful email. Accordingly, guidelines for writing and retaining emails are important.

Firms should use caution when responding to client email inquiries. The informality of email as a communication medium does not make the information contained in emails informal conversation. The same quality control procedures the firm follows for written responses to technical inquiries should also be followed for similar email responses. For instance, assume that a client emails a staff member for guidance on the proper accounting treatment of a transaction in accordance with a newly issued accounting standard. Before the advent of email, the staff member would research the issue and draft a response that provides guidance, complete with support from the professional standards. The response would typically be reviewed and approved by the engagement partner and appropriate disclaimer language would be added to the correspondence. A copy of the formal communication would be maintained in the client correspondence file. None of those steps should be excluded simply because the communication is made electronically. Email documentation is still documentation, and the client has a permanent record of what the firm has advised it to do.

All incoming and outgoing emails normally should be deleted as soon as any necessary action has been taken. When incoming or outgoing emails must be preserved, they should be transferred to the firm's electronic document management system where they can be labeled and indexed. The copy in the email system should then be deleted. Best practices are that in no event should emails remain in the firm's email system more than 30 days.

Some guidelines for email usage include:

- Establish a firm email policy.

- Include email etiquette tips in your email policy.

- Write emails as if they are going to be read by unknown or unintended recipients.

- Establish policies that set forth authorized users and uses as well as prohibited purposes and uses.

- Define the firm's monitoring policy and its rights to inspect and disclose the contents of employee emails.

- Do not include confidential or sensitive information without using encryption or other controls that prevent unauthorized access to the information.

- Establish a filing and retention policy.
- Keep on eye on technology and review the policy at least quarterly.
- Obtain employees' signatures on the policy or include it in their employment contract. Include a copy of the policy in the employee handbook.
- Require that a confidentiality statement be included on every email.

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 that has **not** developed a style guide for use in producing documents will experience:

    a. A consistent professional appearance in all correspondence.

    b. Less time spent training new clerical staff.

    c. Staff members meeting to resolve format disputes.

23. Which of the following describes the best approach in delivering the finished product to the client?

    a. Send the bill separately.

    b. Hand deliver all finished products to the client's office.

    c. Present the client with an understandable reporting package.

24. Holly, a new staff person, is drafting an email to a client. The email includes confidential information. What step should Holly take?

    a. Encrypt the message to the client.

    b. Use the recipient's title in the communication.

    c. Delete the email as soon as it is sent without retaining any documentation of the information.

SELF-STUDY ANSWERS

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

22. A firm that has **not** developed a style guide for use in producing documents will experience: **(Page 168)**

    a. A consistent professional appearance in all correspondence. [This answer is incorrect. Without a style guide that dictates specific, standard style policy, documents produced by the firm will be inconsistent and potentially unprofessional.]

    b. Less time spent training new clerical staff. [This answer is incorrect. Having a style guide provides a reference for new clerical personnel and makes it easier for new personnel to learn the system.]

    c. Staff members meeting to resolve format disputes. [This answer is correct. Without style standards, time is wasted determining how documents should be formatted.]

23. Which of the following describes the best approach in delivering the finished product to the client? **(Page 169)**

    a. Send the bill separately. [This answer is incorrect. It is better to deliver the bill along with the report to shorten the collection cycle.]

    b. Hand deliver all finished products to the client's office. [This answer is incorrect. Generally, tax returns and reports should be delivered by the engagement partner, manager, or primary client contact, however, most firms allow exceptions for monthly write-up engagements.]

    c. Present the client with an understandable reporting package. [This answer is correct. A report that includes summarized financial information in the form of graphs, key financial ratios, or an executive summary provides the client with data that is more understandable, and therefore more useful.]

24. Holly, a new staff person, is drafting an email to a client. The email includes confidential information. What step should Holly take? **(Page 171)**

    a. Encrypt the message to the client. [This answer is correct. The firm's email policy should require encryption to prevent unauthorized access to the information sent by email.]

    b. Use the recipient's title in the communication. [This answer is incorrect. An email is considered informal correspondence and thus, no title is required.]

    c. Delete the email as soon as it is sent without retaining any documentation of the information. [This answer is incorrect. Since the email includes sensitive information, it should be transferred to the firm's electronic document management system for preservation. Then, the copy in the email system should be deleted.]

IMPLEMENTING A DUE DATE MONITORING SYSTEM

Monitoring Due Dates

Due dates are extremely important in the accounting profession, especially in the area of taxes (including payroll taxes). Filing deadlines, payment and deposit deadlines, and even planning deadlines (for instance, to guarantee implementation by year end) present firms with many scheduling challenges each year. The consequences of not complying with a tax deadline can be severe. The resulting late filing penalties and missed opportunities (especially relating to the filing of important elections) can cause clients to lose confidence in the firm. They may even increase the firm's malpractice exposure. An effective system for monitoring due dates is critical to minimizing the risks associated with missed deadlines.

Although a due date monitoring system is generally used more for tax deadlines, it can also be used for accounting and other deadlines. For example, if a firm does several different compilation engagements regularly (such as quarterly compilations for 20 different clients), a due date tracking system can help monitor the compilations each quarter to ensure that the firm completes them on time.

The form of a due date monitoring system can vary from a very simple, manually prepared due date calendar to a much more complex computerized system.

Adequate Lead Time

Most firms have developed their own unique systems for monitoring due dates. However, whatever form the system takes, it is imperative that it identifies due dates far enough in advance so that the firm has adequate lead time to perform the engagement before the deadline. A system that prints a report on April 1 identifying tax returns with April 15 due dates or compilation engagements with April 10 due dates will not be very useful if there is not enough time between the report date and the due date to complete the engagements. The amount of lead time needed will vary with the type of engagement. However, at least two months before the due date is usually sufficient for tax engagements and at least four months before the due date is usually sufficient for accounting engagements.

Normally, computerized monitoring systems track items through the 15th of each month, since this corresponds with most tax deadlines. However, there are returns and other engagements with odd due dates (such as payroll tax, state income tax, and inheritance tax returns), and it is imperative that the system adequately alerts professionals to these deadlines in addition to the mid-month deadlines. It may be helpful to establish a system that has three separate reports. The first report could list all items that are due from the date of the report through the 15th of the upcoming month. The second report could list the items that are due from the date of the report through the 15th of the following month and establish the two-month lead time. The third report could list all of the items that are currently past due. The firm should print and distribute the reports as soon after the 15th of each month as possible.

To illustrate the approach discussed in the preceding paragraph, a firm that uses such a system would generate the following three reports on February 16, 20X1:

a. A report that would list all past due items that were required to be filed on or before February 15, 20X1.

b. A report that would list the items that should be filed from February 16, 20X1, through March 15, 20X1.

c. A report that would list items due from February 16, 20X1, through April 15, 20X1.

Depending on the firm's monitoring system, the system may be able to generate separate reports for tax engagements and accounting engagements. This can be beneficial since a longer lead time is usually necessary for accounting engagements. Therefore, if the system generates separate reports for accounting engagements, the system would generate the reports listed above only for tax engagements. In addition, the system would also generate the following three reports on February 16, 20X1, for accounting engagements:

a. A report that would list all past due items that were required to be completed on or before February 15, 20X1.

b. A report that would list the items that should be completed from February 16, 20X1, through March 15, 20X1.

c. A report that would list items that should be completed from February 16, 20X1, through June 15, 20X1.

The information included on the tax and accounting due date reports will usually show, at a minimum, the client name, the type of service being performed, and the due date of the service. The ability to sort the due date reports by due date, client name, staff person, or other component will depend on the monitoring system that the firm uses.

Maintaining the Integrity of the Monitoring System

The firm can maintain the integrity of its monitoring system only if it has established adequate procedures for maintaining the system. The first step in establishing adequate procedures is to give one person in the firm the responsibility for keeping the due date monitoring system up-to-date (such as a due date administrator). The due date administrator will also be responsible for generating and distributing the due date listings to the appropriate professionals. After designating a due date administrator, a firm should establish procedures to correctly enter the following events into the monitoring system:

a. Adding new clients or engagements.

b. Clearing completed jobs.

c. Purging former clients or engagements.

Adding New Clients or Engagements. One way to ensure that new clients are properly entered into the due date data base is to include a step in the new client setup process that prompts the firm to record and input engagements and corresponding due dates into the system. This forces personnel to input due dates into the monitoring system at the time the firm accepts the job. This can be accomplished through completion of a due date monitoring system input form. The firm can also put new engagements (recurring or nonrecurring) for *existing* clients into the system by using this form. The firm should require that personnel that set up new engagements for existing clients or new clients complete these forms, have them approved by the engagement manager or partner, and then forward them to the due date administrator who will enter them into the due date monitoring system.

Clearing Completed Jobs. It is not enough to ensure that new engagements are properly set up in the firm's due date monitoring system. The due date administrator must also tell the system when the firm completes projects, so that the reports do not show completed projects as past due. The following are two ways to update the due date monitoring system to reflect completed projects:

- The person who mails or delivers the finished product to the client can route a copy of the transmittal letter that accompanies the return or report to the due date administrator.

- The person who mails or delivers the finished product to the client can prepare the due date monitoring system input form, have it approved by the engagement manager or partner, and route it to the due date administrator.

Purging Former Clients and Engagements. The firm needs to establish procedures to purge former clients from the due date monitoring system. This will also be necessary for engagements of continuing clients that will no longer be done. For example, at some point the firm might stop performing monthly compilations for a particular client even though the firm will continue to prepare the company's corporate tax return. The firm can use the due date monitoring system input form to purge former clients or engagements from the system. This completed form should be approved by the manager or partner assigned to the former client or engagement and should be routed to the due date administrator.

Engagements with No Due Date

Certain engagements, such as tax planning engagements and some compilation engagements, do not have required or statutory due dates. Just because there are no required deadlines for these engagements, however, does not mean that they should not be set up in the client's due date monitoring system. In fact, the firm can assign all engagements a due date and set them up in the system. Whenever the firm accepts a new engagement, the partner or manager who will be responsible for the engagement should discuss the engagement completion date with the client. The firm should put the target completion date into the monitoring system and schedule the work accordingly. Assigning a due date to all engagements helps the firm focus on the importance of its engagements, facilitates their timely completion, and increases client satisfaction.

Automating the System

Every firm should have some sort of system to track upcoming due dates and monitor the firm's compliance with them. In very small firms, a formal tracking system may not be necessary. Instead, engagement partners and managers may keep up with their own clients' deadlines. For other firms, it is likely that using due date monitoring software is more efficient and reliable. Firms that use due date monitoring software can usually update status reports with little effort. During busy season, when time and personnel resources are scarce, an automated system can be an efficient way to generate detailed reports at frequent intervals. There are several commercial software packages that are available to monitor due dates. In addition, some tax return preparation software packages have due date tracking capabilities.

With many automated due date monitoring systems, recurring services can be entered once and automatically recur in the due date list on an annual, semiannual, quarterly, bimonthly, or monthly basis (as specified by the user) without further effort. These monitoring packages often include several standard reports with multiple types of due date lists. Some monitoring packages even include options allowing a firm to print customized reports. Besides various due date listings, some of these monitoring systems can generate assignment reports by staff level or by individual staff assignments.

BILLING AND COLLECTING

Billing Philosophies

Generally, accountants bill write-up services based on one (or both) of the following methods:

a. *Fixed Fee for Each Engagement.* This arrangement may be advantageous because it enables accountants and clients to forecast the exact fee that will be billed each period. It has several disadvantages, however. For example:

   (1) The fixed fee is likely to be too high or too low.

   (2) Fixed fees may be difficult to increase to reflect rising costs. Even if the fee is increased, there is often a considerable time lag between when the additional costs are incurred and when the fee is raised.

   (3) If costs have been underestimated, accountants may be tempted to cut corners, which results in substandard work.

   (4) Misunderstandings about the exact services covered by the fixed fee may arise.

b. *Hourly Rates.* The time needed to perform write-up services may vary each period. For example, more work may be necessary if the client's volume of business increases or if payroll tax returns must be prepared at the end of a calendar quarter. This method allows accountants to be compensated for additional work that may be needed during certain periods without requiring extensive revisions of fee estimates or engagement letters. (Even if this method is used, however, accountants must still perform the services efficiently and at reasonable rates to remain competitive.)

