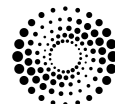


SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

**Compilation and Review
Engagements**



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Interactive Self-study CPE

Companion to PPC's Guide to Compilation and Review Engagements

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

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INTRODUCTION

Companion to PPC's Guide to Compilation and Review Engagements consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Compilation and Review Engagements* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 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 compilation and/or reviews. 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.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

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

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **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.

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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.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 1

INTERIM ENGAGEMENTS, OCBOAS, AND PRESCRIBED FORMS (CARTG091)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides a look at three different variables that can affect compilation and review engagements. Lesson 1 examines interim engagements, and how they differ from year-end engagements. Lesson 2 goes over the basics of financial statements that are presented using an other comprehensive basis of accounting (OCBOA), such as the cash basis or the tax basis. Finally, Lesson 3 discusses prescribed form engagements with an emphasis on SSARS No. 3.

PUBLICATION/REVISION DATE: July 2009

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

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 **September 30, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Interim Engagements

Completion of this lesson will enable you to:

- Describe basic considerations for documenting interim engagements.
- Summarize the general accounting rules for interim financial statements, as well as how revenue recognition, inventory and cost of goods sold, other costs and expenses, and income taxes should be dealt with.
- Prepare to address the following situations related to interim financial statements: extraordinary items, unusual or infrequently occurring items, disposal of an entity component, correcting prior period interim statements, accounting changes, disclosures in the statements of nonissuers, and reporting issues.

Lesson 2—Financial Statements Presented on an Other Comprehensive Basis of Accounting (OCBOA)

Completion of this lesson will enable you to:

- Summarize the basics of using an OCBOA, including background information, OCBOA and accounting standards, deciding when to use an OCBOA, definitions of the cash basis and the tax basis, and the use of different bases of accounting.
- Compare and contrast the statement titles used for cash and tax basis financial statements with those used for GAAP financial statements, and describe other elements of OCBOA statements, including the statement of cash flows, the statement of changes in stockholder's equity, the statement of retained earnings, and comprehensive income.
- Prepare to make presentation considerations, disclose of the basis of accounting, make other disclosures, and make cash to accrual conversions in OCBOA financial statements.

Lesson 3—Prescribed Forms

Completion of this lesson will enable you to:

- Identify the important provisions of SSARS No. 3 related to prescribed form engagements, and determine when SSARS No. 3 is applicable.
- Assess issues that may occur when SSARS No. 3 is applied in practice.

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
CARTG091 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: Interim Engagements

INTRODUCTION

PPC's quality control system is designed to be flexible and can be tailored on a firm-by-firm basis. This lesson discusses ways in which the PPC quality control system, including PPC brand forms and checklists, can be used when the firm has different requirements for interim and year-end compilation engagements. It is recommended that the same forms and checklists be completed for both year-end and interim review engagements.

This lesson also discusses unique GAAP measurement and disclosure principles and unusual reporting situations relating to interim financial statements. It is designed to provide answers to some of the less complex applications of GAAP and to help the practitioner recognize more complex GAAP problems as they relate to interim statements. Illustrated accountant's reports that are appropriate for compilations of interim statements for non-issuers also are included.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe basic considerations for documenting interim engagements.
- Summarize the general accounting rules for interim financial statements, as well as how revenue recognition, inventory and cost of goods sold, other costs and expenses, and income taxes should be dealt with.
- Prepare to address the following situations related to interim financial statements: extraordinary items, unusual or infrequently occurring items, disposal of an entity component, correcting prior period interim statements, accounting changes, disclosures in the statements of nonissuers, and reporting issues.

DOCUMENTING INTERIM ENGAGEMENTS

Are Interim Engagements Subject to Peer Review?

Yes. Compilations and reviews of interim financial statements are subject to peer review. In fact, many peer reviewers will make a point of selecting at least one interim compilation engagement with disclosures, one interim compilation engagement without disclosures, and one interim review engagement to get a cross section of a firm's accounting and auditing engagements. As a result, a firm's quality control policies and procedures should be designed to include its interim engagements. If a firm has different requirements for interim and year-end engagements, those differences should be reflected in its quality control policies and procedures so the staff knows what is expected on each engagement.

According to AICPA Interpretation No. 7 of the "Peer Review Standards," firms that submit compilations of management-use-only financial statements without issuing a compilation report are not required to join a peer review program. However, if the firm is already subject to peer review, the management-use-only compilations will be subject to selection by the peer reviewers. In addition, some state boards may have different requirements.

Since interim engagements are subject to peer review, some firms apply the same quality control policies and procedures to interim engagements as they do to year-end engagements. However, other firms elect less stringent documentation requirements for their interim engagements, particularly interim compilation engagements.

Exhibit 1-1 presents a summary of the course's recommended forms and checklists for use in interim engagements.

Exhibit 1-1**Interim Compilation Checklists and Workpapers**

Note: The terms *required*, *recommended*, *optional*, and *not applicable* indicate this course's preference—not necessarily the SSARS requirements. However, the checklists and practice aids identified as *required* are, according to this course, the minimum necessary to document compliance with the SSARS and peer review requirements.^a

Description	Third-party-use Financial Statement Engagements	Management-use-only Financial Statement Engagements ^b
Compilation Procedures, Review, and Approval Forms	REQUIRED	REQUIRED
Engagement Letters	Recommended	REQUIRED ANNUALLY
Client Information Form	Recommended annually	Recommended annually
Compilation Reporting Checklist	Recommended for the first interim compilation each year	Not Applicable
Financial Statement Disclosure Checklist—Summarized	Recommended when interim financial statements include disclosures	Optional
Long-form		
Adjusted Trial Balance	REQUIRED	REQUIRED ^c
Client's Financial Statements		
Accountant's Compilation Report		
Other Workpapers		

Notes:

- ^a Firms that compile management-use-only financial statements without issuing a report as the highest level of service provided by the firm are not required to join a peer review program. However, if the firm is already subject to peer review, the management-use-only compilations will be subject to selection by the peer reviewers.
- ^b This exhibit assumes the firm will issue an engagement letter in lieu of a report when management-use-only financial statements are compiled.
- ^c All of the items noted are required except the report, which is not applicable as indicated in note b.

* * *

Documenting Procedures in Interim Compilation Engagements

There are numerous ways that firms can choose to document the performance of compilation procedures in interim engagements. Several examples are discussed in this section.

Completing a Compilation Procedures, Review, and Approval Form. The "Compilation Procedures, Review, and Approval Forms" in *PPC's Guide to Compilation and Review Engagements* present the minimum steps that this course considers necessary to comply with SSARS and pass peer review. Each of those steps could apply to any compilation engagement—interim or year-end. Consequently, a firm may choose to complete one of the "Compilation Procedures, Review, and Approval Forms" for every compilation engagement.

Completing an Interim Summarized Form. If a firm has different policies for year-end and interim engagements, it will usually find that time can be saved by having a separate, shorter form for interim compilation engagements. That can be done for several reasons, including the following:

- a. Some of the procedures applicable to annual engagements are rarely applicable to interim engagements.
- b. Some procedures are done routinely.
- c. Some procedures are done annually and need only be updated at each interim period.
- d. For many clients, the financial statements and accountant's report change little, if any, from one interim period to the next.
- e. Most firms do recurring work for their clients in which interim compilation engagements are just one aspect of a continual service that is provided (e.g., year-end financial statements, interim financial statements, and tax planning and compliance work). Consequently, those firms are usually very familiar with the client's operations and aware of changes in the client's circumstances.

Other Alternatives. Other alternatives for documenting compilation procedures in interim engagements include (a) in a paper environment, mounting the first compilation procedures form for the year on a multicolumn workpaper and having the staff sign off at each interim period or in an electronic environment, such as with *PPC's Practice Aids™*, simply adding a column for each period, and (b) adding additional partner and in-charge sign-off blocks to the bottom of the first compilation procedures form for the year. Under any of the scenarios, changes in steps performed or results achieved can be referenced to a memo in the workpapers.

Another way in which a firm can document completion of compilation procedures in an interim engagement is to prepare a memo indicating that the most recent "Compilation Procedures, Review, and Approval Form" has been reviewed and noting any changes. Although that approach might appear to be more efficient, it also might be an open invitation to omit certain necessary steps. Consequently, this course does not recommend that memos be used in place of the checklists discussed previously.

Special Considerations for the First Interim Period. Certain presentation, reporting, and disclosure situations are often encountered in interim engagements that are encountered less often in year-end engagements. For example, interim statements often:

- a. Include supplementary information that may not be included in year-end statements.
- b. Omit substantially all disclosures and the statement of cash flows.
- c. Contain GAAP departures that may not be present in year-end financial statements (e.g., lack of an income tax accrual or failure to adjust inventories).

Firms may choose to require that the same forms and checklists be completed for both year-end engagements and the first interim engagement of each year. However, the unique aspects of interim engagements could be dealt with by having an engagement quality control review performed on a client's first interim compilation of the year for which a report will be issued.

Partner Review on Recurring Interim Engagements. Some CPAs question whether a partner review is required for compilation engagements, especially recurring interim compilation engagements. Although engagements must be adequately supervised, neither SSARS nor the quality control standards require a partner review for such engagements. (Note, however, that the quality control standards do require the firm to establish policies and procedures related to engagement performance which includes review.) As long as the person designated to review the compilation engagement possesses the necessary experience, knowledge, and skills to perform the review effectively, that person's title should not be an issue.

SELF-STUDY QUIZ

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

1. Based on this course's recommendations for documenting interim engagements, which of the following checklists and workpapers is *required* for an interim compilation engagement if the financial statements will be used by third parties?
 - a. The accountant's compilation report.
 - b. A summarized financial statement disclosure checklist.
 - c. An engagement letter.
 - d. A client information form.
2. In which of the following circumstances, could the firm save time by having accountants complete a shorter, summarized form for interim engagements?
 - a. Nearly all of the procedures Whitmore & Associates applies to its annual engagements are also applicable to its interim engagements.
 - b. The client that hires Alston, Brinkman, & Lucik to perform an interim engagement has many changes in its financial statements and the related accountant's report in each interim period.
 - c. Many of the procedures that Locke, Talbot, & Burns perform for their interim engagement clients are performed annually and must only be updated at each interim period.
 - d. The client that hires Weatherford-Stone, LLC, to perform an interim engagement does not engage the firm to provide any other services during the course of that year.

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. Based on this course's recommendations for documenting interim engagements, which of the following checklists and workpapers is *required* for an interim compilation engagement if the financial statements will be used by third parties? **(Page 4)**
 - a. **The accountant's compilation report. [This answer is correct. The checklists and workpapers that this course lists as *required* in an interim compilation engagement when the financial statements will be used by third parties include compilation procedures, review, and approval forms; an adjusted trial balance; the client's financial statements; the accountant's compilation report; and other workpapers. However, if the financial statements were management-use-only, the compilation report would not be required.]**
 - b. A summarized financial statement disclosure checklist. [This answer is incorrect. For this type of engagement, a summarized financial statement disclosure checklist is recommended if the interim financial statements include disclosures, but not required. This would be optional if the financial statements were management-use-only.]
 - c. An engagement letter. [This answer is incorrect. Engagement letters are recommended for this type of engagement, but not required. They are required for engagements when the financial statements are for management's use only.]
 - d. A client information form. [This answer is incorrect. It is recommended that a client information form be included annually for this type of engagement, but it is not required. The same recommendation would be made if the financial statements were for management's use only.]
2. In which of the following circumstances, could the firm save time by having accountants complete a shorter, summarized form for interim engagements? **(Page 5)**
 - a. Nearly all of the procedures Whitmore & Associates applies to its annual engagements are also applicable to its interim engagements. [This answer is incorrect. The shorter form would be appropriate if some of the procedures applicable to the firm's annual engagements are rarely applicable to its interim engagements.]
 - b. The client that hires Alston, Brinkman, & Lucik to perform an interim engagement has many changes in its financial statements and the related accountant's report in each interim period. [This answer is incorrect. The shorter form would be appropriate if the financial statements and the accountant's report change little, if any, from one interim period to the next.]
 - c. **Many of the procedures that Locke, Talbot, & Burns perform for their interim engagement clients are performed annually and must only be updated at each interim period. [This answer is correct. Under these circumstances, the firm could save time by having a separate, shorter form for interim compilation engagements. Another instance in which use of such a form would be applicable would be if some of the firm's procedures were done routinely.]**
 - d. The client that hires Weatherford-Stone, LLC, to perform an interim engagement does not engage the firm to provide any other services during the course of that year. [This answer is incorrect. The shorter form would be appropriate if the firm was hired to do recurring work for the client in which interim compilation engagements are just one aspect of the continual service that is provided (e.g., year-end financial statements, interim financial statements, and tax planning and compliance work). In this type of situation, the firm would usually be very familiar with the client's operations and aware of changes in the client's circumstances. This is not true in the scenario described in this answer choice.]

GENERAL ACCOUNTING RULES THAT APPLY TO INTERIM FINANCIAL STATEMENTS

APB Opinion No. 28, *Interim Financial Reporting* (FASB ASC 270-10; 740-270), SFAS No. 16, *Prior Period Adjustments* (FASB ASC 250-10; 270-10; 450-20), FASB Interpretation No. 18, "Accounting for Income Taxes in Interim Periods" (FASB 740-270), paragraph 15 of SFAS No. 154, *Accounting Changes and Error Corrections* (FASB ASC 250-10-45-14), and International Accounting Standard 34, *Interim Financial Reporting*, are the existing applicable accounting guidance for interim financial statements. This lesson is not a substitute for a thorough understanding of these pronouncements, and the practitioner should consult these technical references.

In accordance with SSARS No. 18 [AR 100.01(b)], SSARS are not applicable to reviews of interim financial information if all of the following conditions are met:

- a. The entity's latest annual financial statements have been audited.
- b. The accountant has been engaged to audit the entity's current year financial statements, or they audited the prior year financial statements and expect to be engaged to audit the current year financial statements.
- c. The client prepares its interim statements using the same financial reporting framework as that used to prepare its year-end statements.

In these instances, the accountant should perform the interim reviews in accordance with SAS No. 116 (AU 722), *Interim Financial Information*.

SSARS No. 18 implies that an accountant is permitted to prepare interim financial statements using a different financial reporting framework than that used to prepare its year-end statements when performing the interim review in accordance with the SSARS. For example, an accountant performing a SSARS review for a client may use an other comprehensive basis of accounting (OCBOA) for preparing its interim financial statements and generally accepted accounting principles (GAAP) for preparing its annual statements. This is not allowed for accountants preparing interim financial statements in accordance with SAS No. 116.

When the same basis of accounting is used to prepare both interim and year-end statements, however, each interim period should be viewed as an integral part of an annual period. The results of each interim period should be based on the accounting principles and practices used by the company in preparing its latest annual financial statements, unless a change in an accounting practice or policy has been adopted in the current year.

In certain situations, various accounting principles and practices followed for annual reporting purposes might require modification at interim dates so that the reported results for the interim period better relate to the annual results of operations. The following paragraphs discuss some of the "dos and don'ts" as they relate to the preparation of interim financial statements.

CONSIDERATIONS RELATED TO REVENUE RECOGNITION

Revenue from products sold or services rendered should be recognized as earned on the same basis as followed for the full year. Generally, this means that revenue should be recognized at an interim period only after goods are delivered (title passes) or when a service is rendered and completed.

Occasionally, application of the general revenue recognition policy used at year end distorts interim revenue. The word *distorts* is used here to mean that if the revenue figure on the interim statement was annualized, it would not bear a reasonable relation to the actual annual sales. For instance, a job-order manufacturing company that customarily derives its revenue from a small number of large jobs that take several months to complete might find that shipments, and thus revenue, would vary significantly from month to month. Nevertheless, APB Opinion No. 28 (FASB ASC 270) requires that interim period revenue be recognized on the same basis as followed for the full year. Supplementary information detailing sales backlog and jobs in progress might be useful disclosures in the situation described above.

A company whose business is highly seasonal has similar problems with distorted interim revenue. Again, APB Opinion No. 28 (FASB ASC 270) offers no relief to the accounting method used. It does, however, require disclosure of the seasonal nature of the company's business.