Regardless of the billing method used, the fee for write-up services should consider the time spent performing the services, standard billing rates for performing the services, and subjective factors such as the following:

a. Skill and experience of the staff.

b. Value of the services to the client.

c. Difficulty of the engagement.

d. Fees charged by other accountants for similar services.

e. Ability to collect the fee.

f. Fees that may be collected by performing other services.

Assigning Responsibility for Billing and Collecting

The responsibility for billing and collecting should be clearly defined. In many firms, the overall responsibility for billing and collecting is assigned to the client-service partner, and in other firms it is assigned to partners or staff that perform the service (for example, the tax partner bills and collects for tax services and another partner or staff accountant bills and collects for write-up services). The best practices indicate that the engagement staff be involved in the billing process and that responsibility for reviewing and collecting the bills be assigned to the client-service partner. That approach allows individuals that are closest to the engagement (and thus more familiar with client personnel, the work performed, and any problems encountered) to have significant input into the billing process. In addition, assigning overall responsibility to the client-service partner helps foster a full-service firm image, and clients generally prefer dealing with a firm rather than a collection of individuals.

Improving Collections

A key ingredient in improving fee collections is the careful consideration before the engagement is accepted of the client's ability to pay the fee. The following practices also can contribute significantly to improving fee collections:

- *Clearly Communicate Fees and Billing Policies.* Best practices are to send each new client a letter that explains the firm's fee structure and billing policies. (This is in addition to the engagement letter previously discussed.) The letter is intended to help avoid future disagreements and complaints about fees and to inform the client about when payment is expected. The letter should be sent to the client upon acceptance.

- *Bill Frequently.* A firm can reduce its exposure to nonpayment by billing the client monthly and following up on collecting the bill. A small bill is easier to pay than a large one.

- *Work Efficiently.* Stress the importance of a logical and systematic approach for obtaining information from the client. Ask for it once, complete the work with it, and return it promptly. That helps prevent a seemingly casual or uncoordinated approach that could destroy a client's confidence.

- *Make Progress Reports.* Keep the client updated on the progress of the engagement when delays are encountered, and inform the client immediately when they are responsible for delays that will require additional time or billing.

- *Use Clear Descriptions on Bills.* Bills should be as descriptive as possible to avoid confusion about the services performed and the services billed. Ideally, the wording used in the engagement letter to describe the services to be rendered should also be used on the actual billings.

- *Identify Slow-paying Clients.* Aged accounts receivable reports should be prepared to help identify slow-paying clients. To speed collection from slow-paying clients, accountants should consider (a) telephoning clients that have past due accounts, (b) charging interest on past due accounts, and (c) writing personal notes on accounts receivable statements. If the client is a habitually slow payer, the firm should also consider requiring payment in advance of providing services.

- *Consider Discontinuing Service.* If the bill is not paid after notifying the client that it is past due, the firm should discontinue providing any services until payment is received. (Accountants should not withhold client records, however, to obtain payment of fees.)

- *Consider Obtaining a Note Receivable from a Client That Is Experiencing Cash Flow Problems.* When clients experience cash flow problems, accountants are usually the last creditors to be paid. In those instances, accountants should ask the client to sign a note receivable covering the unpaid fees. If collection proceedings are necessary, the accountants may have a better chance collecting a note receivable than an open account.

FTC's "Red Flags" Rule

The "Red Flags" rule, which was released November 9, 2007, was mandated by the Fair and Accurate Credit Transactions Act of 2003 (FACTA) and requires financial institutions and creditors to implement programs to identify, detect, prevent and mitigate identify theft. Enforcement of the rule has been postponed three times since the original November 1, 2008, effective date, and was recently postponed until June 1, 2010.

According to the FTC website, the definition of *creditor* in the rule is broad and includes businesses or organizations that regularly provide goods or services first and allow customers to pay later. As examples, the FTC lists accountants and other professionals. The AICPA is concerned with the broad application of the "Red Flags" rule and its impact on the accounting profession. Therefore, in August 2009, the AICPA sent a letter to the FTC asking that CPAs be exempt from certain provisions of its "Red Flags" rule to prevent identity theft. "We are concerned with the potentially broad application of the Red Flags Rule to the accounting profession, and do not believe that there is any reasonably foreseeable risk of identity theft when CPA clients are billed for services rendered," wrote AICPA CEO, Barry Melancon. Many state CPA societies are also sending letters to their members of Congress and the FTC urging exemption. The FTC's "Red Flags" website, **www.ftc.gov/redflagsrule**, offers resources to help entities determine if they are covered and, if they are, how to comply with the Rule. Practitioners should be alert for any actions the FTC takes related to CPAs and enforcement of the "Red Flags" rule.

INFORMING CLIENTS OF OUTSOURCING ARRANGEMENTS

In most instances, 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. Ethics Ruling 112 (ET 191.224–.225) under Rule 102, *Integrity and Objectivity*, 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 must be informed before confidential client information is shared with the service provider. Also, revised Ethics Ruling No. 1 (ET 391.001–.002) under Rule 301, *Confidential Client Information*, states that if the accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party (a) to maintain the confidentiality of the client's information and (b) to have procedures in place to prevent unauthorized release of confidential information, the accounting firm must obtain the client's consent to disclose the client's confidential information to the third-party service provider.

In cases where the practitioner chooses to provide written disclosure that a third-party service provider will be used, the following paragraph may be included in the engagement letter.

> We may from time to time, and depending on the circumstances, use certain third-party service providers to assist us in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

SELF-STUDY QUIZ

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

25. A due date monitoring system is important because:

    a. It minimizes the risks associated with missed deadlines.

    b. It eliminates the need for lead time.

    c. It produces one monthly reminder report.

    d. It frees up staff time.

26. Assigning a due date to all engagements does all **except** which of the following?

    a. Helps the firm focus on the importance of its engagements.

    b. Facilitates timely completion of engagements.

    c. Monitors the progress of the engagement.

    d. Increases client satisfaction.

27. Which of the following is appropriate regarding a due date monitoring system?

    a. When jobs are done, an administrator should close the job on the due date monitoring system.

    b. It is the system administrator's responsibility to ask the partner on the engagement when projects are completed.

    c. Engagements with no due date cannot be kept on a due date monitoring system.

    d. Automated due date monitoring software is the only way to insure that due dates are monitored and complied with for a firm.

28. What is an advantage of using the fixed fee method of billing?

    a. It removes misunderstanding about the services covered.

    b. The client can count on the amount to pay.

    c. The fee is easily adjusted.

    d. Substandard work is avoided.

29. What is the key ingredient in collecting fees due?

    a. Bill frequently.

    b. Clear communication with the client.

    c. The client's ability to pay.

    d. Provide detailed description on billing statements.

30. Fortuitous, Franklin and Faith, P.C. (FFF) is moving forward with their outsourcing decision. They are reviewing a contract with a potential third-party service provider. Correctly match the options FFF has with the Ethics Rulings governing the use of third-party service providers.

Ethics Rulings:

1. Rule 102, *Integrity and Objectivity*
2. Rule 301, *Confidential Client Information*

Options:

i. Inform the client, preferably in writing if the practitioner's firm will outsource professional services to third-party service providers.

ii. If an accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party to (1) maintain the confidentiality of the client's information and (2) to have procedures in place to prevent unauthorized release of confidential information, then the firm must obtain the client's consent to disclose confidential client information to the third-party service provider.

a. 1 and i.

b. 1 and ii.

c. 1 and i; 2 and ii.

d. 1 and ii; 2 and i.

SELF-STUDY ANSWERS

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

25. A due date monitoring system is important because: **(Page 175)**

    a. It minimizes the risks associated with missed deadlines. [This answer is correct. The consequences of not complying with a tax deadline can be severe, costing the client money in penalties and lost opportunities for not taking certain tax elections.]

    b. It eliminates the need for lead time. [This answer is incorrect. Although a monitoring system alerts the accountant to due dates, it cannot eliminate the amount of lead time required to meet deadlines.]

    c. It produces one monthly reminder report. [This answer is incorrect. A more effective due date monitoring system should produce more than a monthly report since many tax deadlines occur mid-month.]

    d. It frees up staff time. [This answer is incorrect. The work to meet due dates will not be reduced by using a due date monitoring system since it only alerts the staff of deadlines and does not complete any work.]

26. Assigning a due date to all engagements does all **except** which of the following? **(Page 176)**

    a. Helps the firm focus on the importance of its engagements. [This answer is incorrect. Assignment of a due date focuses the firm to complete an engagement in a timely fashion.]

    b. Facilitates timely completion of engagements. [This answer is incorrect. Establishing the target completion date allows the firm to schedule work accordingly.]

    c. Monitors the progress of the engagement. [This answer is correct. Having a due date does not ensure progress is monitored without setting up a work schedule.]

    d. Increases client satisfaction. [This answer is incorrect. Clients expect the firm to protect them from missing deadlines and paying penalties and by doing so, it will increase the client's confidence in the firm.]

27. Which of the following is appropriate regarding a due date monitoring system? **(Page 176)**

    a. When jobs are done, an administrator should close the job on the due date monitoring system. [This answer is correct. When a job is completed, the due date administrator needs to tell the system that the firm completed the project so that the completed projects do not appear past due.]

    b. It is the system administrator's responsibility to ask the partner on the engagement when projects are completed. [This answer is incorrect. The person who mails or delivers the finished product to the client can route a copy of the transmittal letter to the due date administrator to inform them that the project is complete.]

    c. Engagements with no due date cannot be kept on a due date monitoring system. [This answer is incorrect. Although there are no required deadlines for some engagements, it does not mean that they should not be set up in the client's due date monitoring system. The firm can assign a date to the engagement, even is if is not required or has statutory due dates so that the firm can schedule accordingly.]

    d. Automated due date monitoring software is the only way to insure that due dates are monitored and complied with for a firm. [This answer is incorrect. In larger firms, using a due date monitoring software is the most efficient and reliable system of keeping up with due date, but in a smaller firm, a formal tracking system may not be necessary. Instead, engagement partners and managers may keep up with their own clients' deadlines.]

28. What is an advantage of using the fixed fee method of billing? **(Page 177)**

    a. It removes misunderstanding about the services covered. [This answer is incorrect. Misunderstandings can arise if the client is unclear as to the exact services covered.]

b. The client can count on the amount to pay. [This answer is correct. Since the amount is stated, the client knows exactly how much to budget and the firm knows how much it will collect.]

c. The fee is easily adjusted. [This answer is incorrect. Fixed fees may be difficult to increase if costs rise because clients are accustomed to the fee. Even if the fee is increased, there can be considerable time lags between higher costs and higher fees.]

d. Substandard work is avoided. [This answer is incorrect. If costs have been underestimated, accountants may be tempted to cut corners, which results in substandard work.]

29. What is the key ingredient in collecting fees due? **(Page 178)**

a. Bill frequently. [This answer is incorrect. Although frequent billing can reduce a firm's exposure to nonpayment, this is not the determining factor for whether or not a client will pay the bill.]

b. Clear communication with the client. [This answer is incorrect. A letter detailing the firm's fee structure and billing policies can be helpful in avoiding future disagreements. However, there is one more important ingredient in collecting fees that are due.]

c. The client's ability to pay. [This answer is correct. Careful consideration should be given to the client's ability to pay prior to accepting the engagement. This is key because, although the client may have the desire to pay, he will not do so if he is unable to pay.]

d. Provide detailed description on billing statements. [This answer is incorrect. Descriptive bills can diminish confusion but cannot ensure the client will pay the bill when it is presented.]

30. Fortuitous, Franklin and Faith, P.C. (FFF) is moving forward with their outsourcing decision. They are reviewing a contract with a potential third-party service provider. Correctly match the options FFF has with the Ethics Rulings governing the use of third-party service providers. **(Page 179)**

Ethics Rulings:

1. Rule 102, *Integrity and Objectivity*
2. Rule 301, *Confidential Client Information*

Options:

i. Inform the client, preferably in writing if the practitioner's firm will outsource professional services to third-party service providers.

ii. If an accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party to (1) maintain the confidentiality of the client's information and (2) to have procedures in place to prevent unauthorized release of confidential information, then the firm must obtain the client's consent to disclose confidential client information to the third-party service provider.

a. 1 and i. [This answer is incorrect. This answer choice does not match both ethics rulings with an action item.]

b. 1 and ii. [This answer is incorrect. This answer choice does not match both action items with the correct ruling.]

c. 1 and i; 2 and ii. [This answer is correct. Ethics Rule 102 does require that clients be informed prior to the accountant outsourcing professional services.]

d. 1 and ii; 2 and i. [This answer is incorrect. The ethics rulings are not appropriately matched with the action item.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (WUSTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. TKM, Inc. is regarded as the leading write-up service firm in the city. They have achieved this status through high ethics and meeting all of their clients' needs. What characteristic is TKM, Inc. relying on for the success of their firm?

   a. Philosophy of the level of work the firm would like to engage.

   b. Reputation of the firm within the community.

   c. Leadership of the firm by the partners.

   d. Commitment of the firm's staff to produce quality work.

2. In the comprehensive planning system, Carrie has been charged with obtaining commitment to achieve the firm's goals. Which task has been assigned to her?

   a. Strategic planning.

   b. Budgeting.

   c. Individual performance planning.

   d. Plan review.

3. The _____________ should be brief. reflect on a firm's business focus, and provide motivation for partners and staff, as well as direction for the firm as a whole.

   a. Mission statement.

   b. Action plan.

   c. Executive summary.

   d. Strategic plan.

4. Which factor included in the SWOT analysis would a firm have little control over influencing and could adversely affect the firm's profitability?

   a. Threats.

   b. Strengths.

   c. Weaknesses.

   d. Opportunities.

5. Which of the following is the most accurate description of objectives and strategies?

   a. Objectives and strategies should be written separately.

   b. Strategies indicate a firm's chosen direction.

   c. The accomplishment of the strategy should not be too simple.

   d. Objectives spell out the details of expected results.

6. The step of the marketing plan in which a firm can define a potential niche is:

   a. Evaluating the firm's capabilities.

   b. Analyzing the competition.

   c. Developing a marketing strategy.

   d. Identifying the target market.

7. The supply of new and experienced accounting staff is:

   a. Plentiful due to the downsizing of accounting firms.

   b. Plentiful due to more accounting professionals available in the market.

   c. Tight due to increased competition for employees.

   d. Do not select this answer choice.

8. Kathy is a single mom with two school-age children. She is a CPA with 10 years of experience in public accounting. Which of the following should Cunningham & Associates offer to improve Kathy's work-life balance?

   a. A hiring bonus.

   b. Flextime.

   c. A life insurance plan.

   d. Incentive pay.

9. Complete the following sentence from SQCS No. 7 (paragraph 37). "A firm should establish policies and procedures over the human resource quality control (QC) element designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to ___________ principles necessary to (a) assure engagements are performed in accordance with professional standards and regulatory and legal requirements and (b) enable the firm to issue appropriate reports."

   a. Ethical.

   b. Accounting.

   c. Management.

   d. Marketing.

10. What is the first step in preparing a staffing plan?

    a. The firm first evaluates its current and anticipated future staffing needs.

    b. The firm first looks for qualified candidates.

    c. The firm first evaluates personnel turnover.

    d. The firm first evaluates the adequacy of its retirement plans.

11. Which of the following is an alternative to hiring full-time professional staff?

    a. Flextime.

    b. Paraprofessionals.

    c. Telecommuting.

    d. Job-sharing.

12. With regard to the hiring process, which of the following statements is most accurate?

    a. Candidates for a write-up staff position should be asked different questions because no two people are alike.

    b. All questions asked during the interview process should be job-related.

    c. Personal references and former employers normally will provide the most objective source of information about a candidate for a write-up staff position.

    d. Pre-employment tests should never be given to candidates for a write-up staff position.

13. The managing partner of Peavy, Pacey and Egerton is seeking to control CPE costs. Name one program the firm could implement to help with these costs.

    a. Intern Program.

    b. Employee Retention Program.

    c. Professional Development Program.

    d. Employee Recruitment Program.

14. Which of the following tools would help accountants assess the level of proficiency in a particular functional specialty and broaden their business perspective?

    a. A performance evaluation.

    b. Completing the required CPE requirements.

    c. A professional development program.

    d. AICPA Competency Self-Assessment Tool.

15. Which of the following is **not** considered a reason for periodically providing write-up staff with performance evaluations?

    a. To inform the employee of strengths and weaknesses noted during past job performances.

    b. To set goals for future job performance.

    c. To obtain feedback about employee concerns and morale.

    d. To provide on-the-job training.

16. Name one business culture benefit a firm can provide to enhance employee retention.

    a. Correspondence policies.

    b. Engagement continuance policies.

    c. Personnel policies.

    d. Open communication.

17. The managing partner of the Lawton CPA firm is surprised to learn that members of the new management of a long term client are related to a new hire of Lawgon. During the client continuance evaluation, what factor should the firm consider?

    a. The determination of the client's needs.

    b. Any significant changes in key management.

    c. Independence issues.

    d. Do not select this answer choice.

18. In which of the following situations should a firm terminate service to a client instead of considering the factors for continuing the engagement?

    a. The CFO of the client has been indicted of fraud since the previous engagement.

    b. The client has been slow to pay any fees due to the firm, after the work was performed.

    c. The company has done a public offering since the last engagement and the firm does not have experience auditing public companies.

    d. The daughter of the president of the company was recently hired by the firm as a new staff auditor.

19. A firm should periodically evaluate the write-up services provided to a client because:

    a. As clients grow, their needs change.

    b. The fees should be increased.

    c. They may no longer be profitable.

    d. Do not select this answer choice.

20. A management-use-only financial statement can only be provided to:

    a. Those individuals who are considered management within a company.

    b. Members of management who understand the limitations of the financial statements.

    c. Members of management and the company's banker.

    d. Anyone inside or outside the company who the accountant determines is an appropriate user.

21. In relation to management-use only financials and the distribution to a third party, which of the following is true?

    a. Management is allowed to distribute them, since they paid the firm for the financials.

    b. Accountants are protected as long as they have a standard engagement letter.

    c. The accountant has a responsibility to discover the ramifications of the distribution.

    d. The accountant should continue to provide a service to the client so that they will know if the financials are correct.

22. An engagement letter should contain which of the following items?

    a. A description of the nature and limitations of the services.

    b. A breakdown of the expected cost of the services.

    c. A statement that the engagement can be relied on to detect errors.

    d. A statement of the accounting firm's professional credentials.

23. Which of the following is **not** an advantage of using engagement letters?

    a. Assist in avoiding client and staff misunderstandings.

    b. Enhances practice management.

    c. Prevents all potential legal liability.

    d. Explains contractual obligations to the client.

24. One key to improving efficiency in a write-up engagement is:

    a. To divide the workload among staff members.

    b. To review each document as soon as completed.

    c. To document services performed at the end of the engagement.

    d. To develop a checklist of procedures to perform.

25. An advantage of using a style guide for use in producing a firm's documents is:

    a. It involves higher level professionals in the process.

    b. It ensures professional looking documents.

    c. It eliminates training time.

    d. It allows staff flexibility in producing correspondence.

26. Denise supervises the word processing staff of a major accounting firm. Her job is to do all **except**:

    a. Make sure each document follows the firm's style policies.

    b. Make sure the format is attractive.

    c. Make sure the content is accurate.

    d. Make sure the document contains no grammatical errors.

27. In adopting a policy for obtaining signatures on documents, which of the following is the most accurate?

    a. Only a partner can sign accountants' reports.

    b. Tax returns are signed using the firm's name.

    c. Accountants' reports are signed using the partner's name.

    d. Correspondence is signed by firm managers.

28. What type of correspondence is described by the following attributes? The correspondence is on the firm's letterhead, includes the recipient's full name, title and credentials.

    a. Formal.

    b. Informal.

    c. Email.

    d. Do not select this answer choice.

29. Which of the following is a disadvantage of a due date monitoring system?

    a. The confidence a client would have in the firm.

    b. The ability to deal with scheduling challenges in the firm.

    c. The complexity of setting up the system.

    d. The compliance with project deadlines.

30. Joyce is entering due dates into the firm's monitoring system. She should allow how much lead time for tax and accounting engagements?

    a. 30 days for tax and 30 days for accounting.

    b. 45 days for tax and 60 days for accounting.

    c. 2 months for tax and 4 months for accounting.

    d. 4 months for tax and 4 months for accounting.

31. The job of the due date administrator includes all of the following **except**:

    a. Adding new clients or engagements.

    b. Determining appropriate due dates.

    c. Clearing completed jobs.

    d. Purging former clients or engagements.

32. Penny Pincher is a habitually late paying client. Name one item her accountant can do to remedy this problem.

    a. Require payment in advance of providing services.

    b. Transfer Penny's account to a new accountant, thus lowering the cost of the services provided.

    c. Withhold Penny's records until payment is received.

    d. Use clearer descriptions on the bills to help Penny process the payment.

33. Tom needs to outsource a portion of the accounting services he performs for his client. Which of the following would keep Tom in compliance with the accounting standards?

    a. Tom will need to enter into a contractual agreement with the third-party service provider and require them to keep the client's information confidential and have procedures in place to prevent any unauthorized release of confidential information.

    b. Since Tom has an engagement letter with his client, he is able to complete the service without informing his client that he is going to outsource a portion of the accounting services.

    c. Tom is using a third-party provider that he has used numerous times in the past, so he does not feel he needs a contract with the provider. He will inform his client that he plans to employ the third-party provider.

    d. Do not select this answer choice.

Lesson 2: Quality Control Standards, Disaster Recovery and Succession Planning

INTRODUCTION

The AICPA and the state societies of CPAs attempt to maintain self-regulation of firm quality and professionalism through various committees, such as ethic committees and practice review committees. The AICPA's Quality Control Standards, Peer Review Program, and Code of Professional Conduct, are discussed in the following paragraphs.

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize the quality control standards that contribute to a successful write-up engagement process.
- Determine the risks and responsibilities in an engagement.
- Identify the features of a disaster recovery plan and a succession plan for the firm.

Quality Control Standards

Statement on Quality Control Standard No. 7, *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. In June 2009, the Auditing Standards Board (ASB) issued a proposed SQCS that would supersede SQCS No. 7, *A Firm's System of Quality Control*. The exposure draft redrafts SQCS No. 7 to apply the ASB's clarity drafting conventions and to converge with International Standards on Quality Control (ISQS) No. 1, *Quality Control For Firms That Perform Audits and Reviews Of Financial Statements, And Other Assurance And Related Services Engagements*. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect. The provisional effective date is for attestation engagement periods beginning on or after December 15, 2010. SQCS No. 7 was effective for a firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

Paragraph 3 of SQCS No. 7 (QC 10.03) states that the firm "must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements," and that the firm or engagement partners issue reports that are appropriate in the circumstances. The firm's quality control system consists of policies and procedures.

The purpose of a quality control system is to promote quality in performing accounting and auditing engagements. As the QC standards indicate, a firm's system of quality control is a system designed to provide the firm with reasonable assurance that the firm is (a) complying with professional standards and legal and regulatory requirements, and (b) issuing reports that are appropriate in the circumstances. In developing and maintaining its quality control system, a firm establishes policies designed to achieve the objectives associated with obtaining reasonable assurance and procedures required to implement and monitor compliance with the policies. *Reasonable assurance* is defined as a "high, but not absolute, level of assurance" (SQCS No. 7, QC 10.05).

The nature of the policies and procedures the firm develops to obtain reasonable assurance and comply with the requirements of SQCS No. 7 will depend on various factors, such as the following:

- The size of the firm.
- The operating characteristics of the firm, for example—
  - Types of services provided.
  - Types of industries served.

- •• Number of partners.

- •• Number of professional personnel.

Major Provisions of SQCS No. 7. SQCS No. 7 was issued to improve the quality of engagement performance. Some of the most important changes to quality control requirements as a result of SQCS No. 7 are as follows:

- The firm must 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 firm should document and communicate its quality control policies and procedures.

- The firm's system of quality control encompasses six QC elements, rather than the previous five.

- The firm should promote a quality-oriented internal culture and firm leadership should assume ultimate responsibility for the firm's system of quality control, including assigning responsibilities so that commercial considerations do not override the objective of the system of quality control.