If interim financial statements are based on a revenue recognition policy other than that used in year-end statements, the accountant's report should disclose the departure from GAAP.

CONSIDERATIONS RELATED TO INVENTORY AND COST OF GOODS SOLD

Some of the more prevalent difficulties encountered in preparing interim financial statements are concerned with inventory valuation and the related effect on cost of goods sold. Frequently, it is not feasible to obtain inventory values by physical count at interim balance sheet dates. Likewise, operations for a period shorter than a year can produce illogical results if normal year-end procedures are followed in application of inventory methods such as LIFO, standard costs, and lower of cost or market. The following paragraphs discuss these inventory-related problem areas and offer guidance.

Gross Profit Method

The gross profit method is the most common method of estimating inventories at interim dates when physical inventories are not taken. The use of this method to determine inventory and cost of goods sold, although not acceptable in annual statements, is an acceptable method for use in interim financial statements (APB Opinion No. 28) (FASB ASC 270). However, the use of estimated gross profit rates should be disclosed in the financial statements. For example:

NOTE A—INVENTORY AND COST OF GOODS SOLD

The Company measures inventory and cost of goods sold for interim financial statements by use of a historically developed gross profit percentage. Annually, the Company adjusts the inventory to reflect the results of a physical count.

Because the method is authorized by APB Opinion No. 28 (FASB ASC 270) for interim financial statements, it is not a departure from GAAP; thus, the accountant's report need not be modified.

Market Declines

The practitioner should be alert to situations where the market value of inventory at the interim balance sheet date is below cost. Even when the gross profit method is used, it may be obvious to the practitioner that market is below cost. *Temporary* declines in the market value of inventory to values below cost need not be recognized in interim financial statements if the market decline can reasonably be expected to be restored *by the end of the fiscal year*. If, however, the company cannot reasonably expect a decline at an interim date to reverse itself by year end, the inventory should be adjusted to market value at the interim date. A subsequent recovery in value before year end should be recognized in the interim period during which the recovery takes place. However, the inventory, once adjusted downward to market, should not be written up above original cost.

LIFO Inventory Approximations

For companies that have adopted the LIFO inventory method, two general approaches are used to value inventory at interim dates. One approach is to compute interim LIFO inventory values based on the actual quantities and inventory costs at the interim date. In other words, the same LIFO valuation technique used at year end is applied at the interim date. Such an exacting calculation can be very time-consuming, especially if a physical inventory must be taken. Accordingly, a precise interim calculation of LIFO values is normally not made in practice. The alternative is to use an estimation technique to arrive at interim LIFO values. Estimation techniques used in practice range from sophisticated calculations that consider management's estimates of changes in product mix, prices, and inventory levels to simple calculations based on historical LIFO gross profit percentages. (The latter approach parallels the use of gross profit percentages discussed previously.) When an estimation technique has been used, this fact should be disclosed along with a description of the technique. For example:

NOTE A—INVENTORIES

Inventories are valued at the lower of cost or market. Cost is determined by the last-in, first-out (LIFO) method. Natural business pool indexes for determining adjustments to LIFO are computed annually based on a double-extended physical inventory. At interim balance sheet dates, the published consumer price indexes are used to estimate LIFO adjustments.

For some companies, use of a consumer price index to determine LIFO values may be GAAP. In this illustration, the indexes are used to estimate values determined by other methods consistently followed in the annual financial statements.

Some companies only compute LIFO inventory values annually and value interim inventories on a FIFO basis. The accountant should consider the following in such circumstances:

- a. If the difference between LIFO and FIFO values as of the interim date is known to be immaterial, the accountant may find it acceptable to identify the inventories as LIFO.
- b. If the difference is material and the statements are issued with inventories on a FIFO basis, the statements are not in accordance with GAAP (because they do not use the same method as used in the year-end statements), and the accountant's report should note the departure. The accountant should also be concerned about violating various IRS regulations regarding LIFO, particularly Reg. 1.472-2(e)(6), which holds that, in certain cases, a series of interim statements presenting results of operations on a non-LIFO basis constitutes presentation of annual results on a non-LIFO basis.

LIFO Inventory Liquidations

When companies encounter a liquidation of a LIFO layer in an interim period, a determination must be made as to whether the liquidation is temporary or permanent. If the liquidation is permanent, the interim period financial statements should disclose the effect on net income resulting from the liquidation.

If the liquidation is temporary, the inventory at the interim reporting date should not give effect to the LIFO liquidation, and consequently, the pretax income effect of the liquidation should be recorded as a current liability in an account captioned "Unearned income from temporary LIFO liquidations." The temporary nature of the liquidation should be disclosed in the financial statements.

Standard Cost System

The same procedures used for annual statements should, generally, be followed in application of standard cost systems for interim statement purposes. Planned variations expected to be absorbed by the end of the fiscal year should ordinarily be deferred in interim financial statements. Unanticipated variances that are not expected to be absorbed should, however, be reported in interim financial statements.

CONSIDERATIONS RELATED TO OTHER COSTS AND EXPENSES

APB Opinion No. 28 (FASB ASC 270) lists four general principles that should be observed when determining charges for other costs and expenses in the interim financial statements:

- a. Costs and expenses other than product costs should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the basis followed by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods.
- b. Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits or other interim periods and should be charged to the interim period in which incurred.

Disclosure should be made as to the nature and amount of such costs, unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

- c. Arbitrary assignment of the amount of such costs to an interim period should not be made.
- d. Gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year.

A complete listing of examples of application of these standards is not practical; however, the following examples from APB Opinion No. 28 (FASB ASC 270) may be helpful:

- a. When a cost that is expensed for annual reporting purposes clearly benefits two or more interim periods, e.g., annual major repairs, each interim period should be charged for an appropriate portion of the annual cost by the use of accruals or deferrals.
- b. When quantity discounts are allowed customers based upon annual sales volume, the amount of such discounts charged to each interim period should be based on the sales to customers during the interim period in relation to estimated annual sales.
- c. Property taxes (and similar costs such as interest and rent) may be accrued or deferred at the annual reporting date to achieve a full year's charge of taxes to costs and expenses. Similar procedures should be adopted at each interim reporting date to provide an appropriate cost in each period.
- d. Advertising costs may be deferred within a fiscal year if the benefits of an expenditure clearly extend beyond the interim period in which it is made. Advertising costs may be accrued and assigned to interim periods in relation to sales prior to the time the service is received if the advertising program is clearly implicit in the sales arrangements. Further discussion regarding advertising costs is found in SOP 93-7, *Reporting on Advertising Costs* (FASB ASC 720-35).

The amounts of certain costs and expenses are frequently subjected to year-end adjustments even though they can be reasonably approximated at interim dates. Such adjustments should be estimated and the estimated costs and expenses assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include inventory shrinkage, allowance for bad debts, allowance for quantity discounts, discretionary year-end bonuses, profit-sharing contributions, and depreciation.

CONSIDERATIONS RELATED TO INCOME TAXES

SFAS No. 109, *Accounting for Income Taxes* (FASB ASC 740), emphasizes the balance sheet by focusing on what the current and deferred liabilities and assets should be at the balance sheet date. Under this method, referred to as the *liability method*, the income tax provisions are the residuals of the changes in the balance sheet accounts from period to period. In addition, tax benefits of net losses are recognized currently if they more likely than not will be recognized. Consequently, in some cases, companies may record deferred tax assets even though book and tax income are the same.

When deliberating SFAS No. 109 (FASB ASC 740), the FASB chose not to reopen the subject of interim reporting of income taxes and, as a result, interim financial statements are still governed by APB Opinion No. 28 (FASB ASC 270), *Interim Financial Reporting*, and FASB Interpretation No. 18, "Accounting for Income Taxes in Interim Periods" (FASB ASC 740-270). However, SFAS No. 109 (FASB ASC 740) did amend APB Opinion No. 28 (FASB ASC 270) and FASB Interpretation No. 18 (FASB ASC 740-10 and 740-20) in the following limited areas:

- a. Recognizing the tax benefit of losses in interim periods based on the assurance of income in future annual periods.
- b. Classifying the realization of previously unrecognized loss carryforwards as extraordinary items.
- c. Reporting the effect of changes in tax rates or new legislation.

FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes" (FASB ASC 740-10), was issued in June 2006. FSP No. FIN 48-2 deferred the effective date of FIN No. 48 (FASB ASC 740-10) for all nonpublic entities to fiscal years beginning after December 15, 2007, and FSP No. FIN 48-3 further extended the effective date for all nonpublic entities to fiscal years beginning after December 15, 2008. The original effective date was deferred twice to allow the FASB time to develop guidance regarding the application of FIN No. 48 (FASB ASC 740-10) to pass-through entities and not-for-profit organizations.

In May 2009, the FASB released proposed FSP No. FIN 48-d, "Application Guidance for Pass-through Entities and Tax-Exempt Not-for-Profit Entities and Disclosure Modifications for Nonpublic Entities," which would amend FIN No. 48 (FASB ASC 740-10) to provide guidance for pass-through entities and not-for-profit organizations and eliminate certain disclosure requirements for all nonpublic entities.

The significant amendments resulting from the proposed guidance are as follows:

- All entities are subject to FIN No. 48 (FASB ASC 740-10) even if the only tax position in question is the entity's status as a pass-through entity or tax-exempt not-for-profit organization, and even if it is more likely than not that the entity's status would be sustained upon examination.
- The determination of whether income taxes are attributable to the entity or its owners must be based on the laws and regulations of the taxing authority, rather than who actually pays the taxes as agreed to between the entity and its owners.
- Consolidated or combined financial statements must include all tax positions for each entity within the group that is subject to income taxes or that has taxable income assigned to it from a pass-through entity.
- Nonpublic entities will not be required to present a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, or to disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective income tax rate.

At its July 8, 2009, meeting, the FASB decided that this guidance would be effective for periods ending after September 15, 2009.

Normally, GAAP for income taxes in annual financial statements applies to interim statements as well. However, the basic principle that interim statements should be viewed as an integral part of an annual period necessitates some special techniques in accounting for income taxes in interim financial statements. These techniques are discussed in the following paragraphs.

Overview of Accounting Requirements

The basic premise underlying APB Opinion No. 28 (FASB ASC 270) is that interim periods are an integral part of an annual period, and annual results should be allocated to interim periods. (Certain revenues and expenses, however, that are directly related to a specific interim period, including items such as significant unusual or infrequently occurring items, extraordinary items, and discontinued operations, should be reported in the interim period in which they occur and, accordingly, should not be prorated over the balance of the fiscal year. Note that the FASB is considering changing the definition of *discontinued operations*.) Under that view, interim income tax provisions related to "ordinary income or loss" are determined using an estimated annual effective tax rate (or tax benefit rate) that is based on estimated annual results. The interim tax effect of "ordinary income or loss" is determined as follows:

- a. Estimate "ordinary income or loss" for the year and calculate the related income tax provision.
- b. Determine the estimated annual effective tax rate (or tax benefit rate) by dividing the income tax provision for the year by estimated "ordinary income or loss" for the year.
- c. Determine the year-to-date tax provision or benefit by multiplying year-to-date "ordinary income or loss" by the estimated annual effective tax rate. (Certain limitations that must be considered in calculating the tax benefit of losses are discussed later in this lesson.)

- d. Subtract the tax provision related to "ordinary income or loss" through the preceding interim period from the provision calculated in step c. to determine the tax effect to report in the current interim period.

"Ordinary income or loss," in this sense, is not used in its income tax context. Rather, FASB Interpretation No. 18 (FASB ASC 740-270-20) defines *ordinary income (or loss)* as "income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items." Thus, unusual or infrequently occurring items, extraordinary items, discontinued operations, and cumulative effects of accounting changes are excluded from that term.

When there is an extraordinary gain or loss or other incremental items, Paragraph 19 of APB Opinion No. 28 (FASB ASC 740-270-30-6; 740-270-30-8; 740-270-35-3) required that the annual effective rate applied to ordinary income be estimated without considering the effect of those items. Although the requirements for annual calculations were revised by SFAS No. 109 (FASB ASC 740) to consider ordinary and incremental items together, the wording of Paragraph 19 of APB Opinion No. 28 (FASB ASC 740-270-30-6; 740-270-30-8; 740-270-35-3) was not modified. It is believed that this was not intentional and that the goal of the interim tax provision calculation is to reflect estimated annual results. That is consistent with the general approach of APB Opinion No. 28 (FASB ASC 740).

Interim Income Taxes When *Ordinary Income* Is Estimated for the Year

Although the basic premise that the annual provision for income taxes should be allocated to interim periods has not been changed, it is believed that both the current and deferred components of the annual provision related to *ordinary income* should now be determined to be consistent with the liability method. The following procedures for determining the estimated annual effective tax rate related to *ordinary income* are recommended:

- a. Estimate the current provision for the year by applying enacted tax rates to estimated taxable *ordinary income* for the year. (That amount should consider the alternative minimum tax system.)
- b. Estimate the deferred tax provision for the year by calculating the deferred tax effect of estimated temporary differences, tax loss carryforwards, and tax credit carryforwards at the end of the year and subtracting it from the balance at the beginning of the year.
- c. Determine the total estimated tax provision for the year by adding the results of steps a. and b.
- d. Divide the results obtained in step c. by the estimated *ordinary income* for the year to determine the estimated annual tax rate for the year.

To illustrate the calculation, assume the following facts:

- a. Year-to-date *ordinary income* at the end of the current interim period of \$80,000.
- b. Year-to-date income tax provision through the end of the preceding interim period of \$5,000.
- c. Taxable temporary differences at the beginning of the year of \$100,000; estimated taxable temporary differences at the end of the year of \$150,000.
- d. Tax rates are 15% on the first \$50,000 and 25% on the excess.
- e. Average graduated tax rate expected to be in effect when temporary differences reverse of 15%.
- f. Estimated annual *ordinary income* of \$130,000, including permanent differences related to tax-exempt income of \$27,600.

The first step in calculating an interim tax provision is to estimate the current income tax provision for the year by applying enacted tax rates to estimated taxable *ordinary income* for the year. Estimated taxable *ordinary income* is determined by estimating *ordinary income* for the year and adjusting for permanent and temporary differences:

Estimated <i>ordinary income</i> for the year	\$ 130,000
Estimated permanent differences for the year	(27,600)
Estimated temporary differences for the year (estimated taxable differences of \$150,000 at the end of the year less differences of \$100,000 at the beginning of the year)	<u>(50,000)</u>
Estimated taxable <i>ordinary income</i> for the year	<u>\$ 52,400</u>
Estimated current income tax provision (\$52,400 × regular tax rates)	\$ 8,100

The deferred income tax provision for the year would be estimated as follows:

Estimated deferred tax liability at the end of the year (estimated taxable temporary differences of \$150,000 × 15%)	\$ 22,500
Deferred tax liability at the beginning of the year (taxable temporary differences of \$100,000 × 15%)	<u>15,000</u>
Estimated deferred tax provision for the year	<u>\$ 7,500</u>

The estimated annual tax rate is 12%, which is determined by dividing the estimated annual income tax provision of \$15,600 (current provision of \$8,100 plus deferred provision of \$7,500) by estimated annual *ordinary income* of \$130,000. The interim tax provision would be determined as follows:

Year-to-date <i>ordinary income</i>	\$ 80,000
Estimated annual tax rate	<u>12 %</u>
Year-to-date income tax provision through the end of the current interim period	\$ 9,600
Year-to-date income tax provision through the end of the preceding interim period	<u>5,000</u>
Income tax provision for the current interim period	<u>\$ 4,600</u>

Interim Income Taxes When *Ordinary Income* Is Estimated for the Year But There Is an Interim Loss

If a company has a year-to-date *ordinary loss*, the tax benefit that may be recognized in the interim period is limited to the amount that more likely than not will be realized. If *ordinary income* is estimated for the year, realization of the tax benefits of the interim loss can be considered more likely than not. Thus, the annual effective tax rate should be applied to the total year-to-date *ordinary loss* to determine the interim year-to-date tax benefit.