- The firm is required to establish criteria to determine which engagements (if any) are subject to an engagement quality control review.

- The firm should follow specific requirements related to dealing with and resolving differences of opinion.

- The firm should establish policies and procedures for dealing with complaints and allegations of noncompliance with professional standards or with the firm's system of quality control.

Professional Requirements. SQCS No. 7 establishes requirements regarding the firm's degree of responsibility it has in complying with the requirements of the standard. The firm's professional requirements as defined in the standard are designated into two categories:

- *Unconditional Requirements.* Unconditional requirements are those the firm must follow in all cases if the circumstances apply to the requirement. These requirements use the words *must* or *is required*.

- *Presumptively Mandatory Requirements.* Firms are also expected to comply with presumptively mandatory requirements if the circumstances apply to the requirement; however, in rare situations, a departure from the requirement is allowed if the firm documents the justification and how alternative procedures that were performed were sufficient to achieve the objectives of the requirement. Presumptively mandatory requirements are identified by the word *should*. If the SQCS uses the words *should consider* for a procedure, the consideration of the procedure is presumptively required.

Elements of a Quality Control System. QC 10.14 states that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements:

- *Leadership responsibilities for quality within the firm (tone at the top).* The firm has policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements.

- *Relevant ethical requirements.* The firm and its personnel comply with relevant ethical requirements.

- *Acceptance and continuance of client relationships and specific engagements.* The firm undertakes or continues only client relationships and engagements in which the firm (a) considers the client's integrity and 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 that 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 (a) relevant and adequate, (b) consistently complied with, and (c) operating effectively.

Documentation and Communication of the Firm's QC Policies and Procedures. One of the most significant changes to the QC standards relates to documentation. QC 10.12 states that the firm should document its QC policies and procedures. However, matters such as the nature of the firm's practice, its size, and its structure may be considered in determining the extent of documentation of the firm's QC policies and procedures. Documentation of the policies and procedures of a single-office firm with a small number of partners and staff might not be expected to be as extensive as those of a large, multi-office firm.

SQCS No. 7 does not require the firm to have a formal quality control policies and procedures *document*; instead, the standard indicates only that the firm's QC policies and procedures be *documented*. SQCS No. 7 allows the firm to have flexibility and latitude in determining the documentation method that best suits their individual practice and circumstances.

In addition to documenting the firm's QC policies and procedures, QC 10.13 states that the firm should communicate its QC policies and procedures to firm personnel. That communication is not required to be in writing, although written communication is preferable. An effective firm communication of its QC policies and procedures, as described in paragraph 13 of SQCS No. 7, incorporates the following:

- A description of the policies and procedures and the objectives they achieve.

- A message that each person is responsible for maintaining quality, as well as being familiar with the policies and procedures and complying with them.

- Comments stressing the importance of receiving feedback on how the QC system is operating and encouraging staff to communicate their concerns on quality control issues.

This practice monitoring requirement is applicable to firms that have a compilation and review practice, as well as firms that have an accounting and auditing practice, and requires those firms to undergo a peer review at least once every three years. As a result, such firms must have in place a quality control system that will withstand such a review or risk termination of firm membership in the program, individual memberships in the AICPA, and, in some states, loss of their licenses to practice.

Quality Control Materials. Quality control materials (QCM) consist of programs, checklists, sample confirmation letters, and other practice aids. When designing the firm's quality control policies and procedures, the firm should indicate the QCM that are being used, or make reference to the firm's accounting manuals that contain the firm's QCM. QCM are an integral part of a firm's QC system is a system of engagement checklists and practice aids that helps ensure compliance with both authoritative literature and peer review standards.

In reviewing Exhibit 2-1, the accountant may note that certain "yes" responses exceed the minimum required by professional standards. For example, authoritative literature does not require written engagement letters unless management-use-only financial statements are compiled under SSARS No. 1, as amended by SSARS No. 8, (Step 3). However, the PPC QC system requires that step because it seems to be the most cost-effective means of providing quality service and minimizing engagement risks. For example, a firm may decide that it will not require engagement letters on some or all types of engagements. If so, it should be aware that authoritative standards require the firm to reach an understanding with clients about the terms of all engagements. While the firm may choose to obtain this understanding orally, peer reviewers may ask for documentation of any oral understandings.

Exhibit 2-1

Quality Control Materials Recommended for Compilation of Historical Financial Statements

ENGAGEMENT PERFORMANCE QUALITY CONTROL STEPS	Person or Group Responsible for Completing Step		Is Step Required?[a]	Description of QCM
	Primary Responsibility	Secondary Responsibility		
1. Evaluate whether to accept/continue the engagement, considering the client's integrity and the firm's capabilities.	Partner (P)	Engagement Team (ET)	Yes	Engagement Acceptance Form/Step on Checklist
2. Communicate the partner's identity and role to the client.	P	ET	Yes	Engagement Letter
3. Obtain an engagement letter.	P	ET	Yes	Engagement Letter
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Step on Checklist
5. Plan the work and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Step on Checklist
6. Consider potential fraud implications.	ET	P	Yes	Step on Checklist
7. Prepare an engagement plan.	ET	P	Yes	Checklist
8. Develop a time estimate.	ET	P	Opt	Budget Form
9. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.	P	ET	Opt	Step on Checklist
10. Perform and document the procedures.	ET	P	Yes	Checklist
11. Supervise procedures (including work of other accountants).	ET	P	Yes	Checklist
12. Evaluate the propriety of a step down to a lower level of service.	ET	P	Yes	Step-down Checklist/ Step on Checklist
13. Draft (or assist in drafting) the financial statements.	ET	P	Yes	Numerous illustrations
14. Perform analytical procedures.	ET	P	No	Step on Checklist
15. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Disclosure Checklist
16. Obtain a management representation letter.	ET	P	Opt	Representation Letter
17. Draft the report.	ET	P	Yes	Numerous illustrations
18. Review the workpapers.	P & ET	—	Yes	Step on Checklist
19. Determine that all review points and open items have been cleared.	ET	P	Yes	Step on Checklist
20. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Technical Reviewer Checklist/ Step on Checklist
21. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Step on Checklist
22. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Step on Checklist
23. Have the partner sign the report or transmittal letter.	P	ET	Yes	Step on Checklist
24. Evaluate the staff's performance.	ET	P	Opt	Evaluation Form
25. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Step on Checklist
26. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Filing Examples

Notes:

[a] Certain steps listed are more than the minimum required by professional standards. For example, authoritative literature requires accountants to obtain written engagement letters if management-use-only financial statements are issued without a report. However, the literature only requires accountants to obtain an understanding with clients about the terms of other engagements involving unaudited financial statements of nonpublic companies. A proposed SSARS would require accountants to establish an understanding with management regarding the services to be performed for *each* compilation or review engagement. This understanding would need to be communicated in the form of an engagement letter. The steps listed are

required in the PPC quality control system because best practices indicate they are the most cost-effective means of providing quality services and minimizing engagement risks.

* * *

Reference Materials. In 2007, the AICPA issued guidance for developing QC policies and procedures in its Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (the AICPA Practice Aid). The AICPA Practice Aid, revised for the issuance of SQCS No. 7, provides illustrative examples of various types of policies and procedures a firm should consider when developing its system of quality control under the guidelines of SQCS No. 7. Illustrative examples of quality control documents are provided for four hypothetical firms varying in size, as follows:

- Firm with multiple offices.
- Single office firm.
- Sole practitioner.
- An alternative practice structure.

The AICPA Practice Aid is not authoritative and only presents the recommendations of the AICPA Quality Control Standards Task Force on the applicability of the new standard. Even so, the AICPA Practice Aid may be a good resource for use by a firm when drafting its QC policies and procedures. The AICPA Practice Aid can be downloaded, free of charge, at **www.aicpa.org/download/members/div/auditstd/System_of_Quality_Control_Practice_Aid.pdf**.

In addition, *PPC's Guide to Quality Control—Compilation and Review* can assist firms in this task. It illustrates suggested policies and procedures that address the elements of quality control listed in SQCS No. 7. It is updated annually to keep firms aware of recent developments relating to quality control issues and peer reviews.

Establishing Criteria for Engagement Quality Control Reviews (EQCR). Firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed. In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. Such criteria may include considerations such as the following:

- The nature of the engagement, including whether it involves a matter of public interest.
- Whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry.
- Whether laws or regulations require an engagement quality control review to be performed.

If no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

The structure and nature of the firm's practice are important factors in establishing criteria to consider when determining which engagements are to be subject to an EQCR. Accordingly, the firm should begin the process of developing EQCR policies and procedures by considering its unique structure and nature. Firm structure includes the size of the firm, whether the firm is a single-office firm or part of a multi-office practice, the number of partners in the firm, etc. The nature of the firm includes the types of services the firm performs and how those services make up the total engagements of the firm. For example, does the firm provide an extensive line of services including reviews, compilations, and attest engagements?

Firms define engagement quality control review criteria based upon the firm's unique circumstances (that is, structure and nature). Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. For that particular firm, since the firm offers a variety of services overseen by multiple partners, some of whom perform both review and tax services, there may be a more pressing need to have EQCRs performed on a larger number of review engagements. Alternatively, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk (as defined by the firm) for EQCR. The preceding discussion indicates that different firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly from the criteria established for compilation engagements or the criteria established for other types of attest engagements. SQCS No. 7 suggests that when establishing criteria for EQCRs, firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. The following list represents the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as by the client's lender for financing purposes.
- High profile clients, for example, well-known individuals or entities in the local community.
- Entities subject to governmental regulations.
- New types of service for the firm.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.
- Clients that have experienced material misstatements during the current or previous engagements.
- First-time clients.
- New firm partners.

Any circumstance that creates an unusual or a higher level of engagement risk should be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement.

Since EQCR criteria is based upon each firm's unique circumstances, firms should consider whether their established EQCR criteria need to change when firm circumstances change. The firm's quality control system should be a dynamic system that changes as the firm changes.

Peer Reviews

Applicability of Peer Review Requirements. AICPA Bylaw 2.2, "Requirements for Admission to Membership," defines the criteria that persons must possess to qualify for membership in the AICPA. Bylaw 2.2.3 states:

> With respect to those persons who are engaged in the practice of public accounting as an owner or as an employee who has been licensed as a CPA for more than two years, either they are practicing in a firm that is enrolled in an Institute-approved practice-monitoring program if the services performed by such a firm are within the scope of the AICPA's practice-monitoring standards and the firm issues reports purporting to be in accordance with AICPA professional standards, or if authorized by council, are themselves enrolled in such a program.

Basically, that bylaw requires accountants who are AICPA members to enroll in a practice monitoring program when they (a) perform services covered by peer review and (b) issue reports in accordance with professional standards. AICPA Council-authorized bylaws allow individual CPAs who practice in a non-CPA owned firm (i.e., an alternative practice structure) to be enrolled in a practice-monitoring program. A Council resolution also allows these individual CPAs to perform SSARS compilations as long as the CPAs (a) sign their reports with their own name (rather than with the name of their non-CPA owned firm employer) and (b) undergo peer review of the compilations. Interpretation No. 3-2 of Peer Review Standards (PRPM Section 2000) states that the term *firm*, as it appears in the Standards, applies to the individual CPAs practicing in a non-CPA owned firm who are enrolled in a practice-monitoring program.

Revisions to the Peer Review Standards. In May 2008, the AICPA Peer Review Board issued revised *Standards for Performing and Reporting on Peer Reviews* (Peer Review Standards) and Interpretations. The revised Peer Review Standards superseded all existing Peer Review Standards and Interpretations and are effective for peer reviews commencing on or after January 1, 2009. The new Peer Review Standards are more principles-based, with detailed guidance provided in the Interpretations. All peer review guidance has been reevaluated, reengineered, updated, and clarified. Some of the more significant changes include:

- Revamping the language of system and engagement review reports to make them shorter and more concise. The *standard*, *modified*, and *adverse* reports have been replaced with *pass*, *pass with deficiencies*, and *fail* reports.
- Incorporating SQCS No. 7 throughout the new Peer Review Standards and Interpretations.
- Folding report reviews into engagement reviews while maintaining several attributes of the report review process, and making other revisions to engagement reviews.
- Eliminating the letter of comments.
- Making various changes to the engagement review process and documentation.
- Allowing, under specified circumstances, the new Peer Review Standards to be used by certain approved administering entities to administer peer review of non-AICPA firms.
- Making changes to reviewer training and resume requirements.
- Adding the concept of a review team assessing its "capability" to perform a peer review.
- Clarifying the information to be included in the reviewed firm's representation letter.
- Incorporating guidance for performing and reporting on peer reviews of QCM and CPE programs.

The revised Peer Review Standards and Interpretations are located in the AICPA Peer Review Program Manual at Sections 1000 and 2000, respectively.

Types of Reviews. The revised Peer Review Standards provide for two types of reviews: a system review and an engagement review. Firms that perform audit engagements under the SASs or *Government Auditing Standards*, examinations of prospective financial statements under the SSAEs, or audits of non-SEC issuers performed under the standards of the PCAOB 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 of prospective financial statements), 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. As discussed in the preceding paragraph, compilation and review firms generally undergo a peer review known as an engagement review. The Peer Review Standards (PR 100.102) state,

> The objective of an engagement review is to evaluate whether engagements submitted for review are performed and reported on in conformity with applicable professional standards in all material respects.

> An engagement review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, together with certain background information and representations and, except for compilation engagements performed under SSARS, the applicable documentation required by professional standards.

The peer reviewer does not attempt to evaluate the adequacy of the firm's quality control system. As a result, an engagement review does not involve a review of engagement workpapers, administrative files or personnel files, personnel interviews, or other procedures. Since an engagement review does not evaluate the firm's system of quality control, an engagement review report is very different from a system review report, which expresses an opinion on the firm's QC system. The engagement review report provides assurance only on the firm's engagements.

Performing Review Procedures. Under an engagement review, the following procedures are performed by the reviewer:

a. Consideration of the financial statements or information and the related accountant's report on the compilation and review engagements performed under SSARS and engagements performed under SSAEs.

b. Consideration of the documentation on the engagements performed via reviewing background and engagement profile information, representations made by the firm, and inquiries.

c. For engagements other than compilation engagements performed under SSARS, review of all other documentation required by applicable professional standards on the engagements.

d. The review captain may request to review other documentation on compilation engagements performed under SSARS (1) if the firm represented that the documentation is appropriate, but the review captain has cause to believe that such documentation may not have been prepared in accordance with applicable professional standards, or (2) to support presentation or measurement issues relating to the financial statements or information.

Applicability of Peer Review Requirements to Compilations of Management-use-only Financial Statements. SSARS No. 1, (as amended) allows CPAs to provide management-use-only financial statements without issuing a compilation report if the statements are not reasonably expected to be used by third parties. A related issue is whether peer review requirements apply to compilations of management-use-only financial statements. (As previously discussed, it is clear that CPAs who issue SSARS review or compilation reports must be in a firm that is enrolled in an AICPA-approved practice-monitoring program, or if the CPA is in a non-CPA owned firm and issue a compilation report, the CPA must individually be in a peer-review program.)

Interpretation No. 6-1 of the Peer Review Standards states that management-use-only financial statements issued under SSARS No. 1 do not include a report for purposes of Section BL 2.2.3 of the AICPA bylaws and, accordingly, will not require a firm to join a peer review program. The Interpretation also states, however, that compilations of management-use-only financial statements performed by firms that are already subject to peer review (because, for instance, they also perform one or more SSARS compilation engagements for third-party use) will be included within the scope of engagements to be reviewed by the peer reviewers. The Interpretation clarifies that such engagements are not required to be selected for review, but only that they are within the scope of the existing engagement selection process and, thus, might be selected.

If selected for review, Interpretation No. 6-3 states that if compilations of management-use-only financial statements are reviewed, the reviewer will only inquire about the engagement letter to determine that it documents the matters required by SSARS No.1 and will review the financial statements only to determine that they include the required use restriction.

Furthermore, accountants should be aware that some state boards of accountancy might have peer review requirements that differ from those of the AICPA. In some cases, those state boards could require peer review of compilations of management-use-only financial statements when a report is not issued, even though the AICPA does not.

SELF-STUDY QUIZ

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

31. Which of the following scenarios demonstrates the *Human Resource Element* of a quality control system (QCS)?

    a. The managing partner of the firm periodically tests the quality control policies and procedures established by the firm to determine if they are operating effectively.

    b. The staff of the firm includes a partner with 20 years of experience and sufficient educational background to qualify her to teach ethics to CPAs statewide.

    c. The firm includes a Client Acceptance and Continuance Checklist as part of its QCS.

32. Jones Hart, LLC performs engagements under the Statements on Auditing Standards. The type of peer review they require is:

    a. An engagement review.

    b. An audit review.

    c. A system review.

33. Which of the following should be completed when undergoing an engagement review?

    a. A review of engagement workpapers.

    b. A reading of the financial statements submitted by the reviewed firm.

    c. Review of the administrative and personnel files of the firm.

34. Connie is a CPA employed by a non-CPA owned firm and produces compilation reports for the firm's clients. Which of the following statements is accurate?

    a. Connie is not subject to a peer-review program.

    b. Connie should sign the compilation reports using the firm's name, not her own.

    c. Connie is allowed to be enrolled in a practice-monitoring program.

    d. Connie is not eligible for a report review.

35. In preparing a compilation of historical financial statements, which of the following quality control steps is optional?

    a. Obtain a management representation letter.

    b. Consider potential fraud implications.

    c. Obtain an engagement quality control review.

    d. Evaluate the propriety of a step down to a lower level of service.

SELF-STUDY ANSWERS

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

31. Which of the following scenarios demonstrates the *Human Resource Element* of a quality control system (QCS)? **(Page 194)**

    a. The managing partner of the firm periodically tests the quality control policies and procedures established by the firm to determine if they are operating effectively. [This answer is incorrect. This answer choice demonstrates the *Monitoring Element* of a quality control system, not the *Human Resource Element*.]

    b. The staff of the firm includes a partner with 20 years of experience and sufficient educational background to qualify her to teach ethics to CPAs statewide. [This answer is correct. The *Human Resource Element* of a QCS is adequately demonstrated by the partner's level of experience and commitment to ethical principles.]

    c. The firm includes a Client Acceptance and Continuance Checklist as part of its QCS. [This answer is incorrect. A Client Acceptance and Continuance Checklist is a highly recommended tool that demonstrates the firm's commitment to the QC element of *Acceptance and Continuance of Client Relationships and Specific Engagements*, not the *Human Resource Element*.]

32. Jones Hart, LLC performs engagements under the Statements on Auditing Standards. The type of peer review they require is: **(Page 199)**

    a. An engagement review. [This answer is incorrect. The engagement review is for firms that are not required to undergo a system review and do not qualify for a report review.]

    b. An audit review. [This answer is incorrect. There is no audit review category of peer reviews.]

    c. A system review. [This answer is correct. The system review is required for firms that perform engagements under SASs, Government Auditing Standards, and/or examinations of prospective financial statements under the SSAEs, as recommended by the AICPA Standards.]

33. Which of the following should be completed when undergoing an engagement review? **(Page 199)**

    a. A review of engagement workpapers. [This answer is incorrect. An engagement review does not include a review of the engagement workpapers when completing a peer review, since and engagement review is not concerned with the adequacy of the firm's quality control system.]

    b. A reading of the financial statements submitted by the reviewed firm. [This answer is correct. An engagement review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, to evaluate whether the engagement submitted for review was performed and reported on in conformity with applicable professional standards in all material respects.]

    c. Review of the administrative and personnel files of the firm. [This answer is incorrect. A peer review is not a review of how the firm runs its practice, but how it manages its engagements. An engagement review would not include review of administrative or personnel files of the firm.]

34. Connie is a CPA employed by a non-CPA owned firm and produces compilation reports for the firm's clients. Which of the following statements is accurate? **(Page 200)**

    a. Connie is not subject to a peer-review program. [This answer is incorrect. If the CPA is in a non-CPA owned firm and issues compilation reports, the CPA must individually be in a peer-review program.]

    b. Connie should sign the compilation reports using the firm's name, not her own. [This answer is incorrect. An individual CPA is allowed to perform SSARS compilations as long as the CPA signs her reports in her own name and not the name of her non-CPA owned firm employer.]

c. Connie is allowed to be enrolled in a practice-monitoring program. [This answer is correct. AICPA Council-authorized bylaws allow individual CPAs who practice in a non-CPA owned firm to be enrolled in a practice-monitoring program.]

d. Connie is not eligible for a report review. [This answer is incorrect. The report review is for firms (or individual CPAs in non-CPA owned firms) that perform only SSARS compilations of financial statements.]

35. In preparing a compilation of historical financial statements, which of the following quality control steps is optional? **(Page 196)**

a. Obtain a management representation letter. [This answer is correct. This QCS step is optional and not required by any authoritative literature.]

b. Consider potential fraud implications. [This answer is incorrect. This is a required step for adequate quality control materials per the Step on Work Program.]

c. Obtain an engagement quality control review. [This answer is incorrect. This is a required step on a technical reviewer checklist.]

d. Evaluate the propriety of a step down to a lower level of service. [This answer is incorrect. This step is required on a step-down checklist or work program.]

PRACTICE ISSUES IN WRITE-UP ENGAGEMENTS

Practicing a profession is generally a stimulating and intellectually rewarding undertaking; however, practice issues and the threat of legal liability can cast shadows on professional lives and ruin an otherwise successful professional career. This section addresses several practice issues accountants should consider while performing a write-up engagement.

Litigation Risks

Liability claims against CPA firms prior to 1970 were relatively rare events. Since 1970, however, such claims have increased dramatically and today, on average, they strike at the rate of one claim per year for approximately every 120 professionals. Not only has the frequency of such claims increased, the severity of claims against CPA firms has also escalated. It is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of $1 million. In fact, a CPA firm that does only tax, compilation, and review and other write-up work should never assume that their malpractice risk is immaterial. There are a large number of malpractice claims filed involving bookkeeping, compilations, and reviews. 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,
- Loss prevention, and
- Engagement letters.

Quality Control. Statement on Quality Control Standard No. 7, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's system of quality control responsibilities for its accounting and auditing practice, and is effective as of January 1, 2009. SQCS No. 7 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 makes itself invulnerable to liability claims. While quality control measures clearly decrease the possibility of substandard performance (and the chances of being sued), they are by no means a total answer. In fact, the changes that have been made to SSARS, ethics, and other professional standards over the past 30 years have, in some respects, increased the vulnerability of CPA firms to liability claims as practitioners struggle to keep up to date with the latest standards.

Professional Liability Insurance. The second line of defense of CPA firms has traditionally been professional liability insurance. Thus, when quality control measures prove inadequate, the CPA firm would nevertheless be protected by its liability insurance coverage. While liability insurance is essential for all professional firms, it too is no panacea. Even throughout the late 1990s when the cost of professional liability coverage was relatively inexpensive there was still a large percentage of CPA firms that practiced without insurance. Immediately following the September 11, 2001 disaster, the liability insurance market began to tighten. Today, some firms are unable to obtain malpractice insurance coverage and many medium size and large firms cannot obtain the limits of liability coverage they desire.

Notwithstanding the relatively competitive state of the current insurance market, it is not altogether 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, as many insurers remain unwilling to cover such claims.

Loss Prevention. Because of the limitations in professional liability insurance and the inability of CPA firms to purchase sufficient insurance to cover their full risk exposure, CPA firms have had to turn to a third line of defense—loss prevention. Loss prevention consists of the following two important components:

- Risk avoidance.
- Damage control.

Risk Avoidance. Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts. Gone are the days when CPA firms made client acceptance decisions solely on the basis of whether the engagement could be performed profitably. Today, before accepting an engagement, CPA firms must not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. (SQCS No. 7 requires firms to establish policies and procedures for client and engagement acceptance and continuance.)

Another aspect of risk avoidance is protecting the assets of the firm and its owners in the event that the firm's defenses against liability prove ineffective. This can be accomplished by organizing the firm's operating assets into separate legal entities. Under this asset protection strategy, a claimant seeking to recover damages inflicted by one element of the firm's operations may not recover from other elements of the firm's operations. In addition, all states now permit CPA firms to conduct their operations as limited liability entities. Thus, a CPA firm can operate as a professional corporation, a limited liability company, or a limited liability partnership. Under these types of structures, the personal assets of each owner are immune to liability claims against the firm unless the owner himself actually committed the acts that gave rise to the liability or supervised the individuals who committed the wrongful acts.