Interim Income Taxes When an *Ordinary Loss* Is Estimated for the Year

Calculating interim income taxes when an *ordinary loss* is expected for the year varies depending on the year-to-date results.

- If there is year-to-date *ordinary income*, year-to-date taxes are calculated by multiplying the year-to-date *ordinary income* by the estimated annual tax benefit rate.
- If there is year-to-date *ordinary loss* that is less than the estimated *ordinary loss* for the year, a deferred tax asset should be recognized at the interim date if the tax benefits of the loss are expected to be recognizable as a deferred tax asset at the end of the year. That limitation is accomplished by reflecting the tax effect of the expected year-end valuation allowance in the effective tax rate.
- If there is year-to-date *ordinary loss* that exceeds the estimated *ordinary loss* for the year, the year-to-date tax benefit is the lesser of (1) the amount calculated by applying the estimated annual tax benefit rate to

the year-to-date *ordinary loss* or (2) the tax benefit obtained by applying the estimated annual tax benefit rate to *ordinary income* for the remainder of the year that is more likely than not plus the tax benefit of the excess loss that can be carried back to taxable income of prior years and the tax benefit of any remaining excess loss that is recognizable as a deferred tax asset at the end of the year. That limitation is accomplished by substituting the year-to-date *ordinary loss* for the estimated annual *ordinary loss*.

To illustrate, assume the following facts:

- The company is in its second year of operations.
- Estimated annual *ordinary loss* is \$50,000.
- Year-to-date *ordinary loss* is \$70,000.
- Tax rates are 15% on the first \$50,000 and 25% on the excess.
- The average graduated tax rate expected to apply to reversals of temporary differences is 17%.

The year-to-date tax benefit would be calculated as follows:

YEAR-TO-DATE TAX BENEFIT USING ESTIMATED ANNUAL TAX BENEFIT RATE

	<u>Prior Taxable Income</u>	<u>Current Year</u>	<u>Future Taxable Income</u>
ANNUAL INCOME CALCULATION USING ESTIMATED ANNUAL <i>ORDINARY LOSS</i>			
Annual "ordinary income (loss)"		\$ (50,000)	\$ 5,000
Taxable reversals		20,000	60,000
Taxable "ordinary income (loss)"	\$ 45,000	(30,000)	65,000
Carryback of taxable <i>ordinary loss</i>	<u>(30,000)</u>	<u>30,000</u>	<u>—</u>
	<u>\$ 15,000</u>	<u>\$ -0-</u>	<u>\$ 65,000</u>

CALCULATION OF TAX BENEFIT OF ESTIMATED ANNUAL *ORDINARY LOSS*

Current benefit from carrying back the estimated annual taxable <i>ordinary loss</i> of \$30,000	\$ (4,500)
Deferred tax benefit	
Ending deferred tax liability (\$60,000 × 17%)	10,200
Beginning deferred tax liability (\$80,000 × 17%)	<u>13,600</u>
	<u>(3,400)</u>
Estimated annual tax benefit	<u>\$ (7,900)</u>

CALCULATION OF ESTIMATED ANNUAL TAX BENEFIT RATE

Estimated annual tax benefit of \$7,900 ÷ estimated annual <i>ordinary loss</i> of \$50,000	<u>16 %</u>
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TAX BENEFIT FROM APPLYING THE ANNUAL TAX BENEFIT RATE TO THE YEAR-TO-DATE *ORDINARY LOSS*

Preliminary year-to-date tax benefit (\$70,000 × 16%)	<u>\$ 11,200</u>
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YEAR-TO-DATE TAX BENEFIT CONSIDERING LOSS RECOGNITION LIMITATIONS

	<u>Prior Taxable Income</u>	<u>Current Year</u>	<u>Future Taxable Income</u>
ANNUAL INCOME CALCULATION SUBSTITUTING YTD "ORDINARY LOSS" FOR ESTIMATED ANNUAL ORDINARY LOSS			
YTD "ordinary income (loss)"		\$ (70,000)	\$ 5,000
Taxable reversals		20,000	60,000
Taxable "ordinary income (loss)"	\$ 45,000	(50,000)	65,000
Carryback of taxable <i>ordinary loss</i>	(45,000)	45,000	—
Offset of taxable <i>ordinary loss</i> against future taxable income	—	5,000	(5,000)
	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 60,000</u>
CALCULATION OF YTD TAX BENEFIT LIMITATION			
Current benefit from carrying back \$45,000 of the year-to-date taxable <i>ordinary loss</i>		\$ (6,750)	
Deferred tax benefit			
Ending net deferred tax liability $[(\$60,000 \times 17\%)$ $-(\$5,000 \times 17\%)$		9,350	
Beginning deferred tax liability $(\$80,000 \times 17\%)$		13,600	
		<u>(4,250)</u>	
YTD tax benefit limitation		<u>\$ (11,000)</u>	

Since the second calculation—the year-to-date tax benefit considering loss recognition limitations—yields the lower amount, the financial statements would report a year-to-date tax benefit of \$11,000.

Prior-year Operating Loss Carryforwards

Loss carryforwards are treated consistently in interim and annual financial statements. The tax benefits of loss carryforwards generally are recognized in the year that the loss occurs. Tax benefits would not be recognized in the prior year for a loss that was incurred that year. However, if the related deferred tax asset were offset by a valuation allowance "if realization of an operating loss carryforward that is attributable to losses in prior years is included in the computation of the estimated annual effective tax rate the same as, for example, tax credit carryforwards." (If, on the other hand, income is expected from extraordinary items or, in unusual cases, from discontinued operations, the tax benefit of prior-year loss carryforwards should be allocated to those items in the interim period in which they occur.)

GAAP does not include any specific guidelines for recognizing the effect of prior-year loss carryforwards in determining the annual effective tax rate. The following steps are recommended:

- Add year-to-date *ordinary income* and estimated *ordinary income* for the remainder of the year that is more likely than not to determine the maximum prior-year tax loss carryforward that can be offset against estimated *ordinary income* for the year.
- Apportion the maximum amount from the preceding step between taxable income and temporary differences based on estimated annual results.
- If the carryforward is less than the maximum calculated in the preceding step, apportion it between taxable income and temporary differences based on the allocation in the preceding step.

Note that the preceding discussion deals with previously unrecognized tax benefits, which would only arise if prior-year carryforwards were not recognized as a deferred tax asset. If the net operating loss carryforward in step

a. exceeds estimated *ordinary* income for the year, the calculation is the same except that the need for a valuation allowance must be evaluated for the loss carryforward at the end of the year.

Accounting for Changes in Tax Rates or New Tax Legislation

Deferred tax assets and liabilities in both annual and interim financial statements are required to be adjusted for the effects of changes in tax laws or rates in the period that includes the enactment date, that is, for federal tax purposes, the period in which the President signs the legislation and it becomes law. For interim reporting, it is not acceptable to allocate the effects of the changes to subsequent interim periods by adjusting the annual effective tax rate for the remainder of the year. Thus, in any interim period that includes a change, the tax provision will have two components: (a) the adjustment of the deferred tax asset or liability for the enacted changes and (b) the remainder. However, unlike annual financial statements, interim financial statements are not required to disclose the components.

The estimated deferred tax provision for the year should be based on the newly enacted laws. The difference between the year-to-date tax provision and the provision reported through the end of the preceding interim period should be reported as the provision for the current interim period. It is believed unnecessary to recompute the deferred tax asset or liability as of the end of the prior interim period or to calculate the adjustment of the deferred tax asset or liability because of the enacted changes at the interim reporting date.

Disclosure Considerations

The only required disclosure related to interim income tax provisions is the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the company's business. The financial statements need not disclose the current and deferred components of the interim provision.

Classifying Deferred Tax Balance Sheet Accounts

GAAP does not discuss how to allocate or classify an interim income tax provision to components of current and noncurrent taxes payable. Since the objective of APB Opinion No. 28 (FASB ASC 270; 740-270) is to allocate annual results to interim periods, it is believed that the interim income tax provision should be apportioned between current and noncurrent income tax assets and liabilities based on estimated annual results.

Following the recommendations of this course for calculating the interim tax provision will provide estimates of the total tax provision for the year and its current and deferred components. Generally, those two amounts will be added together in determining the estimated annual effective tax rate and may be used to allocate the year-to-date interim income tax provision to the appropriate income tax balance sheet accounts as follows:

- a. Divide the estimated total current provision for the year by the estimated total provision for the year, and multiply the result by the year-to-date total tax provision to determine the total year-to-date current provision. The resulting amount is the adjustment to refundable or accrued income taxes, and the balance ordinarily is classified as current.
- b. Subtract the result of step a. from the total year-to-date tax provision to determine the total year-to-date deferred tax provision.
- c. Determine the current and noncurrent portions of the estimated deferred tax asset or liability at the end of the year, and calculate the estimated change in the current and noncurrent balances from the beginning of the year to the end of the year.
- d. Divide the change in the current deferred tax asset or liability by the total estimated deferred tax provision for the year, and multiply the result by the total year-to-date deferred tax provision from step b. to determine the adjustment to the current deferred tax asset or liability.
- e. Subtract the result of step d. from the total year-to-date deferred tax provision in step b. to determine the adjustment to the noncurrent deferred tax asset or liability.

To illustrate, assume that the total year-to-date tax provision is \$50,000, and the annual income tax provision is estimated as follows:

Estimated total current provision for the year		\$ 60,000	60 %
Estimated total deferred provision for the year			
Ending liability	\$ 90,000		
Beginning liability	50,000	<u>40,000</u>	<u>40 %</u>
Total provision		<u>\$ 100,000</u>	<u>100 %</u>

The current and deferred components of the total year-to-date provision based on the calculation of the total estimated provision for the year would be determined as follows:

Total year-to-date provision	\$ 50,000
Current portion ($\$50,000 \times 60\%$)	<u>30,000</u>
Deferred portion	<u>\$ 20,000</u>

The next step would be to determine the change in the deferred tax asset and liability accounts. The change would be calculated as follows (using assumed balances):

	<u>Beginning</u>	<u>Estimated Ending</u>	<u>Change</u>	
Deferred tax accounts:				
Current asset	\$ (10,000)	\$ —	\$ 10,000	
Current liability	—	20,000	<u>20,000</u>	
			30,000	75 %
Noncurrent liability	<u>60,000</u>	<u>70,000</u>	<u>10,000</u>	<u>25 %</u>
	<u>\$ 50,000</u>	<u>\$ 90,000</u>	<u>\$ 40,000</u>	<u>100 %</u>

The current and noncurrent deferred tax liabilities based on the estimated changes during the year would be determined as follows:

Total year-to-date deferred tax provision	\$ 20,000
Change in the current deferred tax liability ($\$20,000 \times 75\%$)	<u>15,000</u>
Change in the noncurrent deferred tax liability	<u>\$ 5,000</u>

Since there was an opening current deferred tax asset and the balance classified as current at the end of the year is expected to be a liability, it is believed that the year-to-date deferred provision should first be applied against the asset until it is eliminated. Any remainder would be credited to a deferred tax liability account. In the preceding illustration, the \$10,000 opening balance of the current deferred tax asset would be eliminated, and a current deferred tax liability of \$5,000 would be recorded for the difference.

SELF-STUDY QUIZ

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

3. What does SSARS No. 18 allow for interim reviews that SAS No. 116 does not allow?
 - a. The accountant is allowed to prepare interim financial statements for a client using GAAP when the annual statements are prepared using GAAP.
 - b. The accountant is allowed to prepare interim financial statements using OCBOA while using GAAP for preparing annual statements.
4. What method is most commonly used to estimate inventories at interim dates if physical inventories are not taken?
 - a. The last-in, first-out (LIFO) method.
 - b. The first-in, first-out (FIFO) method.
 - c. The gross profit method.
 - d. A standard cost system.
5. Which of the following is one of the four general principles found in APB Opinion No. 28 for determining charges for other costs and expenses in interim financial statements?
 - a. All costs and expenses must be charged to income in interim periods as they are incurred.
 - b. Costs and expenses incurred in an interim period must be identified with activities, benefits, or other interim periods.
 - c. Costs can be arbitrarily assigned to an interim period.
 - d. Gains and losses arising in an interim period similar to those that would not be deferred at year end, should not be deferred to later interim periods.
6. What is the basic underlying premise of APB Opinion No. 28?
 - a. It emphasizes the balance sheet with a focus on what current and deferred liabilities and assets should be on the balance sheet date.
 - b. Interim periods are an integral part of an annual period; therefore, annual results should be allocated to the interim periods.
 - c. Interim income tax provisions that are related to "ordinary income or loss" should be determined using an estimated annual effective tax rate based on annual results.
7. When calculating the estimated annual effective tax rate for the year related to ordinary income, how is the current provision for the year estimated?
 - a. Enacted tax rates are applied to the year's estimated taxable ordinary income.
 - b. The deferred tax effect of estimated temporary differences is calculated.
 - c. The total estimated tax provision is divided by estimated ordinary income.

8. Which of the following statements best describes how loss carryforwards are treated in interim financial statements?
- a. Loss carryforwards are treated differently in annual financial statements than they are in interim financial statements.
 - b. The tax benefits of loss carryforwards would generally be recognized in the year that the loss occurred.
 - c. If the related deferred tax asset was offset by a valuation allowance, tax benefits are recognized in the prior year if the loss was incurred that year.
 - d. Specific guidelines for recognizing the effect of prior-year loss carryforwards on the annual effective tax rate are included in GAAP.
9. If tax law or tax rates are changed, should interim financial statements be adjusted for the effects of the change?
- a. Yes.
 - b. No.

SELF-STUDY ANSWERS

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

3. What does SSARS No. 18 allow for interim reviews that SAS No. 116 does not allow? **(Page 9)**
 - a. The accountant is allowed to prepare interim financial statements for a client using GAAP when the annual statements are prepared using GAAP. [This answer is incorrect. SSARS No. 18 and SAS No. 116 both allow an accountant to prepare interim financial statements using GAAP in this situation.]
 - b. The accountant is allowed to prepare interim financial statements using OCBOA while using GAAP for preparing annual statements. [This answer is correct. SSARS No. 18 implies that an accountant is allowed to prepare interim financial statements using a different financial reporting framework than that used to prepare its year-end statements when performing the interim review in accordance with the SSARS. SAS No. 116 does not allow this.]**
4. What method is most commonly used to estimate inventories at interim dates if physical inventories are not taken? **(Page 10)**
 - a. The last-in, first-out (LIFO) method. [This answer is incorrect. This is not the method most commonly used to estimate inventories at interim dates when physical inventories are not taken. For companies that have adopted the LIFO inventory method, two general approaches are used to value inventory at interim dates. One approach is to compute interim LIFO inventory values based on the actual quantities and inventory costs at the interim date. The alternative is to use an estimation technique to arrive at interim LIFO values.]
 - b. The first-in, first-out (FIFO) method. [This answer is incorrect. Some companies compute LIFO values annually and value interim inventories on a FIFO basis, but this is not the method that is most commonly used to estimate inventories at interim dates when physical inventories are not taken.]
 - c. The gross profit method. [This answer is correct. The gross profit method is the most common method of estimating inventories at interim dates when physical inventories are not taken. The use of this method to determine inventory and cost of goods sold, although not acceptable in annual statements, is an acceptable method for use in interim financial statements. However, the use of estimated gross profit rates should be disclosed in the financial statements.]**
 - d. A standard cost system. [This answer is incorrect. The same procedures used for annual statements should, generally, be followed in the application of standard costs systems for interim statement purposes. However, this is not the method most commonly used to estimate inventories at interim dates when physical inventories are not taken.]
5. Which of the following is one of the four general principles found in APB Opinion No. 28 for determining charges for other costs and expenses in interim financial statements? **(Page 11)**
 - a. All costs and expenses must be charged to income in interim periods as they are incurred. [This answer is incorrect. Costs and expenses other than product costs should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods.]
 - b. Costs and expenses incurred in an interim period must be identified with activities, benefits, or other interim periods. [This answer is incorrect. Some costs and expenses incurred in an interim period cannot be readily identified with the activities or benefits or other interim periods and should be charged to the interim period in which incurred.]
 - c. Costs can be arbitrarily assigned to an interim period. [This answer is incorrect. According to APB Opinion No. 28, arbitrary assignment of other costs and expenses to an interim period should not be made.]
 - d. Gains and losses arising in an interim period similar to those that would not be deferred at year end, should not be deferred to later interim periods. [This answer is correct. This is one of the four general principles found in APB Opinion No. 28. This type of gains or losses should not be deferred to later interim periods within the same fiscal year.]**

6. What is the basic underlying premise of APB Opinion No. 28? (Page 13)

- a. It emphasizes the balance sheet with a focus on what current and deferred liabilities and assets should be on the balance sheet date. [This answer is incorrect. This is known as the *liability method*, and it is found in SFAS No. 109.]
- b. Interim periods are an integral part of an annual period; therefore, annual results should be allocated to the interim periods. [This answer is correct. The basic premise underlying APB Opinion No. 28 is that interim periods are an integral part of an annual period, and annual results should be allocated to interim periods. Certain revenues and expenses, however, that are directly related to a specific interim period, including items such as significant unusual or infrequently occurring items, extra ordinary items, and discontinued operations, should be reported in the interim period in which they occur and, accordingly, should not be prorated over the balance of the fiscal year.]**
- c. Interim income tax provisions that are related to "ordinary income or loss" should be determined using an estimated annual effective tax rate based on annual results. [This answer is incorrect. However, this view of determining the interim tax effect of "ordinary income or loss" is supported by the basic underlying premise of APB Opinion No. 28.]

7. When calculating the estimated annual effective tax rate for the year related to ordinary income, how is the current provision for the year estimated? (Page 14)

- a. Enacted tax rates are applied to the year's estimated taxable ordinary income. [This answer is correct. This is the first recommended step for determining the estimated annual effective tax rate related to ordinary income. The current provision for the year is estimated by applying enacted tax rates to estimated taxable ordinary income for the year. The amount should consider the alternative minimum tax system.]**
- b. The deferred tax effect of estimated temporary differences is calculated. [This answer is incorrect. This is the second recommended step for determining the estimated annual effective tax rate related to ordinary income. The deferred tax provision for the year, not the current provision, is estimated by calculating the deferred tax effect of estimated temporary differences, tax loss carryforwards, and tax credit carryforwards at the end of the year and subtracting it from the balance at the beginning of the year.]
- c. The total estimated tax provision is divided by estimated ordinary income. [This answer is incorrect. This is the final recommended step for determining the estimated annual effective tax rate related to ordinary income. After the current tax provision and the deferred tax provision have been added, the sum is divided by the estimated ordinary income for the year. This determines the estimated annual tax rate for the year.]

8. Which of the following statements best describes how loss carryforwards are treated in interim financial statements? (Page 17)

- a. Loss carryforwards are treated differently in annual financial statements than they are in interim financial statements. [This answer is incorrect. Loss carryforwards are treated consistently in interim and annual financial statements.]
- b. The tax benefits of loss carryforwards would generally be recognized in the year that the loss occurred. [This answer is correct. The tax benefits of loss carryforwards generally are recognized in the year that the loss occurs.]**
- c. If the related deferred tax asset was offset by a valuation allowance, tax benefits are recognized in the prior year if the loss was incurred that year. [This answer is incorrect. Tax benefits would *not* be recognized in the prior year for a loss that was incurred that year, if the related deferred tax asset were offset by a valuation allowance. In those circumstances, "if realization of an operating loss carryforward that is attributable to losses in prior years is expected because of estimated *ordinary* income in the current year, the operating loss carryforward is included in the computation of the estimated annual effective tax rate the same as, for example, tax credit carryforwards."]
- d. Specific guidelines for recognizing the effect of prior-year loss carryforwards on the annual effective tax rate are included in GAAP. [This answer is incorrect. GAAP does *not* include any specific guidelines for recognizing the effect of prior-year loss carryforwards in determining the annual effective tax rate. However, a series of recommended steps is available in Lesson 1 of this course.]

9. If tax law or tax rates are changed, should interim financial statements be adjusted for the effects of the change?
(Page 18)
- a. **Yes.** [This answer is correct. Deferred tax assets and liabilities in both annual and interim financial statements are required to be adjusted for the effects of changes in tax laws or rates in the period that includes the enactment date, that is, for federal tax purposes, the period in which the president signs the legislation and it becomes law.]
 - b. No. [This answer is incorrect. For interim reporting, it is not acceptable to allocate the effects of the changes to subsequent interim periods by adjusting the annual effective tax rate for the remainder of the year. Thus, in any interim period that includes a change, the tax provision will have two components: (1) the adjustment of the deferred tax asset or liability for the enacted changes and (2) the remainder. However, unlike annual financial statements, interim financial statements are not required to disclose the components.]

CONSIDERATIONS RELATED TO EXTRAORDINARY ITEMS, UNUSUAL OR INFREQUENTLY OCCURRING ITEMS, AND DISPOSAL OF A COMPONENT OF AN ENTITY

Definitions

Extraordinary Items. Extraordinary items are events and transactions that are distinguished by their *unusual* nature *and* by the *infrequency* of their occurrence. (See APB Opinion No. 30, Paragraph 20 (FASB ASC 225-20-45-2; 225-20-45-8).)

Extraordinary items should be rare and will normally result from a major casualty, an expropriation, or a prohibition under a newly enacted law or regulation. Events or transactions such as write-down of inventories or receivables, gains on the sale or abandonment of assets, effects of strikes, etc., generally will not qualify as extraordinary items. (See APB Opinion No. 30, Paragraphs 20–23 (FASB ASC 225-20-45-2; 225-20-45-8), for additional guidance.) Reporting the tax benefits of an operating loss carryforward as an extraordinary item is precluded unless realization of the loss carryforward results from an extraordinary gain.

Unusual or Infrequently Occurring Items. An *unusual* or *infrequently occurring item* is a material event or transaction that is unusual in nature or occurs infrequently, but not both, and thus does not meet both criteria for classification as an extraordinary item. (See APB Opinion No. 30, Paragraph 26 (FASB ASC 225-20-45-16), for additional guidance.)

Component of an Entity. The phrase *component of an entity* refers to the operations and cash flows of an entity that can be clearly distinguished from the rest of the entity. A component of an entity may be in the form of a reportable segment or an operating segment (as defined in SFAS No. 131, Paragraph 10) (FASB ASC 280-10-50), a reporting unit (as defined in SFAS No. 142) (FASB ASC 350-20), a subsidiary, or an asset group (as defined in SFAS No. 144, Paragraph 4) (FASB ASC 360-10-20). See SFAS No. 144 (FASB ASC 360-10) for additional guidance.

Financial Statement Presentation

The following principles should be applied to extraordinary items, unusual or infrequently occurring items, and disposal of a component of an entity in interim financial statements:

- a. Material extraordinary items, unusual or infrequently occurring items, and gains and losses on disposal of a component of an entity should be recognized in the interim period in which they occur. They should not be prorated over the fiscal year.
- b. For extraordinary items, materiality should be related to the full fiscal year. However, for unusual or infrequently occurring items and discontinued operations, materiality should be related to the interim period in which they occur.
- c. Extraordinary items and discontinued operations should be presented as separate line items on a net-of-tax basis in interim statements.
- d. Material unusual or infrequently occurring items should also be presented as separate line items. However, they should be presented as a component of income from continuing operations and should not be net of tax. The related tax expense or benefit should be included in the income tax expense or credit related to continuing operations.
- e. If more than one of the preceding items exists, the appropriate order of presentation in the income statement is as follows: (1) income from continuing operations including unusual or infrequently occurring items; (2) discontinued operations of a component of an entity; and (3) extraordinary items.
- f. The tax expense or benefit associated with unusual or infrequently occurring items is computed as the incremental tax from adding the unusual or infrequently occurring items to *ordinary income*. As noted in

item d., the incremental tax should be added to the tax on ordinary income from continuing operations in order to obtain the income tax expense for the period.

- g. The tax expense or benefit associated with extraordinary items or disposal of a component of an entity is likewise the incremental tax or benefit. However, the resulting incremental tax or benefit is netted against the income or loss from the extraordinary item, the gain or loss on disposal, or from discontinued operations, rather than becoming a part of income tax expense or credit for the period.

DETERMINING WHEN TO CORRECT PRIOR PERIOD INTERIM FINANCIAL STATEMENTS

It is appropriate to restate prior period interim financial statements only in the event that either of the following types of items is present:

- a. Items qualifying as *prior period adjustments* as defined in SFAS No. 16, *Prior Period Adjustments* (FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; 450-20-25-7).
- b. Items qualifying as *adjustments related to prior interim periods of the current fiscal year*, also defined in SFAS No. 16 (FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; 450-20-25-7).

Interim financial statements would also be restated for a change in accounting basis from one interim period to the next, as discussed later in this lesson.

Prior Period Adjustments

SFAS No. 16 (FASB ASC 250-10-05-4; 250-10-20; 250-10-45-22 through 45-24) limits the definition of prior period adjustments to the correction of an error.

Errors in financial statements as defined in SFAS No. 154, *Accounting Changes and Error Corrections* (FASB ASC 250-10-20), include—

- a. Mathematical mistakes.
- b. Mistakes in the application of accounting principles.
- c. Oversight or misuse of facts that existed at the time the financial statements were prepared.

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error under the above definition. Because a change in accounting estimate results from new information or subsequent developments, it is usually distinguishable from an error and should not be reported as a prior period adjustment.

Examples

Application of this definition is illustrated in the following examples.

- a. Situations qualifying for correction of errors in prior period statements include—
 - (1) When preparing the second-quarter financial statements, you discover that the list used to record accounts payable in the first-quarter financial statement was footed incorrectly by a material amount. This is obviously a mathematical error that should be reported as a prior period adjustment.
 - (2) You have obtained a new client, a contractor on the percentage-of-completion method. Your first task is to prepare reviewed statements for the first quarter. When inquiring about a substantial loss on a job completed in the quarter, you discover that the loss had been anticipated and was very close in amount to estimates made by management at the end of the prior fiscal year. You also learn that the

projected loss was not recorded in the prior year statements. This represents a mistake in application of the percentage-of-completion method or an oversight of facts and thus qualifies as a prior period correction.

- (3) When preparing the second-quarter financial statements of a new client, you discover that the statements for the previous quarter included income tax expense computed on income-to-date instead of being computed using an estimated annual effective rate. This represents an incorrect application of GAAP, and thus the first-quarter statements should be restated for the errors, if material, before preparing the second-quarter statements.

b. Examples of situations that do not qualify as errors in prior period statements:

- (1) At the end of the first quarter, XYZ Company had pretax income of \$20,000, the estimated taxable income for the year was \$50,000, and the estimated annual effective tax rate was 15%. At the end of the second quarter, the Company had pretax income of \$70,000, and the estimated taxable income for the year was revised to \$200,000, producing an estimated annual effective tax rate of 28%. Had the estimated effective tax rate been 28% at the end of the first quarter, the income tax would have been \$5,600 instead of \$3,000. The change in estimated effective tax rates is a change in accounting estimate, not an error, and thus the second-quarter income tax expense should include the entire effect of the rate change. The first quarter would not be restated to reflect the higher income tax expense.
- (2) When preparing the second-quarter statements of the ABC Company, a contractor on the percentage-of-completion method, you determine that the expected profit on Job No. 207 is estimated to be \$44,000 and that the job is estimated to be 50% completed at the end of the quarter. You therefore record \$22,000 of profit on the job. The job is completed by the end of the third quarter with a total profit of \$30,000. Had you correctly estimated the profit at the end of the second quarter, you would have recorded only \$15,000 of profit in the second quarter rather than \$22,000. This difference is a result of subsequent developments affecting the estimate and does not qualify as an error. Thus, the second-quarter statements are not restated.

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

Prior Interim Period Adjustments That Are Not Errors. SFAS No. 16 (FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; 450-20-25-7) establishes special situations that warrant correction of prior interim periods *that would not otherwise qualify as an error to be corrected in a prior period under the general rules for prior period adjustments*. Thus, treatment of these items in interim financial statements differs from the treatment they would receive in annual financial statements.

In summary, SFAS No. 16 (FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18) indicates that adjustment or settlement of the following items requires restatement of prior interim periods if the effect is material, can be identified with a specific prior interim period, and is now (but not previously) subject to estimation:

- a. Litigation or similar claims.
- b. Income taxes.
- c. Renegotiation proceedings.
- d. Utility revenue under rate-making processes.

Normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process, such as changes in the allowance for bad debts, are not considered to be prior period adjustments.

An adjustment caused by one of the occurrences in the previous paragraph that occurs in an interim period should be accounted for as follows:

- a. The portion related to the current interim period should be included in the determination of net income of the current period.

- b. Prior interim periods should be restated to include the portion related to each interim period in the determination of net income of that period. The portion related to prior fiscal years should be included in the net income of the first interim period of the current fiscal year.

The following example illustrates application of these rules. However, the practitioner should consult SFAS No. 16 (FASB ASC 250-10; 270-10) when dealing with prior period adjustments.

Approximately 30% of the sales of the XYZ Company are made in a neighboring state, and the Company has taken the position that it is not subject to that state's sales tax. In the third quarter, the controller of the neighboring state completed an audit of the last four fiscal years of the Company and assessed substantial additional sales taxes. The lawyer for the XYZ Company advised that the state will prevail if the assessment is challenged.

In preparing financial statements that present the third quarter results of operations and the year-to-date operations, the year-to-date operations should include as an expense the assessment for the prior years as well as for the accrual of similar taxes on sales for the first three quarters of this year. The third-quarter operations would include only the sales tax expense accrued on sales made in the third quarter.

In the interim period in which a prior period adjustment occurs, the *effects* on income from continuing operations and net income should be disclosed for each prior interim period of the current year. The restated income from continuing operations and net income of each prior interim period also should be disclosed.

Prior Interim Period Adjustments That Are Errors. In single period statements (month of June or second quarter), prior interim period adjustments of errors shall be reflected as adjustments to beginning retained earnings. When comparative statements are presented, the prior-period adjustments of errors should be applied retroactively for all prior periods presented. Net income and retained earnings balances should be restated for each interim period presented.

Materiality

Materiality is discussed later in this lesson.

THE EFFECT OF ACCOUNTING CHANGES ON INTERIM FINANCIAL STATEMENTS

General

Accounting changes include changes in an accounting principle, changes in an accounting estimate, and changes in the reporting entity. The term does not include corrections of errors.

Change in Accounting Estimate

The accounting treatment applicable to changes in accounting estimates in annual statements is equally applicable to interim statements. The effects of changes in estimates should be reported in the interim period of change and subsequent periods. Restatement of prior interim periods is not appropriate. Disclosure of a change in an accounting estimate is necessary if the change affects several future periods, such as a change in the useful lives of depreciable assets, or if the effect of change is material. Changes in accounting estimates are discussed further in *PPC's Guide to Compilation and Review Engagements*.

Change in Reporting Entity

The accounting treatment applicable to a change in reporting entity in annual statements applies also to interim statements. Changes in reporting entity are discussed further in *PPC's Guide to Compilation and Review Engagements*.

Change in Accounting Principle

For purposes of interim financial statements, an accounting change has occurred if an accounting principle or the method of application of that principle is different from that used in the preceding interim period, the prior annual period, or the comparable interim period of the prior year.

SFAS No. 154 (FASB ASC 250-10-05-2) requires a change in accounting principle to be reported by retrospective application of the new principle to the financial statements of all prior periods, unless impracticable. However, for changes in an accounting principle made in an interim period, an entity is not allowed to apply the impracticability exception to prechange interim periods in the fiscal year in which the change is made. Therefore, if it is impracticable to retrospectively apply a new accounting principle to prechange interim periods, the change is required to be made as of the beginning of a subsequent fiscal year.