In addition to these structural protections, CPAs can protect their personal assets in a number of other ways, including placing assets in protected pension plans and holding property jointly with others with rights to survivorship. Moreover, personal assets may be protected by outright transfers of assets to others or by placing them in trust.

Damage Control. Another 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. 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 discussed in lesson one, best practices indicate that accountants should always utilize an engagement letter when performing write-up engagements. The form and content of the letters should be structured to help minimize legal liability.

Responsibility for Fraud and Illegal Acts

SSARS No. 1, as amended by SSARS No. 12, sets forth the accountant's responsibilities for fraud and illegal acts in compilation and review engagements. The Statement defines *fraud* as "an intentional act that results in a misstatement in compiled or reviewed financial statements" and defines *illegal acts* as "violations of laws or government regulations, excluding fraud."

Do SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients*, apply to compilation engagements? The answer is no. SAS No. 99 and SAS No. 54 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 engagement. Nor do SSARS performance requirements impose detection requirements for illegal acts. No expression of assurance is contemplated in a compilation. In addition, SSARS No. 1 obligates the accountant in compilation (AR 100.09) engagements to obtain additional or revised information when the accountant becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory.

Use of Engagement Letters to Clarify the Accountant's Responsibilities. Management is responsible for the prevention and detection of fraud and illegal acts, and the maintenance of internal control. However, many small business clients do not understand management's responsibility. They may have unrealistic expectations and may assume that the accountant is providing a higher level of assurance than he or she actually is, including detecting fraud, illegal acts, and internal control deficiencies. A written engagement letter can be helpful in clarifying and documenting the understanding of the accountant's responsibility regarding fraud, illegal acts, and internal control deficiencies. SSARS No. 1 (AR 100.05), as amended by SSARS No. 12, states that the accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. The understanding should provide, among other things, (a) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (b) that the accountant will inform the appropriate level of management of any suspected fraud or material errors and any illegal acts, unless clearly inconsequential, that come to his or her attention.

Whether an act actually is fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. Accountants—when reporting on financial statements—present themselves as being proficient in accounting and compilation and review services. The accountant's training, experience, and understanding of the client and its industry may cause him or her to recognize some client acts as fraudulent or illegal. However, the determination of whether a particular act is fraudulent or illegal should be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Communication of Suspected Fraud or Illegal Acts. SSARS No. 1 (AR 100.84), as amended by SSARS No. 12, addresses the question of what the accountant should do to communicate suspected fraud or illegal acts discovered during the performance of a compilation engagement. The Standard states that when the accountant suspects fraud or illegal acts may have occurred, the matter should be communicated to the appropriate level of management. The accountant need not report matters regarding illegal acts that are clearly inconsequential (e.g., misdemeanor traffic violation) and may reach agreement in advance with the entity on the nature of any such matters to be communicated. If the suspected fraud or illegal acts involve senior management, then the matter should be communicated at the highest level within the company. And, if the suspected fraud or illegal act 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 illegal acts 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 illegal acts.

The disclosure to third parties of any evidence or information that comes to the accountant's attention during the performance of the compilation procedures that indicate fraud or an illegal act may have occurred is not usually the accountant's responsibility. In fact, in most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality. There are certain instances, however, such as complying with legal and regulatory requirements, communicating with a successor accountant regarding acceptance of an engagement in accordance with SSARS No. 4, and responding to a subpoena, where an accountant has a duty to disclose matters related to fraud and illegal acts to parties outside of the entity.

Other Practice Issues

Bookkeeping Services. Accountants who perform compilation services for their clients often also perform bookkeeping services for those same clients. Bookkeeping engagements have usually been viewed as presenting minimal professional liability risk because the accountant provides no assurance and the work is relatively straightforward and without technical complexities. However, if a client company suffers a financial loss due to fraud or theft, the accountant is often viewed by the client as contributing to the loss. Consequently, there is a growing trend of lawsuits being filed against accountants who perform bookkeeping services when the accountant fails to detect fraud or theft.

The potential for fraud exists on all engagements. The accountant's responsibility to detect fraud is often different than the public's perception of the accountant's responsibility. See the earlier discussion of the accountant's responsibility for fraud in compilation engagements. When performing bookkeeping services, best practices indicate that the accountant should take special care in having an engagement letter that specifically details exactly what procedures the accountant will perform. This is especially important as it relates to any work being performed relative to the cash account. For example, if the accountant is performing a bank reconciliation, the engagement letter should specify exactly what procedures will (or will not) be performed with respect to the payee and endorsement of the cancelled checks. That is, the engagement letter should clearly communicate whether the accountant will look at cancelled checks to review for proper payees or endorsements.

Licensing Problems. State legislatures and the courts have determined that it is in the public interest to regulate professional services offered by CPAs. Accountancy laws governing the licensing of certified public accountants and prescribing entry requirements for those who wish to hold themselves out to the public to practice accounting have been enacted in all fifty states, District of Columbia, Puerto Rico, Guam and Virgin Islands.

CPAs should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel. Some states require firms to be licensed while other states do not. A firm may also do business in states other than where it is domiciled. Those states may also require licenses. While licensing is not a QC standard, the failure of firms to have one or more required firm licenses has been an issue in certain states as to acceptance of the peer review report by the state board of accountancy. 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. Because the licensing rules vary significantly from state to state, the CPA firm should investigate a state's licensing requirements by contacting the applicable state board or consulting an attorney prior to doing business in that state.

SELF-STUDY QUIZ

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

36. Cantwell & Associates, LLC is a growing accounting firm which carries professional liability insurance. In addition to providing tax services and investment advice, the firm is now offering auditing services. Should the partners feel assured that they are adequately covered now and in the future?

    a. Yes, because their staff only occasionally provides investment advice.

    b. No, because they may not be able to obtain the amount of liability coverage they need as they grow.

37. In order to protect the personal assets of the owners against liability claims, an accounting firm should elect to organize under which form of business?

    a. A professional corporation.

    b. A general partnership.

    c. A general corporation.

38. Arnie's Gun Shop has hired an accounting firm to prepare the company's financial statements and taxes. Arnie expects the accounting firm to detect any fraud or internal control deficiencies in his business. What is the best action for the accountant to take?

    a. The accountant should have a conversation with Arnie and tell him that fraud detection is beyond the scope of the engagement.

    b. The accountant should tell Arnie to contact a lawyer if he suspects fraud.

    c. The accountant should provide a written engagement letter clarifying the accountant's responsibilities.

39. Susan is performing a compilation engagement for her new client, Wilton Manufacturing. She has discovered that Mr. Wilton, the owner, is committing fraud. What should Susan do?

    a. Resign and consult legal counsel.

    b. Communicate her discovery to senior management.

    c. Complete the engagement and consult with her client.

    d. Disclose to third parties any evidence or information she has to substantiate the fraud.

40. CPAs operate under licensing laws. Which of the following statements is accurate?

    a. Not all states require CPAs to be licensed.

    b. All states require accounting firms to be licensed.

    c. A firm cannot do business in any state other than where it is domiciled.

    d. A CPA's expert witness testimony may be disallowed if the CPA is not licensed in that state.

SELF-STUDY ANSWERS

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

36. Cantwell & Associates, LLC is a growing accounting firm which carries professional liability insurance. In addition to offering tax services and investment advice, the firm is now offering auditing services. Should the partners feel assured that they are adequately covered now and in the future? **(Page 206)**

    a. Yes, because their staff only occasionally provides investment advice. [This answer is incorrect. Professional liability risk is greater for those offering investment advice, no matter how infrequently. The firm may not have adequate coverage to cover this risk and the cost could be prohibitive.]

    b. No, because they may not be able to obtain the amount of liability coverage they need as they grow. [This answer is correct. The liability insurance market has tightened since 9/11/2001 and has made some firms unable to obtain malpractice insurance coverage and many medium and large size firms cannot obtain the limits of liability coverage they desire.]

37. In order to protect the personal assets of the owners against liability claims, an accounting firm should elect to organize under which form of business? **(Page 207)**

    a. A professional corporation. [This answer is correct. A professional corporation operates as a limited liability entity which protects the individual owners from liability.]

    b. A general partnership. [This answer is incorrect. A general partnership does not protect the individual owners' assets.]

    c. A general corporation. [This answer is incorrect. The general corporation's assets are at risk but the individual owner's can be held liable as well.]

38. Arnie's Gun Shop has hired an accounting firm to prepare the company's financial statements and taxes. Arnie expects the accounting firm to detect any fraud or internal control deficiencies in his business. What is the best action for the accountant to take? **(Page 207)**

    a. The accountant should have a conversation with Arnie and tell him that fraud detection is beyond the scope of the engagement. [This answer is incorrect. While it is accurate that the client should be informed, it is best to have this communicated in writing.]

    b. The accountant should tell Arnie to contact a lawyer if Arnie suspects fraud. [This answer is incorrect. While an accountant may suspect fraud, the determination of whether an act is fraudulent should be based on the advice of an informed expert qualified to practice law. However, unless the client is certain fraud has occurred, it would be in the client's best interest for the accountant to confirm if fraud is suspected before suggesting the client hire an attorney.]

    c. The accountant should provide a written engagement letter clarifying the accountant's responsibilities. [This answer is correct. A written engagement letter can clarify and document the understanding of the accountant's responsibility regarding fraud, illegal acts and internal control deficiencies.]

39. Susan is performing a compilation engagement for her new client, Wilton Manufacturing. She has discovered that Mr. Wilton, the owner, is committing fraud. What should Susan do? **(Page 208)**

    a. Resign and consult legal counsel. [This answer is correct. Since the owner is involved, there is no higher level Susan can report the fraud to. So, her best action is to remove herself from the engagement immediately.]

    b. Communicate her discovery to senior management. [This answer is incorrect. This would be the correct action if the owner was not involved and she could communicate to a higher level.]

c. Complete the engagement and consult with her client. [This answer is incorrect. She does not want to become further involved in any fraudulent acts of the client. Waiting until the engagement is concluded and then speaking to the client is not in her best interests as an accountant.]

d. Disclose to third parties any evidence or information she has to substantiate the fraud. [This answer is incorrect. Disclosure to third parties is not the accountant's responsibility. In most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality.]

40. CPAs operate under licensing laws. Which of the following statements is accurate? **(Page 209)**

a. Not all states require CPAs to be licensed. [This answer is incorrect. State legislatures have determined that it is in the public interest to regulate professional services offered by CPAs so that accountants will be held to laws governing the licensing requirements.]

b. All states require accounting firms to be licensed. [This answer is incorrect. Some states require firms to be licensed while other states do not.]

c. A firm cannot do business in any state other than where it is domiciled. [This answer is incorrect. A firm may also do business in states other than where it is located, but the firm may need to obtain the appropriate license to do business in that state.]

d. A CPA's expert witness testimony may be disallowed if the CPA is not licensed in that state. [This answer is correct. Without a license to practice in the state, a CPA may be barred from providing expert witness testimony per the rules of the state licensing board.]

DISASTER RECOVERY PLANNING

In recent years, many firms have had to recover from unexpected damages to their offices, equipment, and files. In some instances, the damages were caused by natural disasters. In other cases, man-made disasters, such as fire, theft, terrorism, or vandalism, have caused firms to close—sometimes for good. Even less catastrophic events, such as a power failure or an inadvertent coffee spill on a computer, have prevented firms from conducting business as usual and, consequently, have caused them to lose time and money.

Although it is virtually impossible to plan for every conceivable disaster, firms can anticipate and plan for those that are more likely to occur. All firms need to have some type of disaster recovery plan in place. The plan should provide for items such as the following:

- Continuing to handle the firm's activities with as little interruption as possible.
- Communicating with clients, employees, vendors, and others if the firm must vacate its offices.
- Relocating the office if the firm's current space is damaged or destroyed.
- Replacing equipment, such as computers, servers, network infrastructure, fax machines, scanners, copiers, and the telephone system.
- Reinstalling all system and accounting applications, current version updates, and restoring all client data into a usable format.
- Replacing furniture and office supplies.
- Reconstructing lost or damaged paper files and computer records.
- Shifting work assignments if key employees are unable to report to work.
- Obtaining financial assistance, if necessary, to pay the firm's obligations while business is interrupted.
- Response to the media.