Disclosure of Change in Accounting Principle

The disclosures required in interim statements for a change in accounting principle are summarized as follows:

- a. The nature and justification for the change should be disclosed in interim statements in which the new principle is adopted.
- b. The method of applying the change, and—
 - (1) A description of the prior-period information that has been retrospectively adjusted, if any.
 - (2) The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
 - (3) The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
- c. If indirect effects of a change in accounting principle are recognized—
 - (1) A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period.
 - (2) Unless impracticable, the amount of the total recognized indirect effects of the accounting change that are attributable to each prior period presented.
- d. In financial statements of subsequent (post-change) interim periods in the year of adoption, the effect of the change on income from continuing operations and net income for the post-change interim periods should be disclosed.

Materiality

Materiality for the purpose of reporting the effect of an accounting change or correction of an error should be based on estimated income for the full fiscal year and also on the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

DISCLOSURE REQUIREMENTS FOR INTERIM FINANCIAL STATEMENTS OF NONISSUERS

Disclosure requirements for interim financial statements of nonissuers are basically the same as for annual financial statements with the following exceptions:

- a. Disclosure of accounting policies does not apply to unaudited interim statements unless an accounting policy has been changed (APB Opinion No. 22) (FASB ASC 235-10-50-2). (However, most accountants disclose accounting policies when interim statements include notes.)
- b. For companies with material seasonal variations, the seasonal nature of their activities should be disclosed, and consideration should be given to supplementing interim reports with information for a 12-month period ending with the interim date (APB Opinion No. 28, Paragraph 18) (FASB ASC 270-10-45-11). For example:

NOTE A—SEASONAL FLUCTUATIONS

The Company's primary business is the operation of an amusement park from May 1 to September 30 each year. The Company generally derives 90% of its revenue during this period. The current financial statements for the three months ended March 31, 20X1, therefore, reflect results of operations during part of the Company's off-season, during which it incurs expenses in preparation for its operating season.

- c. Use of the gross profit method of interim inventory pricing should be disclosed. Significant adjustments to reconcile to the annual physical inventory should also be disclosed (APB Opinion No. 28, Paragraph 14) (FASB ASC 270-10-45-6).
- d. Other unusual methods of accounting for interim inventories such as LIFO estimations should be disclosed.
- e. Generally, disclosure should be made as to the nature and amount of material costs or expenses incurred in an interim period that cannot be readily identified with the activities or benefits of other interim periods (APB Opinion No. 28, Paragraph 15) (FASB ASC 270-10-45-8). These disclosures can generally be made on the face of the income statement by providing an appropriate descriptive title to the cost or expense shown as a single line item.
- f. If any accounting principle used in an interim financial statement differs from that applied in—
 - (1) the preceding interim period,
 - (2) the prior annual financial statements, or
 - (3) the comparable interim period of the prior year,
 disclosure of the change is required in the interim financial statements (APB Opinion No. 28, paragraph 23) (FASB ASC 270-10-45-12).
- g. The gross and net of tax effects of prior period adjustments on net income should be disclosed in the interim period in which the adjustments are made.
- h. When adjustments related to prior interim periods of the current fiscal year are made, (1) the effect on income from continuing operations and net income for each prior interim period and (2) restated income from continuing operations and net income of each prior interim period should be disclosed.

Additional disclosure considerations for interim financial statements can be found in *PPC's Guide to Compilation and Review Engagements*.

REPORTING ISSUES THAT CAN AFFECT INTERIM FINANCIAL STATEMENTS

Introduction

SSARS No. 1 requires accountants to compile financial statements that they submit to clients or others. The intended use of those statements determines whether accountants must issue a compilation report. SSARS No. 1 does not require accountants to report on financial statements that are intended for management's use only; instead, it allows accountants to issue an engagement letter in lieu of a compilation report. (Accountants can continue to issue a SSARS No. 1 compilation report on management-use-only financial statements.) When financial statements are intended for third party use, however, accountants must issue a SSARS No. 1 compilation report. The guidance in this section, therefore, applies whenever accountants issue a SSARS No. 1 compilation report on financial statements that they have compiled.

Use of Different Bases of Accounting at Interim and Annual Periods

SSARS No. 18 implies that a nonissuer is permitted to use an other comprehensive basis of accounting (OCBOA) for preparing its interim financial statements and generally accepted accounting principles (GAAP) for preparing its annual statements. As long as the basis of accounting and how it differs from GAAP is adequately disclosed in the interim financial statements, accountants should issue a standard compilation or review report (modified only by using the appropriate OCBOA statement titles) on the interim statements. Accountants also should issue a standard compilation or review report on the annual GAAP financial statements.

Disclosing the Basis of Accounting in OCBOA Financial Statements

As previously discussed, interim financial statements are often prepared in conformity with an other comprehensive basis of accounting (OCBOA) such as the cash or income tax basis of accounting. In addition, such statements frequently omit substantially all disclosures required by the basis of accounting used to prepare them. When financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP do not include disclosure of the basis of accounting used, AR 100.20 requires that the accountants' report be modified to disclose the basis of accounting used to prepare the statements.

Change in the Basis of Accounting

Lesson 2 addresses reporting when a company changes its basis of accounting (for example, from GAAP to OCBOA) from that used in a prior year. The same guidance is believed to apply when an entity changes the basis of accounting it uses from one interim period to the next. In summary, they believe that:

- It is preferable, for comparative purposes, to restate any prior interim periods presented to the new basis of accounting adopted by the company.
- Accountants are not required (but are permitted) to add a paragraph highlighting the change in basis to their compilation or review reports. (The change in basis should be adequately disclosed in the interim financial statements.)

Special Considerations for Twelfth-month Interim Statements When a Higher Level of Service Will Be Performed

Frequently, companies issue interim statements that omit (a) substantially all disclosures and (b) accruals for items such as taxes, bonuses, depreciation, etc. Sometimes, the interim statements might even be prepared using an OCBOA. At year-end, however, management wants full-disclosure compiled, reviewed, or audited GAAP statements. Anxious about year-end results, the client generally wants the twelfth-month statements as soon as possible, but considerable work might be necessary to issue even a compilation report on the full-disclosure, year-end GAAP statements. How can accountants satisfy their clients and still ensure they have time to perform necessary procedures required by professional standards? Accountants who find themselves in that position could stamp the twelfth-month statements "Draft" and follow up with final audited, reviewed, or compiled statements after the year-end work is complete.

Using Standardized Reports

Using standardized reports is often possible in recurring interim engagements because interim financial statements tend to be consistent from one period to the next. For example, a client that chooses to omit disclosures and not record certain accruals will tend to do so for all interim financial statements. The use of standardized reports is desirable because it allows the accountant to be more efficient.

One common method of standardizing reports is to refer to “the periods then ended” rather than to the specific periods covered. For example, a report on financial statements covering the one month and nine months ended September 30, 20XX, might refer to the “balance sheet of XYZ Company as of September 30, 20XX, and the related statement of income and retained earnings *for the periods then ended.*” While this is not technically correct, it may be a practical necessity, particularly if the accountant is using a software package that is set up this way and cannot be easily modified. Such a report would not be misleading as long as the related statements of income and retained earnings (and, if included, cash flows) specify the periods covered in the financial statements’ headings.

SELF-STUDY QUIZ

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

10. Define *extraordinary items*.
- a. A material transaction or event that is unusual in nature or occurs infrequently, but not both.
 - b. Transactions or events that are distinguished by the infrequency of their occurrence and their unusual nature.
 - c. Cash flows and operations of an entity that can be clearly distinguished from the rest of the entity.
 - d. Errors in financial statements, such as mathematical mistakes or mistakes in applying accounting principles.
11. In which of the following scenarios would the prior period interim financial statements **not** be restated or adjusted?
- a. Jane prepares the second-quarter statements of Company A. She discovers that the list used to record accounts payable in the first-quarter statements was footed incorrectly by a material amount.
 - b. Jim prepares the second-quarter financial statements of Company B, his new client. He discovers that the statements for the previous quarter included income tax expense that was computed on income-to-date instead of using an estimated annual effective rate. The difference in the amount is material.
 - c. Company C is a contractor using the percentage-of-completion method. When preparing the company's second-quarter statements, Joe estimates a job's expected profit as \$50,000. The job is estimated to be 50% complete at the end of the quarter, so Joe records \$25,000 total profit on the job. The job is completed at the end of the third quarter with total profit of \$40,000, which makes the second quarter profit only \$20,000.
 - d. Company D is a contractor that uses the percentage-of-completion method. The first task for Jill, the company's new accountant, is to prepare reviewed statements for the first quarter. Jill inquires about a substantial loss on a job completed in the quarter and discovers that the loss was anticipated and very close in amount to estimates management made at the end of the prior fiscal year. Jill also learns that the projected loss was not recorded in the prior year statements.
12. Which of the following is a special situation under SFAS No. 16 that warrants correction of prior interim periods?
- a. Oversight of facts when the financial statements were prepared.
 - b. Changing in accounting estimate.
 - c. Changes in the allowance for bad debts.
 - d. Adjustment of income taxes.
13. When there is a change in accounting principle, which of the following must always be disclosed in the interim financial statements?
- a. The justification for the change should be disclosed in subsequent interim periods.
 - b. The effect on financial statement totals and subtotals other than income from net income and continuing operations.
 - c. The total amount of recognized indirect effects of the change attributable to each prior period presented.
 - d. The method used to apply the change and a description of prior-period information retrospectively adjusted.

14. Generally, the disclosure requirements for the interim statements of nonissuers are the same as those for the annual financial statements. Which of the following is an exception to this rule?
- a. Accounting policies never need to be disclosed in unaudited interim statements.
 - b. Seasonal variations should be disclosed, but no supplementary information is needed.
 - c. Use of an accounting principle that differs from the preceding interim period should be disclosed.
 - d. If material, the gross and net of tax effects on prior-period adjustments on net income should be disclosed.
15. Beakers 'N Stuff (BNS), a nonissuer, prepares its interim financial statements using the cash basis of accounting, but it uses GAAP to prepare its annual financial statements. The basis of accounting and its differences from GAAP are disclosed in the interim statements. All of BNS's statements are intended for third-party use. What type of report should an accountant issue on BNS's interim statements?
- a. A standard compilation or review report.
 - b. A standard compilation or review report with certain modifications.
 - c. An engagement letter issued in lieu of a compilation report.

SELF-STUDY ANSWERS

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

10. Define *extraordinary items*. **(Page 26)**

- a. A material transaction or event that is unusual in nature or occurs infrequently, but not both. [This answer is incorrect. This is the definition of and *unusual* or *infrequently occurring item*.]
- b. Transactions or events that are distinguished by the infrequency of their occurrence and their unusual nature. [This answer is correct. Extraordinary items are events and transactions that are distinguished by their *unusual* nature and by the *infrequency* of their occurrence. Extraordinary items should be rare and will normally result from a major casualty, an expropriation, or a prohibition under a newly enacted law or regulation.]**
- c. Cash flows and operations of an entity that can be clearly distinguished from the rest of the entity. [This answer is incorrect. This is the definition of *component of an entity*. A component of an entity may be in the form of a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.]
- d. Errors in financial statements, such as mathematical mistakes or mistakes in applying accounting principles. [This answer is incorrect. This is the definition of a *prior period adjustment*. SFAS No. 16 limits the definition of prior period adjustments to the correction of an error. Errors in financial statements as defined in SFAS No. 154 include mathematical mistakes, mistakes in the application of accounting principles, and oversight or misuse of facts that existed at the time the financial statements were prepared.]

11. In which of the following scenarios would the prior period interim financial statements **not** be restated or adjusted? **(Page 27)**

- a. Jane prepares the second-quarter statements of Company A. She discovers that the list used to record accounts payable in the first-quarter statements was footed incorrectly by a material amount. [This answer is incorrect. This scenario is obviously a mathematical error that should be reported as a prior period adjustment.]
- b. Jim prepares the second-quarter financial statements of Company B, his new client. He discovers that the statements for the previous quarter included income tax expense that was computed on income-to-date instead of using an estimated annual effective rate. The difference in the amount is material. [This answer is incorrect. This scenario describes an incorrect application of generally accepted accounting principles (GAAP), and, thus, the first-quarter statements should be restated for the errors before preparing the second-quarter statements.]
- c. Company C is a contractor using the percentage-of-completion method. When preparing the company's second-quarter statements, Joe estimates a job's expected profit as \$50,000. The job is estimated to be 50% complete at the end of the quarter, so Joe records \$25,000 total profit on the job. The job is completed at the end of the third quarter with total profit of \$40,000, which makes the second quarter profit only \$20,000. [This answer is correct. The difference in profit Joe recorded is the result of subsequent developments affecting the estimate and does not qualify as an error. The second-quarter statements would not be restated under these circumstances. Joe would record a profit of \$15,000 for the third quarter.]**
- d. Company D is a contractor that uses the percentage-of-completion method. The first task for Jill, the company's new accountant, is to prepare reviewed statements for the first quarter. Jill inquires about a substantial loss on a job completed in the quarter and discovers that the loss was anticipated and very close in amount to estimates management made at the end of the prior fiscal year. Jill also learns that the projected loss was not recorded in the prior year statements. [This answer is incorrect. The scenario described here is a mistake in application of the percentage-of-completion method and, thus, qualifies as a prior period correction.]

12. Which of the following is a special situation under SFAS No. 16 that warrants correction of prior interim periods? **(Page 28)**

- a. Oversight of facts when the financial statements were prepared. [This answer is incorrect. The oversight or misuse of facts that existed at the time the financial statements were prepared would qualify as the correction of an error under SFAS No. 16, and, thus, would be corrected. However, this is not a special situation under SFAS No. 16, but the normal situation under which prior period interim statements are adjusted.]
- b. Changing in accounting estimate. [This answer is incorrect. Because a change in accounting estimate results from new information or subsequent developments, it is usually distinguishable from an error and should not be reported as a prior period adjustment.]
- c. Changes in the allowance for bad debts. [This answer is incorrect. Normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process, such as changes in the allowance for bad debts, are not considered to be prior period adjustments.]
- d. **Adjustment of income taxes. [This answer is correct. SFAS No. 16 establishes special situations that warrant correction of prior interim periods that would not otherwise qualify as an error to be corrected in a prior period under the general rules for prior period adjustments. SFAS No. 16 indicates that adjustment or settlement of the following items requires restatement of prior interim periods if the effect is material, can be identified with a specific prior interim period, and is now (but not previously) subject to estimation: (1) litigation or similar claims, (2) income taxes, (3) renegotiation proceedings, (4) utility revenue under rate-making processes.]**

13. When there is a change in accounting principle, which of the following must always be disclosed in the interim financial statements? **(Page 30)**

- a. The justification for the change should be disclosed in subsequent interim periods. [This answer is incorrect. The nature and justification for the change should be disclosed in interim statements in which the new principle is adopted. In financial statements of subsequent interim periods in the year of adoption, the effect of the change on income from continuing operations and net income for the post-change interim periods should be disclosed.]
- b. The effect on financial statement totals and subtotals other than income from net income and continuing operations. [This answer is incorrect. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.]
- c. The total amount of recognized indirect effects of the change attributable to each prior period presented. [This answer is incorrect. If indirect effects of a change in accounting principle are recognized, this disclosure should be considered; however, if it is impracticable, the disclosure does not have to be made.]
- d. **The method used to apply the change and a description of prior-period information retrospectively adjusted. [This answer is correct. When an accounting principle is changed, the interim statements must disclose the method of applying the change and (1) a description of the prior-period information that has been retrospectively adjusted, if any; (2) the effect of the change on income from continuing operations, net income, any other affected financial statement line item for the current period and any prior periods retrospectively adjusted; and (3) the cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.]**

14. Generally, the disclosure requirements for the interim statements of nonissuers are the same as those for the annual financial statements. Which of the following is an exception to this rule? **(Page 31)**
- a. Accounting policies never need to be disclosed in unaudited interim statements. [This answer is incorrect. Disclosure of accounting policies does not apply to unaudited interim statements unless an accounting policy has been changed.]
 - b. Seasonal variations should be disclosed, but no supplementary information is needed. [This answer is incorrect. For companies with material seasonal variations, the seasonal nature of their activities should be disclosed, and consideration should be given to supplementing interim reports with information for a 12-month period ending with the interim date.]
 - c. **Use of an accounting principle that differs from the preceding interim period should be disclosed. [This answer is correct. If any accounting principle used in an interim financial statement differs from that applied in the preceding interim period, the prior annual financial statements, or the comparable interim period of the prior year, disclosure of the change is required in the interim financial statements.]**
 - d. If material, the gross and net of tax effects on prior-period adjustments on net income should be disclosed. [This answer is incorrect. The gross and net of tax effects of prior period adjustments on net income should be disclosed in the interim period in which the adjustments are made. This exception does not specify that only material effects need to be disclosed.]
15. Beakers 'N Stuff (BNS), a nonissuer, prepares its interim financial statements using the cash basis of accounting, but it uses GAAP to prepare its annual financial statements. The basis of accounting and its differences from GAAP are disclosed in the interim statements. All of BNS's statements are intended for third-party use. What type of report should an accountant issue on BNS's interim statements? **(Page 32)**
- a. A standard compilation or review report. [This answer is incorrect. In this scenario, the accountant would issue a standard compilation or review report on BNS's annual financial statements.]
 - b. **A standard compilation or review report with certain modifications. [This answer is correct. In this scenario, the accountant should issue a standard compilation or review report (modified only by using the appropriate OCBOA statement titles) on the interim statements.]**
 - c. An engagement letter issued in lieu of a compilation report. [This answer is incorrect. An accountant can only issue an engagement letter in lieu of a compilation report when financial statements are intended for management's use only.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (CARTG091)**

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. How should a firm's quality control policies and procedures affect its interim engagements?
 - a. Interim engagements are not subject to peer review, so they should not be covered by a firm's quality control system.
 - b. A quality control system should only cover interim engagements if the firm has different requirements for year-end and interim engagements.
 - c. Interim engagements should be included in a firm's system of quality control because interim engagements may be selected for review by the firm's peer reviewers.
 - d. The Peer Review Standards require that interim engagements undergo the exact same quality control policies and procedures as year-end engagements.
2. List all of the following that would be considered special presentation, reporting, and disclosure situations for interim engagements.
 - i. Supplementary information is included that would not be included in year-end statements.
 - ii. Partner review is required for recurring interim compilation engagements.
 - iii. Substantially all disclosures and the statement of cash flows is omitted.
 - iv. Departures from generally accepted accounting principles (GAAP) are present that would not occur in year-end statements.
 - a. i. and iv.
 - b. i., iii., and iv.
 - c. ii., iii., and iv.
 - d. i., ii., iii., and iv.
3. SSARS are not applicable to reviews of interim financial information if three conditions are met. Which one of the following is **not** one of those conditions?
 - a. The accountant audited the prior year financial statements but does not expect to be engaged to audit the current year financial statements.
 - b. The client uses the same financial reporting framework to prepare interim statements as well as year-end statements.
 - c. The entity's latest annual financial statements were audited.
 - d. The accountant has been engaged to audit the entity's current year financial statements.
4. Swimwear Inc. recognizes revenue after goods are delivered. The company uses this policy for its annual financial statements. However, due to the nature of the goods sold by the company, its income is highly seasonal. How should the company recognize revenue on its interim financial statements?
 - a. Revenue recognition should be broken up on an average basis throughout the year so as not to distort income.
 - b. Revenue should be recognized the same way for interim statements as it is for the annual statements, and no disclosures are needed.
 - c. Revenue should be recognized the same way for both interim and annual statements, but the seasonal nature of the business should be disclosed.
 - d. Do not select this answer choice.

5. How are interim financial statements affected if the market value of inventory is below cost as of the interim balance sheet date?
- Market declines do not have an affect on the interim financial statements, but if they are not restored by year-end, they will affect the annual financial statements.
 - Market declines should be recognized in interim financial statements if they cannot be reasonably expected to be restored by the end of the fiscal year.
 - Inventory can be adjusted downward to market at the interim date and adjusted above original cost if the market rebounds by the end of the fiscal year.
 - All market declines, temporary or otherwise, must be recognized in both the interim financial statements and the annual financial statements.
6. How did SFAS No. 109, *Accounting for Income Taxes*, affect APB Opinion No. 28 and FASB Interpretation No. 18's guidance over interim financial statements?
- SFAS No. 109 superseded APB Opinion No. 28 and FASB Interpretation No. 18 by requiring all interim financial statements use the liability method to report income taxes.
 - SFAS No. 109 does not discuss interim financial statements and, therefore, does not change or amend the guidance for such statements in APB Opinion No. 28 and FASB Interpretation No. 18.
 - SFAS No. 109 amends APB Opinion No. 28 and FASB Interpretation No. 18 in a few limited areas, such as reporting the effects of new legislation or changes in tax rates.
 - Do not select this answer choice.
7. Calculate the income tax provision for the current interim period using the following facts:

Year-to-date ordinary income at the end of the current interim period is \$40,000.

Year-to-date income tax provision through the end of the preceding interim period is \$2,500.

Taxable temporary differences at the beginning of the year are \$50,000; estimated taxable temporary differences at the end of the year are \$75,000.

Tax rates are 15% on the first \$50,000 and 25% on the excess.

Average graduated tax rate expected to be in effect when the temporary differences reverse of 15%.

Estimated annual ordinary income of \$65,000, including permanent differences related to tax-exempt income of \$13,800.

- \$2,220.
 - \$3,750.
 - \$3,930.
 - \$4,720.
8. How would a company's year-to-date taxes be calculated if ordinary loss is expected for the year, but there is year-to-date ordinary income as of the interim period?
- A deferred tax asset would be recognized at the interim date.
 - The estimated annual tax benefit rate is applied to the ordinary loss.
 - The estimated annual tax benefit rate is applied to ordinary income for the remainder of the year.
 - The ordinary income is multiplied by the estimated annual tax benefit rate.

9. What amounts are added together to determine the estimated annual effective tax rate when classifying deferred tax balance sheet accounts?
- The amounts of annual results added to interim periods.
 - The current and deferred components of the estimates of the year's total tax provision.
 - Variations in the relationship between income tax expense and pretax accounting income.
 - The year's estimated total current provision and the year's estimated total provision.
10. Which of the following principles should be applied to extraordinary items in interim financial statements?
- Materiality should be related to the interim period in which the items occur.
 - The items should be prorated over the fiscal year.
 - They should be presented net-of-tax as separate line items.
 - Tax expenses or benefit should be computed as incremental tax from adding the items to ordinary income and reported as a part of income tax expense.
11. The presence of what type(s) of items make it appropriate to restate prior period interim financial statements? List all that qualify.
- Items that qualify as prior period adjustments under SFAS No. 16
 - Items that qualify as adjustments related to prior interim periods of the current fiscal year under SFAS No. 16.
 - Error corrections, including mathematical mistakes, mistakes in accounting principle application, and oversight or misuse of facts that existed when the financial statements were prepared.
- iii.
 - i. and ii.
 - i. and iii.
 - i., ii., and iii.
12. How should prior interim period adjustments of errors be presented in comparative statements?
- Adjustments to beginning retained earnings.
 - Adjustments applied retroactively to all prior periods presented.
 - Prior interim period adjustments cannot be made in comparative statements.
 - Do not select this answer choice.
13. SFAS No. 154 requires this type of accounting change to be made as of the beginning of a subsequent fiscal year, if it is impracticable to retrospectively apply it to prechange interim periods. What type of accounting change is this?
- Error correction.
 - Reporting entity change.
 - Accounting estimate change.
 - Accounting principle change.

14. Jason, an accountant, reports on the interim financial statements of AlphaCo. AlphaCo prepares its interim statements using the income tax basis of accounting and omits all disclosures. What affect will that have on Jason's report?
- a. The report must be modified to disclose the basis of accounting.
 - b. The report must include an adverse opinion, because disclosures cannot be omitted when an OCBOA is used.
 - c. A standard compilation or review report should be issued with no modifications.
 - d. A special paragraph discussing these changes must be added to the report.
15. If a client wants its twelfth-month statements as soon as possible, but those statements are reported on using a higher level of service than that required for the interim statements, what can the accountant do?
- a. Use a standardized report referring to "the periods then ended" instead of using specific dates.
 - b. Submit draft statements followed by final audited, compiled, or reviewed statements after year-end work has been completed.
 - c. Modify the accountant's report on the twelfth-month statements to cover the special situation.
 - d. The accountant has no option but to take the time to perform all the year-end work before submitting his or her report.

Lesson 2: Financial Statements Presented on an Other Comprehensive Basis of Accounting (OCBOA)

INTRODUCTION

Unaudited financial statements of nonpublic companies prepared in accordance with an other comprehensive basis of accounting (OCBOA) are clearly governed by SSARS No. 1. OCBOA is defined in SSARS No.1 (AR 100.04), as—

A definite set of criteria, other than GAAP, having substantial support underlying the preparation of financial statements prepared pursuant to that basis. Examples of an OCBOA are:

- (a) A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting insurance companies use pursuant to the rules of a state insurance commission).
- (b) A 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.
- (c) The cash basis of accounting and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

A proposed SSARS would amend the definition of an OCBOA to say “A definite set of criteria, other than GAAP or International Financial Reporting Standards. . .” This course does not address issues related to financial statements prepared in accordance with International Financial Reporting Standards.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the basics of using an OCBOA, including background information, OCBOA and accounting standards, deciding when to use an OCBOA, definitions of the cash basis and the tax basis, and the use of different bases of accounting.
- Compare and contrast the statement titles used for cash and tax basis financial statements with those used for GAAP financial statements, and describe other elements of OCBOA statements, including the statement of cash flows, the statement of changes in stockholder's equity, the statement of retained earnings, and comprehensive income.
- Prepare to make presentation considerations, disclose of the basis of accounting, make other disclosures, and make cash to accrual conversions in OCBOA financial statements.

ACCOUNTING STANDARDS RELATED TO OCBOAs

Standards Overload

There is growing appeal in the accounting profession to find an alternative for small businesses to some of the measurement and disclosure requirements of GAAP. One solution often mentioned is the use of OCBOA financial statements. In 1981, the AICPA's Special Committee on Accounting Standards Overload was formed to consider alternative means of providing relief from accounting standards that are not cost-effective, particularly for small, closely held businesses. In its final report published in 1983, the committee concluded:

Small, nonpublic entities can gain some measure of relief from accounting standards overload by issuing compiled, reviewed, or audited financial statements prepared on a comprehensive basis of accounting other than GAAP in accordance with existing disclosure and measurement standards and with the existing reporting requirements for CPAs.

This lesson discusses existing literature pertaining to the three most frequently used OCBOAs—tax basis, pure cash basis, and modified cash basis.

Some accountants have questioned whether fair value is an OCBOA. While the authoritative guidance on fair value measurements is increasing, this course maintains that the available guidance does not comprise a “definite set of criteria having substantial support,” and fair value should therefore not be viewed as an other comprehensive basis of accounting. That conclusion is consistent with the one reached in AU 9623.57 that preparing financial statements on fair value would result in a presentation that is not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. *PPC's Guide to Cash, Tax, and Other Bases of Accounting* discusses considerations in developing fair value presentations.

Authoritative Literature

Little authoritative guidance on applying other comprehensive bases of accounting exists. References to OCBOAs appear in Statements on Auditing Standards (SAS) and Statements on Standards for Accounting and Review Services (SSARS). SAS No. 62, *Special Reports* (AU 623.03), states that “an independent auditor’s judgment concerning the overall presentation of financial statements should be applied within an identifiable framework.” Ordinarily, that framework is provided by GAAP; but SAS No. 62 allows a comprehensive basis of accounting other than GAAP to be used. SSARS No. 1 at AR 100.04 defines OCBOAs for compiled and reviewed financial statements.

SSARS No. 1 includes guidance on the definitions of an OCBOA, examples of appropriate OCBOA financial statement titles, and illustrative reports for compilations or reviews of OCBOA financial statements. The SSARS literature does not include guidance on disclosures in compiled or reviewed financial statements.

SAS No. 62, *Special Reports*, (AU 623.09–.10) and Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, provide the only guidance for disclosures in OCBOA financial statements, stating that the financial statements should include all informative disclosures appropriate for the basis used. They also state that the basis of presentation and how it differs from GAAP should be disclosed and that financial statements should disclose at least the substance of the information that would be disclosed if GAAP were used.

Guidance for OCBOA financial statements continues to evolve. In those instances when SSARS provides guidance, this course refers to that guidance. When SSARS is silent on a situation related to OCBOA financial statements (such as disclosures), the current practice is to look to SAS No. 62 and Interpretation No. 14 for guidance and to consider that guidance in the context of compiled or reviewed financial statements. Prior to the issuance of SSARS No. 15, AR 100.04, footnote 6, referred the accountant to SAS No. 62 for guidance on evaluating the adequacy of disclosures in OCBOA financial statements. Although SSARS No. 15 eliminates that reference to SAS No. 62, that guidance is believed still helpful to accountants. Therefore, SAS No. 62 and Interpretation No. 14 are referred to throughout this lesson when applicable.

Additional guidance on OCBOA financial statements is expected to be issued in the form of a practice aid sometime in 2009. That guidance is not expected to differ from the guidance currently used in SAS No. 62.

DETERMINING WHEN TO USE AN OCBOA

The basis that a company uses to prepare its financial statements generally is determined by the needs of those who will use the financial statements. Companies reporting financial results to third parties often use GAAP for financial statements. The use of GAAP in such circumstances promotes comparability among financial statements and, because users become familiar with GAAP through experience with it, its general use increases user understanding.

There are, however, instances when a company may choose to present OCBOA financial statements; for example, when—

- a. Third-party use of the financial statements is limited to a few creditors who do not require GAAP.

- b. The operations are heavily influenced by:
 - (1) Cash flow (for example, professional corporations of doctors typically distribute all cash basis earnings through salary, bonuses, and retirement plan contributions), and
 - (2) Tax implications (for example, partners in some partnerships are primarily interested in the tax treatment of transactions because of the ultimate effect on their personal tax returns).

Cash and Modified Cash Bases

In practice, use of the pure cash basis is generally limited to entities with very simple operations. Entities that might use the pure cash basis of accounting include small brokers, small manufacturer representatives, school activity funds, fairs and other civic ventures, trusts and estates, political action committees, and political campaigns.

Use of the modified cash basis is more common. To help provide some consistency, however, it is recommended that use of this basis be limited to entities whose operations are—

- a. oriented toward cash receipts and disbursements,
- b. not significantly influenced by financing of sales or purchases, and
- c. relatively simple and do not have complexities (such as manufacturing, development, or other conversion activities or common acquisitions of property and equipment) that require significant modifications.

Tax Basis

Companies that use the tax basis of accounting are typically either profit-oriented enterprises (such as small, closely held companies) for which the cost of conversion to GAAP would exceed the benefit, or partnerships whose partnership agreements require use of the tax basis of accounting.

DEFINITIONS OF THE CASH AND TAX BASES OF ACCOUNTING

The following discussion is intended to present simple rules of thumb for identifying the basis of accounting used.

Cash or Modified Cash Basis

The cash basis of accounting, in its pure form, recognizes revenues and expenses based on the receipt and disbursement of cash. The pure cash basis treats all disbursements of cash as expenses; thus, the purchase of property and equipment or inventory is recognized as an expense rather than as an asset. Stated another way, under the pure cash basis of accounting, the balance sheet contains only cash and equity, and the income statement reflects all cash receipts as revenues and all cash disbursements as expenses.

Modification of the cash basis should have *substantial support*. A modification would usually have “substantial support” if the modification is equivalent to GAAP for the particular item and if the modifications taken together are not illogical. An example of modifications taken together that are illogical would be recording revenue on the accrual basis and recording purchases and other costs on the cash basis.

A modification of the cash basis of accounting to record depreciation on property and equipment is noted in AR 100.04, as amended, as having substantial support. If modifications to the cash basis of accounting do not have substantial support, the accountant should appropriately modify his or her report.

Examples of modifications recognized as having substantial support in practice are recording—

- a. Property and equipment purchased as assets.
- b. Accumulated depreciation.

- c. Material amounts of inventory purchased for cash as assets.
- d. Liabilities arising from the receipt of borrowed cash.
- e. Employee FICA and withholding taxes that have not been deposited with the IRS but relate to compensation paid.
- f. Accrued income taxes.