Simply put, a disaster recovery plan is a list of procedures and activities that allow normal operations to continue (or resume quickly) if disaster strikes. The plan should provide for many items; however, protecting the firm's hardware and software and protecting files and records are the most critical of those items.

Protecting the Computer System

Many firms rely heavily on their computer systems. Consequently, a firm has much to lose if equipment or files are destroyed, lost, or stolen. In such cases, the firm must not only replace physical assets, but also reconstruct important data that may have been lost.

Firms should carefully evaluate computer system security controls, which fall into three basic categories:

- *Physical Access.* Physical security limits the physical access to equipment, reducing the risk of theft or hardware destruction. Because PCs, servers, workstations, and printers are relatively small, this equipment is often placed near employees' work areas, making physical isolation difficult.
- *User Access.* User access controls protect against physical damage and access to computing systems and data files by unauthorized users, whether physically located in the firm's facility or remotely through some form of communications link. Those measures include items such as passwords, user identification codes, and audit trails. Passwords should be at least eight characters with a mix of numbers, letters, and punctuation characters, and users should be required to change their passwords regularly.
- *Data Access.* The best defense against loss of data files is to regularly and systematically copy (or back up) data files.

Protecting Files and Records

Because firms rely on data, their client and firm files are important assets. Some records, such as current workpaper files, may be impossible to replace if they are destroyed. Other records, such as permanent files and certain firm records, may be reconstructed if they are lost, but only at considerable cost. To protect their files, firms should consider adopting some or all of the following procedures:

- *Store Important Papers in Fire-proof File Cabinets.* Although more expensive than conventional filing cabinets, insulated, fire-proof cabinets may be the most practical method of protecting the firm's physical files. When purchasing a fire-proof cabinet, make sure that its internal temperature rating is sufficient to protect the types of materials (e.g., paper files or electronic media) that will be stored inside.

- *Keep File Cabinet Drawers Closed.* Even uninsulated file cabinets offer some protection from fire and water damage, but no file cabinet (including a fire-proof cabinet) will protect its contents if its drawers are left open. Closing and locking file cabinet drawers can reduce the supply of oxygen inside the file cabinet and, thus, help protect files from fire damage.

- *Return Files to File Cabinets at the End of Each Day.* Files left in the open on the top of file cabinets, desks, or the floor have no protection from fire or water damage. By adopting a policy of returning files to file cabinets at the end of each day, the firm not only reduces its risk of losing files in a fire, but it reduces its risk of losing or misplacing files as well.

- *Destroy Old Files.* Old unnecessary files can be expensive to store and, in some cases, may become a fire hazard. Consider adopting a record retention policy and destroy files whose retention periods have expired.

- *Maintain Duplicate Copies of Certain Irreplaceable Files at an Off-site Location.* Certain records, such as client lists and the firm's internal accounting records, are extremely important to the firm's continuing operations and would be difficult to reconstruct if they were lost or destroyed. Consider making copies of such records and storing them in an off-site location or scanning them into a digital format on the network where they can be backed up and stored off-site.

- *Restrict Access to Files.* Files are less likely to be lost if only authorized employees have access to them. If possible, store files in a separate file room or in locked cabinets and allow only those who need the files to have access to them.

- *Store Permanent Files in Digital Format.* It should be noted that as firms transition to a "less-paper" environment and acquire scanners and document management systems, they are storing files primarily in a digital format, particularly those that are on a permanent retention cycle. Firms should only scan those documents deemed permanent, unless the cost of labor to scan them is less than the storage costs would be.

SUCCESSION PLANNING FOR THE TRANSFER OF OWNERSHIP

There are two important aspects to succession planning: (a) planning for the transfer of the firm to new owners and (b) protecting the firm from potential damage caused by the loss of critical firm partners, managers, and employees. The succession planning process as it relates to protecting the firm from the loss of critical partners, managers, and employees on an ongoing basis is discussed in Lesson 1. This lesson discusses succession planning as it relates to the transfer of ownership.

In the not too distant past, say 10–15 years ago, CPA firm owners and partners did not have to spend a lot of their time considering succession planning until perhaps the last few years of their career. The accounting industry had an ample supply of eager practitioners striving to be chosen to take over as owner or partner of the firm they had worked in for years. Times have changed. For the past several years, the top two concerns of firm owners and partners have been staffing shortages and succession planning. These are related issues in that the lack of qualified and committed *up-and-coming* CPA professionals has partially been the cause of the current succession planning crisis that is facing the accounting industry today. Another significant cause of the succession planning crisis is the aging accounting firm owner population.

Determining what the owner wants to do with the firm when he or she retires is the first step in succession planning. The options available include:

- Do nothing and close the doors for good one day (the worst-case scenario if the owner desires any funded retirement).
- Groom an individual within the firm to buy out the practice.
- Locate and hire a practitioner from outside the firm who could be groomed as an internal candidate for future ownership.
- Merge the practice with another public accounting firm.

After the decision is made as to which succession alternative best suits the owner's needs, another choice remains to be made. Succession planning can be performed in one of two ways:

a. In crisis mode, when the firm faces a sudden death, disability, or withdrawal, or when retirement is just a short time away.

b. In proactive mode, by performing specific planning steps in a logical order, giving careful consideration to issues raised and conclusions reached.

Obviously, the latter approach provides the most effective way of ensuring long-term firm success and survival. The owner makes a conscious decision how to perform succession planning for the firm. If the owner does not give succession planning the priority it requires, then in effect, he or she has chosen the crisis mode option since a sudden death or disability can occur without warning.

While having a viable succession plan is important for every firm, for sole proprietor firms the consequences of not having a succession plan will generally be immediately disastrous. In a small firm, when the senior or managing partner becomes disabled or dies with little or no warning, the firm is likely to experience considerable turmoil, loss of clients, and potentially the risk of going out of business entirely if a succession plan or practice continuation agreement is not in place.

If done properly, succession planning lays out a game plan to effectively deal with the inevitable transfer of ownership from current owners to others. Most accounting firm owners want to receive the highest value possible for their investment in the firm they worked long and hard to create or perpetuate. The value of an accounting firm lies primarily in the value of the firm's client relationships and the firm's professional personnel. A succession plan serves to preserve both client and staff continuity and firm value.

A few of the goals of succession planning are to—

- Lay the groundwork for transferring authority and control.
- Maximize firm value for owners and their families by making the firm attractive to prospective successors.
- Provide continuity of service delivery to clients.
- Provide a reasonable and secure retirement income for retiring owners.
- Avoid crisis situations.

Although there are numerous factors to be considered, some of the keys to ensuring firm continuity through succession planning include the following:

- Developing and implementing the plan.
- Reviewing and revising the plan as needed.
- Requiring a two-year notification of retirement.
- Capping retirement payments to a level that will not hurt the firm's future financial viability.
- Creating a plan that is a "win-win" situation for both the continuing and retiring owners.

The Succession Planning Process

The succession planning process should be performed in a methodical, rational manner, with sufficient time to address all owner, firm, and client issues prior to the owner's retirement. Succession planning is not a process that can be performed well under pressure or time-constraints. The impact throughout the firm when a leading partner or owner retires should be carefully considered to develop a comprehensive succession plan. The plan should consider everybody who will be affected by the retiring partner's departure: clients, the successor, the firm and its staff, the remaining partners, and the retiring partner.

The succession planning process can be broken down into the following five steps:

a. *Choosing a Successor.* For a firm succession plan to work effectively, the firm must identify an individual to transfer ownership to and allow sufficient time to complete the needed transition steps by the time the exiting owner is ready to retire. In some cases, there may be a clear candidate for successor. However, many practitioners in recent years have indicated they are having difficulty retaining and grooming qualified staff to become owners. In those cases, the successor selection decision can be much more difficult. Additionally, the successor selection needs to include all roles that the retiring partner provides. Consider the hours and fees that must be replaced when the retiring partner retires. Often, practitioners in the senior years of their career have developed extensive client relationships and are well-known in the accounting and finance communities. Those relationships result in business coming to the firm and that community presence should be replaced. The retiring partner's administrative leadership roles also must be transitioned. The firm should consider whether administrative roles performed by the retiring partner are better transitioned to someone other than the successor partner. Some of the more common methods of identifying candidates for succession are to promote an employee from within the firm, bring in an individual from outside the firm, merge with another firm, or enter into a practice continuation agreement with another firm.

b. *Creating a Personal Technical Development Plan for the Successor.* Once the successor candidate has been identified, the firm should identify activities tailored to that individual's specific development needs as they relate to transitioning from high-level new-hire, manager, or entry-level partner into a key full-service partner in the firm. Activities may include taking post-graduate college courses, obtaining industry certifications, attending specialized industry or other targeted technical training courses, and going to accounting profession conferences (e.g., marketing and practice management conferences). It is important to provide a learning path that will optimize the successor candidate's ability to transition into his or her new role.

c. *Implementing a Leadership Development Program for the Successor.* Investing in a leadership development program is a critical component in extending a firm's lifecycle. In fact, it is the lifeblood of a firm's future. Firms without such a program eventually develop management problems that may lead to a forced merger for survival or dissolution, and the lack of a program certainly does not promote the advancement of the next generation of owners. Additionally, not having an effective leadership development program can have significant negative implications on recruitment and retention. Potential new recruits may choose a firm that has a formal leadership development program over a firm that does not. A firm's top performers will more easily be tempted to leave the firm if they cannot see that there is a process in place to develop them into a firm leader. However, having a development plan that exhibits the firm's process for elevating people throughout the organization, evaluating staff strengths and weaknesses, and offering individualized development plans that address those strengths and weaknesses helps differentiate a firm from the competition.

d. *Planning Succession within the Firm.* Transitioning the retiring owner's responsibilities to the successor begins as an internal firm process. Although clients and others outside the firm should not be informed until well into the transition, the transition plan and timeline should be fully communicated within the firm early in the process. It is important to communicate the upcoming transition to the staff early so they understand why the successor in-training is taking on more authority within the firm and assuming the retiring owner's responsibilities. Thus, the staff will appreciate why the successor warrants the same respect afforded the other owners. Additionally, eventually clients and others outside the firm will learn that an owner transition is taking place. It is helpful for the staff to be coached about the proper way to answer questions from individuals outside the firm to ensure that a consistent message is conveyed to the public.

e. *Transitioning Leadership Roles.* One of the biggest mistakes a retiring owner can make is to refuse to relinquish authority. Firms should consider establishing a mandatory retirement age and, in conjunction with that event, set a time prior to retirement (such as three to five years) when the owner begins to transition his or her leadership and client service roles to the identified successor. If the transition is properly implemented, at retirement, the retiring owner should no longer have any leadership responsibility and very limited client service responsibilities.

SELF-STUDY QUIZ

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

41. The most important reason an accounting firm should have a disaster recovery plan in place is:

    a. To have a predetermined location to continue operations.

    b. To provide the means for staff members to communicate with clients and each other.

    c. To protect the firm's hardware and software and protect files and records.

    d. To continue to handle the firm's activities with little interruption.

42. Regularly backing up data files falls into which category of computer system security controls:

    a. User Access.

    b. Data Access.

    c. System Access.

    d. Physical Access.

43. Mark is in charge of protecting the firm's files and records. Which of the following procedures should he **not** include on his checklist?

    a. Make sure old files are stored appropriately.

    b. Use only fire-proof file cabinets to store important papers.

    c. Keep file cabinet drawers closed.

    d. Put files away in file cabinets at the end of each day.

44. When selecting a successor to replace a retiring partner, which of the following statements is most accurate?

    a. Firms should expect the successor to produce the same amount of fees as the retiring partner.

    b. Firms should limit their search for a successor to an individual within the firm.

    c. Firms should expect the successor to assume all of the retiring partner's administrative leadership roles.

    d. Firms are having difficulty retaining and grooming qualified staff to become owners.

45. The Hartman Clark accounting firm has implemented a leadership development program. What is the most important effect this will have on the firm?

    a. The firm will avoid management problems.

    b. The firm will attract and retain top performers.

    c. The firm will avoid discrimination in its selection of potential leaders.