If the cash basis statement has so many modifications that it is in substance a GAAP basis statement, it should be reported on as such. The accountant should use the standard form of report, modified as appropriate because of departures from generally accepted accounting principles.

Some accountants prefer identifying cash basis financial statements with modifications as *modified cash basis* financial statements. Others prefer the term *cash basis*. Whichever term is used, the financial statements should be appropriately titled and the accountant's compilation or review report should refer to the titles used.

The modified cash basis, while widely used in the profession, is not viewed by many as the OCBOA that offers the best solution to the standards overload problems of GAAP. One reason is the difficulty of identifying which modifications of the cash basis are appropriate in the circumstances and which are departures from the cash basis. A frequently mentioned alternative to GAAP that presently has more appeal is the tax basis of accounting.

Tax Basis

Some entities maintain their accounting records on a basis identical to, or substantially identical to, that needed to file their income tax returns. When financial statements are prepared from such records, a determination of the proper description of the basis of accounting used can become a confusing issue. For example, the basis of accounting allowed by tax law could range from GAAP to the cash basis. Between these two options, tax law may also allow special accounting treatments that conform neither to GAAP nor cash basis principles.

If the basis of accounting used to file the tax return is accrual, the additional cost of preparing GAAP financial statements may be minimal. (OCBOA and GAAP disclosures are very similar.) In that set of facts and circumstances, it is normally preferable to describe and report on such financial statements as GAAP. However, this general advice is not appropriate if an agreement, e.g., a partnership agreement, specifically calls for use of the tax basis because (a) it is confusing to the users of the financial statements to refer to the statements as GAAP when they expect the tax basis (even if the two are the same) and (b) in future years, the entity may elect a tax accounting treatment that would be materially different from GAAP, resulting in a confusing accountant's report.

When the accrual basis of accounting used to file the tax return contains an unusual tax election that is not appropriate for GAAP financial statements, and the cost of converting to GAAP exceeds the benefits, the financial statements should normally be identified and reported on as tax basis. Examples of such tax elections are—

- a. Depreciation computed based on the periods used for tax reporting that result in material differences from depreciation computed on estimated useful lives.
- b. Deduction of statutory depletion.
- c. Deduction of intangible development costs on producing wells.
- d. Use of property valuations allowed for tax purposes that differ materially from historical cost (e.g., stepped-up basis).
- e. Accounting for investments in other entities at cost that would be required to be consolidated or carried on the equity basis in GAAP financial statements.
- f. Accounting for leases that meet the requirements of capital leases under SFAS No. 13 (FASB ASC 840-10-25) but are treated as operating leases for tax purposes.

USING THE DIFFERENT BASES OF ACCOUNTING

Change in Basis of Accounting

Sometimes, an entity may change its basis of accounting from that used in prior years to prepare its financial statements. For example, it may decide to change from using an other comprehensive basis of accounting, such as the cash or tax basis, to generally accepted accounting principles to prepare its statements or vice-versa. SSARS do not address how accountants should report when an entity changes its basis of accounting. Such changes are addressed, however, in SAS No. 62 (AU 623), *Special Reports*, and in an AICPA Technical Practice Aid (TIS 9030.10):

- SAS No. 62 (AU 623) states that a change in basis of accounting from GAAP to an OCBOA does not require auditors to add an explanatory paragraph to their report because of the inconsistent application of accounting principles. (Thus, it implies that a change from GAAP to an OCBOA is not a change in accounting principle.) The SAS recognizes, however, that some auditors may wish to add a paragraph highlighting the change in basis and allows them to do so.
- TIS 9030.10 states that a change from GAAP to OCBOA (or OCBOA to GAAP) is considered to be a change in accounting basis rather than an accounting change. The TPA also says that whether the financial statements for the year in which the basis is changed are presented alone or in comparison with one or more earlier years, the change in accounting basis should be disclosed in the notes to the financial statements. Further, it provides an explanatory paragraph for an audit report and states that accountants performing review or compilation engagements may also consider adding an explanatory paragraph. However, AR 100.55 prohibits the use of emphasis of matter paragraphs in compilations of financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements.

Use of Different Bases of Accounting for Financial Statements of the Same Period

Companies may request that accountants compile or review financial statements prepared using an OCBOA when the accountants have previously compiled or reviewed GAAP financial statements for the same period. For example, a regulatory agency might require that a company use the accounting basis it uses for preparing its federal income tax returns to prepare financial statements it submits to the agency, while a bank may request GAAP financial statements for the same period of time. SAS No. 62 (AU 623) states that auditors are not required to add an explanatory paragraph to their report to highlight the fact that both GAAP and OCBOA financial statements exist for the same period of time. Consequently, it is believed that accountants are not required, although they are permitted, to add an explanatory paragraph highlighting that fact in their compilation or review reports. However, AR 100.55 prohibits the use of emphasis of matter paragraphs in compilations of financial statements that omit substantially all disclosures.

SELF-STUDY QUIZ

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

16. What piece of authoritative literature provides the only guidance for disclosures in financial statements prepared using an other comprehensive basis of accounting (OCBOA)?
 - a. SSARS No. 1, *Compilation and Review of Financial Statements*.
 - b. SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*.
 - c. SAS No. 62, *Special Reports*.
 - d. The final report of the AICPA's Special Committee on Accounting Standards Overload.
17. The political campaign for state representative Marion Sawyer has very simple operations. What basis would it be likely to use to prepare its financial statements in the least complex form?
 - a. Generally accepted accounting principles (GAAP).
 - b. The pure cash basis of accounting.
 - c. The modified cash basis of accounting.
 - d. The tax basis of accounting.
18. Which of the following modifications to the cash basis would **not** be recognized as having substantial support?
 - a. Recording purchases and other costs on the cash basis, and recording revenue on the accrual basis.
 - b. Recording depreciation on property and equipment.
 - c. Recording as assets material amounts of inventory purchased for cash.
 - d. Recording withholding and employee FICA taxes that have not been deposited with the IRS but that related to compensation paid.
19. Which of the following statements is correct concerning the tax basis of accounting?
 - a. The basis of accounting allowed by tax law is simple, with few variations.
 - b. If the accrual basis is used for the tax return, the additional cost of preparing GAAP statements is always prohibitive.
 - c. If a partnership agreement calls for tax basis financial statements, it can still be appropriate to describe and report on the statements as GAAP.
 - d. If the accrual basis used for the tax return includes an unusual tax election and the cost of GAAP conversion exceeds the benefits, the statements are reported on as tax basis.
20. According to authoritative literature, does a change in basis of accounting from GAAP to an OCBOA qualify as a change in accounting principle?
 - a. Yes.
 - b. No.

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. What piece of authoritative literature provides the only guidance for disclosures in financial statements prepared using an other comprehensive basis of accounting (OCBOA)? **(Page 46)**
- a. SSARS No. 1, *Compilation and Review of Financial Statements*. [This answer is incorrect. This SSARS, as amended, includes guidance on the definitions of an OCBOA, examples of appropriate OCBOA financial statement titles, and illustrative reports for compilations or reviews of OCBOA financial statements. It does not include guidance on disclosures in compiled or reviewed financial statements.]
 - b. SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*. [This answer is incorrect. SSARS No. 15 amends SSARS No. 1. SSARS No. 15 also provides information on using an OCBOA and guidance that clarifies the accountant's responsibility with respect to fact discovered subsequent to the date of the accountant's compilation or review report.]
 - c. **SAS No. 62, *Special Reports*. [This answer is correct. SAS No. 62, *Special Reports*, and Interpretation 14 of SAS No. 62, *Evaluating the Adequacy of Disclosure and Presentation in Financial Statement Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, provide the only guidance for disclosures in OCBOA financial statements, stating that the financial statements should include all informative disclosures appropriate for the basis used.]**
 - d. The final report of the AICPA's Special Committee on Accounting Standards Overload. [This answer is incorrect. This committee was formed in 1981 to consider alternative means of providing relief from accounting standards that are not cost-effective, particularly for small, closely held businesses. The committee's report, published in 1983, concluded that issuing compiled, reviewed, or auditing financial statements on a comprehensive basis of accounting other than GAAP could provide some measure of relief.]
17. The political campaign for state representative Marion Sawyer has very simple operations. What basis would it be likely to use to prepare its financial statements in the least complex form? **(Page 47)**
- a. Generally accepted accounting principles (GAAP). [This answer is incorrect. A company is more likely to present GAAP financial statements if it reports its financial results to third parties. The use of GAAP in such circumstances promotes comparability among financial statements and, because users become familiar with GAAP through experience with it, its general use increases user understanding.]
 - b. **The pure cash basis of accounting. [This answer is correct. In practice, use of the pure cash basis of accounting is generally limited to entities with very simple operations. Entities that might use the pure cash basis of accounting include small brokers, small manufacturer representatives, school activity funds, fairs and other civic ventures, trusts and estates, political action committees, and political campaigns.]**
 - c. The modified cash basis of accounting. [This answer is incorrect. It is recommended that the use of this basis be limited to entities whose operations are (1) oriented toward cash receipts and disbursements, (2) not significantly influenced by financing of sales or purchases, and (3) relatively simple and do not have complexities that require significant modifications. While the campaign could use this basis of accounting, there is another basis that would be more appropriate.]
 - d. The tax basis of accounting. [This answer is incorrect. Companies that use the tax basis of accounting are typically either profit-oriented enterprises (such as small, closely held companies) for which the cost of conversion to GAAP would exceed the benefit, or partnerships whose partnership agreements require the use of the tax basis of accounting.]

18. Which of the following modifications to the cash basis would **not** be recognized as having substantial support? **(Page 47)**
- a. **Recording purchases and other costs on the cash basis, and recording revenue on the accrual basis. [This answer is correct. A modification would usually have “substantial support” if the modification is equivalent to GAAP for the particular item and if the modifications taken together are not illogical. An example of modifications taken together that are illogical would be recording revenue on the accrual basis and recording purchases and other costs on the cash basis.]**
 - b. Recording depreciation on property and equipment. [This answer is incorrect. A modification of the cash basis of accounting to record depreciation on property and equipment is noted in AR 100.04, as amended, as having substantial support.]
 - c. Recording as assets material amounts of inventory purchased for cash. [This answer is incorrect. In practice, this modification would be recognized as having substantial support. Another example of acceptable modifications include property and equipment purchased as assets.]
 - d. Recording withholding and employee FICA taxes that have not been deposited with the IRS but that related to compensation paid. [This answer is incorrect. This is an example of a modification to the cash basis that is recognized as having substantial support in practice. Other examples acceptable modifications include recording liabilities arising from the receipt of borrowed cash and accrued income taxes.]
19. Which of the following statements is correct concerning the tax basis of accounting? **(Page 48)**
- a. The basis of accounting allowed by tax law is simple, with few variations. [This answer is incorrect. When financial statements are prepared from accounting records used to file income tax returns, a determination of the proper description of the basis of accounting used can become a confusing issue. For example, the basis of accounting allowed by tax law could range from GAAP to the cash basis. Between these two options, tax law may also allow special accounting treatments that conform neither to GAAP nor cash basis principles.]
 - b. If the accrual basis is used for the tax return, the additional cost of preparing GAAP statements is always prohibitive. [This answer is incorrect. If the basis of accounting used to file the tax return is accrual, the additional cost of preparing GAAP financial statements may be minimal. In that set of facts and circumstances, it is normally preferable to describe and report on such financial statements as GAAP.]
 - c. If a partnership agreement calls for tax basis financial statements, it can still be appropriate to describe and report on the statements as GAAP. [This answer is incorrect. It is not appropriate to report on financial statements as GAAP when the accrual method was used to file the tax return if a partnership agreement specifically calls for use of the tax basis because (1) it is confusing to the users of the financial statements to refer to the statements as GAAP when they expect the tax basis (even if the two are the same) and (2) in future years, the entity may elect at ax accounting treatment that would be materially different from GAAP, resulting in a confusing accountant's report.]
 - d. **If the accrual basis used for the tax return includes an unusual tax election and the cost of GAAP conversion exceeds the benefits, the statements are reported on as tax basis. [This answer is correct. When the accrual basis of accounting used to file the tax return contains an unusual tax election that is not appropriate for GAAP financial statements and the cost of converting to GAAP exceeds the benefits, the financial statements should normally be identified and reported on as tax basis.]**
20. According to authoritative literature, does a change in basis of accounting from GAAP to an OCBOA qualify as a change in accounting principle? **(Page 49)**
- a. Yes. [This answer is incorrect. SAS No. 62 states that a change in basis of accounting from GAAP to an OCBOA does not require auditors to add an explanatory paragraph to their report because of the inconsistent application of accounting principles.]
 - b. **No. [This answer is correct. Because SAS No. 62 does not require auditors to add an explanatory paragraph to their report about the inconsistent application of accounting principles when changing from GAAP to an OCBOA, it implies that this change is not a change in accounting principle. TIS 9030.10 states that a change from GAAP to an OCBOA (or OCBOA to GAAP) is considered to be a change in accounting basis rather than an accounting change.]**

THE USE OF STATEMENT TITLES IN CASH AND TAX BASIS FINANCIAL STATEMENTS

Since cash basis and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP, they should not be titled or otherwise referred to as "Balance Sheet," "Income Statement," etc., without appropriate modification. SSARS No. 1 (AR 100.04) illustrates the following statement titles:

- Balance sheet—cash basis
- Statement of assets and liabilities arising from cash transactions
- Statement of assets, liabilities, and stockholders' equity—income tax basis
- Statement of revenue collected and expenses paid
- Statement of revenue and expenses—income tax basis
- Statement of operations—income tax basis

The understandability of OCBOA statements is believed to be enhanced by the consistent use of uniform statement titles. Thus, the titles used in this lesson are the same for cash basis and tax basis financial statements except for the modifier "cash basis" or "tax basis." Exhibit 2-1 summarizes the course's recommendations for OCBOA financial statement titles.

Strict adherence to proper titles is not always necessary for management-use-only financial statements because of the restricted nature of the financial statements and the fact that management is already aware of the limitations of such statements. Therefore, accountants may use any reasonable titles that management understands.

Exhibit 2-1

Recommended OCBOA Statement Titles^{a, b}

GAAP	Cash ^c	Tax
1. Balance Sheet	1. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis	1. Statement of Assets, Liabilities, and Equity (Capital)—Income Tax Basis
2. Statement of Income	2. Statement of Revenues and Expenses—Cash Basis	2. Statement of Revenues and Expenses—Income Tax Basis
3. Statement of Income and Retained Earnings	3. Statement of Revenues, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Cash Basis	3. Statement of Revenues, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Income Tax Basis
4. Statement of Retained Earnings	4. Statement of Retained Earnings—Cash Basis	4. Statement of Retained Earnings—Income Tax Basis
5. Statement of Changes in Stockholders' Equity	5. Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Cash Basis	5. Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Income Tax Basis
6. Statement of Cash Flows	6. Statement of Cash Flows—Cash Basis ^d	6. Statement of Cash Flows—Income Tax Basis ^d

Notes:

- a These statement titles are recommended by the course. They are acceptable under SAS No. 62 (AU 623), *Special Reports*, and SSARS No. 1, as amended by SSARS No. 15 (AR 100.04). Other equally suitable titles can be derived from the suggested titles.
- b These statement titles may not be appropriate for governmental or not-for-profit organizations. See relevant AICPA Audit and Accounting Guides.
- c The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a balance sheet. Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is ordinarily presented.
- d Although a statement of cash flows for OCBOA financial statements is not required, if it is presented, "Statement of Cash Flows—Cash (or Income Tax) Basis" is believed to be the appropriate title.

* * *

THE STATEMENT OF CASH FLOWS

Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, notes that a statement of cash flows is not required in OCBOA financial statements. In practice, many entities present statements of cash flows in OCBOA presentations anyway. In such cases, the statement of cash flows should be treated and reported on as a basic financial statement—not as supplemental information.