SELF-STUDY ANSWERS

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

41. The most important reason an accounting firm should have a disaster recovery plan in place is: **(Page 214)**

    a. To have a predetermined location to continue operations. [This answer is incorrect. While selecting a site for operations in advance is important, it is not the most critical reason for a disaster recovery plan since it is not the most important resource of the firm.]

    b. To provide the means for staff members to communicate with clients and each other. [This answer is incorrect. Staff will need the ability to communicate, but this is not the most critical element of the plan.]

    c. To protect the firm's hardware and software and protect files and records. [This answer is correct. Although the other items of a disaster recovery plan are important, the most critical are protecting the firm's hardware and software and protecting files and records since firms rely heavily on their computer systems.]

    d. To continue to handle the firm's activities with little interruption. [This answer is incorrect. This answer is not the most important; in fact, it will be a consequence of the most important reason.]

42. Regularly backing up data files falls into which category of computer system security controls: **(Page 214)**

    a. User Access. [This answer is incorrect. User access controls protect against physical damage and access to computing systems and data files by unauthorized users.]

    b. Data Access. [This answer is correct. Regularly and systematically copying data files is the best defense against loss of data files.]

    c. System Access. [This answer is incorrect. This is not a category of computer security controls.]

    d. Physical Access. [This answer is incorrect. Physical security limits the physical access to equipment, reducing the risk of theft or hardware destruction.]

43. Mark is in charge of protecting the firm's files and records. Which of the following procedures should he **not** include on his checklist? **(Page 215)**

    a. Make sure old files are stored appropriately. [This answer is correct. Old unnecessary files can be expensive to store and could become a fire hazard. They should be destroyed according to the firm's record retention policy.]

    b. Use only fire-proof file cabinets to store important papers. [This answer is incorrect. Fire-proof, insulated cabinets can be the most practical method of protecting the firm's files in case of a disaster.]

    c. Keep file cabinet drawers closed. [This answer is incorrect. Even uninsulated file cabinets offer some protection from fire and water damage, but no file cabinet will protect its contents if the drawers are left open.]

    d. Put files away in file cabinets at the end of each day. [This answer is incorrect. Adopting a policy of returning files to file cabinets at the end of each day will reduce the risk of losing files in a fire and the risk of losing or misplacing files as well.]

44. When selecting a successor to replace a retiring partner, which of the following statements is most accurate? **(Page 215)**

    a. Firms should expect the successor to produce the same amount of fees as the retiring partner. [This answer is incorrect. A retiring senior partner has developed extensive client relationships and is well-known in accounting and finance communities. It is unrealistic to expect a successor to begin producing the same level of fees.]

    b. Firms should limit their search for a successor to an individual within the firm. [This answer is incorrect. There may not be a qualified candidate within the firm so consideration should be given to bringing in an individual from outside.]

    c. Firms should expect the successor to assume all of the retiring /partner's administrative leadership roles. [This answer is incorrect. The firm should consider whether administrative roles are better transitioned to someone other than the successor partner.]

    d. Firms are having difficulty retaining and grooming qualified staff to become owners. [This answer is correct. The overall shortage of qualified accounting professionals has made identifying successor owners very difficult.]

45. The Hartman Clark accounting firm has implemented a leadership development program. What is the most important effect this will have on the firm? **(Page 217)**

    a. The firm will avoid management problems. [This answer is incorrect. Although having a leadership development program helps avoid management problems, this is not the most important effect.]

    b. The firm will attract and retain top performers. [This answer is correct. Not having an effective leadership development program can have significant negative implications on recruitment and retention. Having a development plan exhibits the firm's commitment to developing leaders from within.]

    c. The firm will avoid discrimination in its selection of potential leaders. [This answer is incorrect. Having a formal plan that offers individualized development of potential leaders does not eliminate the potential of perceived discrimination.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (WUSTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

34. Which of the following statements accurately describes the effective date of Statement of Quality Control Standard No. 7, *A Firm's System of Quality Control* (SQCS No. 7)?

    a. As of January 1, 2009, SQCS No. 7 is effective for a firm's system of quality control for its tax practice.

    b. As of January 1, 2009, SQCS No. 7 is effective for a firm's system of quality control for its accounting and auditing practice.

    c. As of January 1, 2009, SQCS No. 7 is effective for a firm's system of quality control for its consulting practice.

    d. Do not select this answer choice.

35. QC 10.14 requires that all firms consider the following quality control elements in establishing their QC systems, **except** for:

    a. Monitoring.

    b. Human Resources.

    c. Security access.

    d. Engagement performance.

36. Firms with employees who are members of the AICPA and engaged in the practice of public accounting must participate in an AICPA peer review. This independent review of the firm's quality control system must be conducted every _____ years.

    a. 2.

    b. 3.

    c. 4.

    d. 5.

37. Which of the following statements is the most accurate regarding Interpretation No. 7 of the Peer Review Standards?

    a. Management-use-only financial statements issued under SSARS No. 1 do not include a report and will require a firm to join a peer group.

    b. Compilations of management-use-only financial statements performed by firms already subject to peer review will not be included with the scope of engagements to be reviewed by peer reviewers.

    c. The reviewer will check the engagement letter for inclusion of the matters required by SSARS No. 1, if compilations of management-use-only financial statements are reviewed.

    d. If compilations of management-use-only financial statements are reviewed, the reviewer has no reason to review the financial statements.

38. Which of the following is true regarding liability claims against CPAs?

    a. A firm should cultivate a system to help avoid liability claims and diminish their impact.

    b. CPA firms that do not engage in tax work will not have to worry about litigation claims.

    c. The frequency of claims against CPAs has increased, but the severity has remained the same.

    d. If a firm uses an engagement letter, it should negate any possible litigation problems.

39. What are the two components of loss prevention?

    a. Security systems and ethics training.

    b. Restricted access and fireproof file cabinets.

    c. Risk avoidance and damage control.

    d. Liability insurance and regular compliance reviews.

40. Which statement most accurately describes SSARS and SAS rules regarding fraud and illegal acts?

    a. SSARS performance standards require accountants to document their assessment of fraud in a compilation engagement.

    b. SSARS performance requirements impose detection requirements for illegal acts.

    c. If the accountant becomes aware that information is incorrect in a compilation engagement, SSARS No. 1 compels the accountant to acquire additional information.

    d. SSARS performance standards do not apply to audits of financial statements.

41. Winston's client is worried that the bookkeeper has committed fraud. Winston's responsibility as the accountant is:

    a. To advise the client to seek legal counsel.

    b. To assure the client he will determine whether fraud has been committed.

    c. To ignore the situation because it is the client's responsibility.

    d. Do not select this answer choice.

42. Which of the following statements is the most accurate regarding performance of bookkeeping services?

    a. The work is usually complex.

    b. The accountant is responsible for detecting fraud.

    c. More lawsuits are being filed involving bookkeeping services.

    d. Bookkeeping engagements have minimal liability risk.

43. Maintaining duplicate copies of files at an off-site location is an example of:

    a. Succession planning.

    b. Strategic planning.

    c. Marketing planning.

    d. Disaster recovery planning.

44. Albert Klein, the senior partner and majority owner in the firm Klein and Korn, Inc., unexpectantly passed away over the weekend. Which of the following is true regarding the firm and its plans for the future?

    a. The firm should be able to continue on with everyone doing their job and will not have interruptions to the workflow.

    b. Klein and Korn, Inc. has been placed into proactive mode with their succession planning.

    c. The firm does not have to worry because there are so many qualified and committed up-and-coming CPAs in the marketplace today.

    d. Klein and Korn, Inc. has been thrust into crisis mode in regards to their succession planning.

45. Arch & Associates has decided to develop a succession plan for the firm. Factors to be considered include all **except** which one of the following?

    a. Develop and implement the plan.

    b. Cap retirement payments.

    c. Determine who the successors should be.

    d. Require a two-year notification of retirement.

GLOSSARY

Action Plans: Action plans serve several basic purposes, including the following: Individual responsibilities are assigned. Tasks can be prioritized and sequenced so that conflicts and delays will be minimized. Some tasks may surface that affect the related cost/benefit analysis. Monitoring the progress of the project is easier because of the due dates that are established.

Budgeting: Budgeting can be described as the strategic plan put into numbers.

Damage Control: Another aspect of loss prevention is damage control, which considers ways of containing potential liability problems and thereby minimizing their impact.

Disaster Recovery Plan: The plan should provide for items such as the following: Continuing to handle the firm's activities with as little interruption as possible. Communicating with clients, employees, vendors, and others if the firm must vacate its offices. Relocating the office if the firm's current space is damaged or destroyed. Replacing equipment, such as computers, fax machines, scanners, copiers, and the telephone system. Replacing furniture and office supplies. Reconstructing lost or damaged paper files and computer records. Shifting work assignments if key employees are unable to report to work. Obtaining financial assistance, if necessary, to pay the firm's obligations while business is interrupted. Response to the media.

Due Date Monitoring System: Although a due date monitoring system is generally used more for tax deadlines, it can also be used for accounting and other deadlines. The form of a due date monitoring system can vary from a very simple, manually prepared due date calendar to a much more complex computerized system.

Engagement Letter: A document to help prevent any type of misunderstanding with the client, the, the accountant should document in writing his or her understanding with the client regarding the following—Objectives of the engagement (i.e., the nonattest services), Services to be performed, Client's acceptance of its responsibilities, Accountant's responsibilities.

Executive Summary: A reporting package may include summarized financial information in the form of graphs or tables, key financial ratios, or an executive summary highlighting the information most important to the client.

Government Auditing Standards (GAS): When performing an audit in accordance with the GAO's Government Auditing Standards, (the Yellow Book), an auditor is required to adhere to the Yellow Book's independence standards.

Management-use-only Financial Statements: Factors such as the definition of management and third parties, the adequacy of management's knowledge, and the intended use of the financial statements will affect the accountants' ability to submit management-use-only financial statements without a report in specific client situations.

Marketing Plan: Generally, a marketing plan includes the following steps: Evaluate the firm's capabilities, Analyze the competition, Identify the target market, Develop a marketing strategy, Select specific marketing methods.

Mission Statement: The mission statement answers three very important questions that a firm must address early in the planning process. Those questions are as follows: What business are we in? What business do we want to be in? What do we want to achieve?

Objectives: When part of a SWOT Analysis, objectives represent the general or high-level goals for improving the firm.

Peer Review: The AICPA's peer review programs evaluate compliance with the QC standards. The AICPA Standards for Performing and Reporting on Peer Reviews recognize the needs of firms with different scopes of practice by providing for three types of peer reviews—a system review, an engagement review and a report review.

Risk Avoidance: Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts.

Strategic Planning: The development of a firms' goals.

Strategies: A strategic plan can be described as a road map of where a firm wants to go during the next three to five years. In developing such a plan, the firm defines its current status and where the firm plans to go in the future. The firm then develops strategies and a detailed action plan that will help it achieve its long-term goals.

Succession Planning: Determining what the owner wants to do with the firm when he or she retires is the first step in succession planning.

SWOT Analysis: Once the firm has developed its mission statement, the next planning step is to thoroughly analyze its current operating conditions. This process is commonly called a SWOT analysis. SWOT is an acronym for strengths, weaknesses, opportunities, and threats.

INDEX

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Write-Up Services—Course 1— Bookkeeping Services (WUSTG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   WUSTG091 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 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 $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Write-Up Services—Course 1—Bookkeeping Services (WUSTG091)

Price $79

First Name: ______________________________

Last Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________________

Firm Fax No.: ______________________________

Firm Email: ______________________________

Express Grading Requested: ☐ Add $24.95

Signature: ______________________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Write-Up Services—Course 1—Bookkeeping Services

Course Acronym: WUSTG091

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Write-Up Services—Course 2— Managing a Write-up Practice (WUSTG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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   Thomson Reuters
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   WUSTG092 Self-study CPE
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   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Write-Up Services—Course 2—
Managing a Write-up Practice (WUSTG092)

Price $79

First Name: ______________________________

Last Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________________

Firm Fax No.: ______________________________

Firm Email: ______________________________

Express Grading Requested: ☐ Add $24.95

Signature: ______________________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⦸ ⊗ ✓ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

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Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Write-Up Services—Course 2—Managing a Write-up Practice Course Acronym: WUSTG092

Your Name (optional): ____________ Date: ____________

Email: ____________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________