THE STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

APB Opinion No. 12, *Omnibus Opinion—1967* (FASB ASC 505-10-50-2), requires disclosure of changes in components of stockholders' equity other than retained earnings when both financial position and results of operations are presented. Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, requires OCBOA financial statements with items requiring disclosure under GAAP to either follow the GAAP disclosure requirements for those items or provide information that communicates the substance of those GAAP requirements. Accordingly, it is believed that OCBOA financial statements that present both financial position and results of operations should disclose changes in the components of stockholders' equity.

THE STATEMENT OF RETAINED EARNINGS

Under GAAP, changes in retained earnings are required to be disclosed whenever results of operations are presented. Based on Interpretation 14 of SAS No. 62 (AU 9623.90–.95), *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, and because it is believed that GAAP when relevant should be applied to OCBOA financial statements, the OCBOA statements also should disclose the changes in retained earnings whenever results of operations are presented. Changes in retained earnings can generally be disclosed by one of the following methods:

- a. Presentation in the stockholders' equity section of the statement of assets, liabilities, and equity.
- b. A combined statement of income and retained earnings.
- c. A separate statement of retained earnings.
- d. Notes to the financial statements.

REPORTING COMPREHENSIVE INCOME

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10-45-3), requires comprehensive income and its components to be reported when an entity presents a full set of financial statements that report financial position,

results of operations, and cash flows. If a statement of cash flows is not presented, reporting comprehensive income is not believed to be required. As a practical matter, however, even if an entity presents a full set of OCBOA financial statements that includes a statement of cash flows, the requirement to disclose comprehensive income typically is not believed applicable. Comprehensive income includes net income and certain other changes in assets and liabilities that are not reported in income, but as a separate component of stockholders' equity, such as—

- Unrealized gains and losses on available-for-sale marketable securities.
- Foreign currency translation adjustments and gains and losses from certain foreign currency transactions.
- Changes in the market value of certain futures contracts that qualify as a hedge.
- Gains and losses, prior service costs or credits, and transition assets or obligations associated with pension or other postretirement benefits.

SELF-STUDY QUIZ

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

21. Mac-2 presents its financial statements using the pure cash method of accounting. What title should the company use for its balance sheet?
- a. Balance Sheet.
 - b. Balance Sheet—Cash Basis.
 - c. Statement of Cash Receipts and Disbursements.
 - d. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis.
22. Should changes in stockholders' equity be disclosed in OCBOA financial statements?
- a. Yes.
 - b. No.
23. Under what circumstances should OCBOA financial statements disclose changes in retained earnings?
- a. When the entity presents a full set of financial statements reporting financial position, results of operations, and cash flows.
 - b. When both financial position and results of operations are presented.
 - c. Whenever results of operations are presented.
 - d. This disclosure would not be required in OCBOA statements.

SELF-STUDY ANSWERS

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

21. Mac-2 presents its financial statements using the pure cash method of accounting. What title should the company use for its balance sheet? **(Page 54)**
- a. Balance Sheet. [This answer is incorrect. This title should only be used for GAAP financial statements. Since cash basis statements do not purport to present financial position and results of operations in accordance with GAAP, they should not be titles or otherwise referred to as, "Balance Sheet," "Income Statement," etc., without appropriate modification.]
 - b. Balance Sheet—Cash Basis. [This answer is incorrect. This illustrative financial statement title is found in SSARS No. 1, as amended, and would be appropriate for cash basis financial statements. However, there is another answer choice that would better fit the pure cash basis statements described in this scenario.]
 - c. **Statement of Cash Receipts and Disbursements.** [This answer is correct. The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a balance sheet. Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is ordinarily presented.]
 - d. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis. [This answer is incorrect. This financial statement title is recommended by this course for use on a balance sheet in cash basis financial statements; however, there is another answer choices that would better fit the pure cash basis statements described in this scenario.]
22. Should changes in stockholders' equity be disclosed in OCBOA financial statements? **(Page 55)**
- a. **Yes.** [This answer is correct. APB Opinion No. 12 requires disclosure of changes in stockholders' equity other than retained earnings when both financial position and results of operations are presented. Interpretation 14 of SAS No. 62 requires OCBOA financial statements with items requiring disclosure under GAAP to either follow the GAAP disclosure requirements for those items or provide information that communicates the substance of those GAAP requirements.]
 - b. No. [This answer is incorrect. This course believes that OCBOA financial statements that present both financial position and results of operations should disclose changes in the components of stockholders' equity.]
23. Under what circumstances should OCBOA financial statements disclose changes in retained earnings? **(Page 55)**
- a. When the entity presents a full set of financial statements reporting financial position, results of operations, and cash flows. [This answer is incorrect. SFAS No. 130 requires comprehensive income and its components, not changes in retained earnings, be reported when an entity presents a full set of financial statements that report financial position, results of operations, and cash flows. However, typically, this requirement will not be applicable to OCBOA financial statements.]
 - b. When both financial position and results of operations are presented. [This answer is incorrect. Under these circumstances, it is believed that the OCBOA financial statements need to disclose stock holders' equity. These specific circumstances are not described for disclosure of changes in retained earnings.]
 - c. **Whenever results of operations are presented.** [This answer is correct. Statements of income and retained earnings are designed to present results of operations. Based on Interpretation 14 of SAS No. 62 and because it is believed that GAAP when relevant should be applied to OCBOA financial statements, OCBOA statements should disclose the changes in retained earnings whenever results of operations are presented.]
 - d. This disclosure would not be required in OCBOA statements. [This answer is incorrect. A statement of cash flows is not required in OCBOA statements; though, in practice, many entities present one. There are certain circumstances in which changes in retained earnings should be disclosed in OCBOA statements.]

PRESENTATION CONSIDERATIONS FOR OCBOA FINANCIAL STATEMENTS

Captions within OCBOA Financial Statements

Some practitioners do not use “net income,” “retained earnings,” etc., as captions within OCBOA financial statements. Instead, captions such as “excess of revenues collected over expenses paid,” “accumulated excess revenues over expenses paid,” etc., are used. SSARS No. 1, as amended (AR 100.04), requires OCBOA financial statement *titles* to differ from GAAP financial statement titles. However, AR 100.04, as amended, is silent as to whether different *captions* are required within financial statements. As such, there is no requirement to modify GAAP captions for inclusion in an OCBOA presentation. Accountants may modify captions if they desire, however. Technical Practice Aid Section 1500, *Financial Statements Prepared Under an Other Comprehensive Basis of Accounting (OCBOA)*, provides the following examples of modified captions (TIS 1500.04):

Cash Basis

- Excess of Revenue Collected over Expenses Paid
- Excess of Expenses Paid over Revenue Collected
- Accumulated Excess of Revenue over Expenses Paid

Income Tax Basis

- Retained Earnings—Income Tax Basis
- Net Income—Tax Basis

Nontaxable Revenues and Nondeductible Expenses in Tax Basis Financial Statements

Certain revenues and expenses are not recognized under income tax laws. An example of such an item would be interest income on state and local government obligations. Many practitioners have questioned how to present these nontaxable revenues and nondeductible expenses when preparing tax basis financial statements. Although there is no authoritative guidance on this issue, any of the following alternatives is believed appropriate:

- Present the nontaxable revenues and nondeductible expenses as separate line items on the financial statements (for example, a financial statement line item that reads, “tax-free interest income on state and local government obligations”).
- Present the nontaxable revenues and nondeductible expenses as deductions from or additions to net income to derive taxable income.
- Include the nontaxable revenues and nondeductible expenses with regular income and expense categories on the financial statements and disclose the nontaxable revenues and nondeductible expenses in the notes to the financial statements.

DISCLOSURE OF BASIS OF ACCOUNTING IN OCBOA FINANCIAL STATEMENTS

SAS No. 62 states that, when reporting on OCBOA financial statements, the accountant should consider whether the financial statements, which include the notes to the financial statements, include all informative disclosures that are appropriate for the basis of accounting used. The accountant should base the report on the accountant's judgment as to whether the financial statements, including the notes, are informative of matters that may affect their use, understanding, and interpretation.

SSARS No. 1, AR 100.20, states that when the accountant reports on compiled financial statements that omit substantially all disclosures, he or she should disclose the basis of accounting in the compilation report if it is not

disclosed in the statements. AR 100.22, as amended, goes on to note that when financial statements that the accountant has compiled omit substantially all disclosures with no reference to the basis of accounting but are otherwise in conformity with an OCBOA, the accountant's compilation report should be modified by adding a sentence such as the following to the first paragraph of the report:

The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

Note that this illustrative modifying sentence states the basis of presentation and states the basis is different from GAAP, but does not *describe* how the basis differs from GAAP.

Interpretation No. 12 of SSARS No. 1 is superseded by SSARS No. 15. Interpretation No. 12 specifically noted that ordinarily the notes to OCBOA financial statements should state the basis on which the financial statements are presented and describe how that basis differs from GAAP. Most accountants will likely consider it necessary to include such a description in the notes to the financial statements in order for them to be informative. Therefore, the basis of accounting could be disclosed as follows:

- *Compiled Financial Statements that Omit Substantially All Disclosures.* The accountant's report would be modified as discussed above.
- *Compiled Financial Statements that Include Disclosures.* The financial statements would include a note that discloses the basis of presentation and describes how the basis differs from GAAP.
- *Reviewed Financial Statements.* The financial statements would include a note that discloses the basis of presentation and describes how the basis differs from GAAP. Otherwise, the review report must be modified for an OCBOA disclosure exception.

Nondisclosure of the basis of accounting in compiled management-use-only financial statements is addressed in the engagement letter by the following statement: Material departures from GAAP or OCBOA may exist and the effects of those departures, if any, on the financial statements may not be disclosed.

OTHER DISCLOSURES THAT APPLY TO OCBOA PRESENTATIONS

Authoritative Literature

Guidance on disclosures in OCBOA financial statements is found in paragraphs 9 and 10 of SAS No. 62 (AU 623.09–.10) and in Interpretation No. 14 of SAS No. 62.

Paragraph 9 of SAS No. 62 establishes the overriding criterion that OCBOA financial statements should be “informative of matters that may affect their use, understanding, and interpretation.” Paragraph 10 expands on that by stating that—

- a. The financial statements should include a summary of significant accounting policies that discusses the basis of the presentation and describes how the basis differs from GAAP.
- b. When financial statements contain items the same as, or similar to, those in financial statements prepared in conformity with GAAP, “similar informative disclosures are appropriate.” (To illustrate how to apply that statement, paragraph 10 states that the disclosures for depreciation, long-term debt, and owners' equity should be comparable to those in financial statements prepared in conformity with GAAP.)
- c. The accountant also should consider disclosing matters not specifically identified on the face of the statements, such as (1) related party transactions, (2) restrictions on assets and owners' equity, (3) subsequent events, and (4) uncertainties. In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (FASB ASC 855). The guidance on subsequent events is moved to the accounting standards from the auditing standards (former AU 560). In addition, disclosure of the date through which an entity has

evaluated subsequent events and the basis for that date (i.e., whether that date represents the date the financial statements were issued or were available to be issued) is required. TIS 1500.07 clarifies that this disclosure requirement is also applicable to OCBOA financial statements. The guidance is effective for interim and annual periods ending after June 15, 2009.

Interpretation No. 14 of SAS No. 62, *Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)*, provides that—

- a. The discussion of the basis of presentation required by paragraph 10 of SAS No. 62 may be brief and only needs to describe the primary differences from GAAP. Quantifying differences is not required.
- b. If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure.
- c. If GAAP sets forth requirements that apply to the presentation of financial statements, OCBOA financial statements should either comply with those requirements or provide information that communicates the substance of those requirements.
- d. A statement of cash flows is not required in OCBOA presentations. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement should either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.
- e. If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered.

Financial Statement Items for Which GAAP Would Require Disclosure

Based on guidance in Interpretation 14, if OCBOA financial statements contain amounts for which GAAP would require disclosure, it is believed that compiled or reviewed statements should either provide the relevant disclosure that would be required in a GAAP presentation or provide information that communicates the substance of that disclosure. Applying that guidance involves (a) identifying financial statement items for which GAAP would require disclosure, (b) deciding whether the GAAP disclosure requirement is relevant to the basis used, and (c) if the requirement is relevant, deciding whether to follow that requirement or to meet the objective of that requirement through other means. Generally, that decision can be made based on efficiency.

Summary of Significant Accounting Policies

The notes to the financial statements should include a summary of accounting policies that describes the following:

- a. *Basis of Accounting Used to Prepare the Financial Statements.* The description only needs to name the basis; for example:
 - (1) Cash basis—"the basis of cash receipts and disbursements."
 - (2) Modified cash basis—"the basis of cash receipts and disbursements, with some assets and liabilities recorded" or "the modified cash basis."
 - (3) Income tax basis—"the basis of accounting used for income tax reporting" or "the accrual basis of accounting used for income tax purposes."
- b. *Primary Differences between the Basis of Accounting Used and GAAP.* Generally, the primary differences are those that individually have a material effect on the financial statements. Immaterial differences need not be mentioned. Differences can be identified by looking for items in the statement of financial position that would be accounted for differently under GAAP. SAS No. 62 states that quantifying the effects of differences in the description of the basis is unnecessary. As a practical matter, accountants normally can

quickly estimate whether the effect of a difference is likely to be material. If unsure, however, disclosing the difference is recommended.

Sometimes there may be no material differences between GAAP and the basis used. That may occur, for example, when an entity uses the income tax basis of accounting solely to comply with a partnership agreement or continues to use a modified cash basis that was first used when the differences were material. In that situation, disclosing that there are no material differences is recommended.

Generally, APB Opinion No. 22, *Disclosure of Accounting Policies* (FASB ASC 235-10-50-1), requires an entity to disclose in its GAAP financial statements all of the significant accounting policies used to prepare the statements. In particular, it requires an entity to disclose any of its accounting policies that involve a selection from existing acceptable alternatives, industry peculiarities, and unusual or innovative applications of accounting principles. Other pronouncements also require disclosure of accounting policies, such as the requirement of APB Opinion No. 12, *Omnibus Opinion—1967* (FASB ASC 360-10-50-1), to disclose depreciation methods.

It is believed that the preceding guidance should be followed in presentations prepared using the cash, modified cash, or income tax basis of accounting. Therefore, in addition to the description of the basis, the statements should disclose the accounting policies significant to the presentation.

Typically, the description of the basis can be provided together with the description of other significant accounting policies. Starting the summary of significant accounting policies with the description of the basis is recommended. If only a few accounting policies are significant, the policies may be described in a single note. If there are too many significant policies to describe in a single note, the policies may be described individually. Often, accounting policies can be described sufficiently through the description of the major differences from GAAP.

Other Information That GAAP Would Require Disclosing

GAAP requires entities to disclose a variety of information that does not relate directly to items reported in GAAP financial statements, such as going concern considerations, related party transactions for which amounts are not recorded, and risks and uncertainties. The need for similar disclosures in cash, modified cash, and income tax basis financial statements can be evaluated by following an approach similar to the one discussed in the “Financial Statement Items for Which GAAP Would Require Disclosure” paragraph. In October 2008, the FASB issued an exposure draft of a proposed SFAS, *Going Concern*.

Risks and Uncertainties

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275-10-50-1), offers a variety of disclosure considerations that can be used to illustrate how to apply the approach discussed previously. The financial statements must provide information about the nature of operations, the general use of estimates, certain significant estimates, and significant concentrations of risk.

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

Some items that require estimates in GAAP financial statements, do not require estimates in income tax basis statements. Although the requirement does not apply to those amounts, if a material loss is likely on realization of an asset recorded in the financial statements or on settlement of a recorded liability, disclosure of that likelihood may be necessary to keep the statements from being misleading, similar to the discussion in paragraph 11 of SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450-20-50-9). (In June 2008, the FASB issued an exposure draft, *Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R)*, that would expand disclosures about certain loss contingencies and make related amendments to SOP 94-6 (FASB ASC 275-10). Because of feedback from constituents, the Board now plans to redeliberate the exposure draft. The effective date has not been finalized but will be no earlier than fiscal years ending after December 15, 2009. Practitioners can monitor the status of the exposure draft at www.fasb.org. Future editions of this course will provide updates on this exposure draft.)

- d. *Significant Concentrations of Risk.* This requirement is intended to notify financial statement readers of the reasonable possibility that the loss of a significant customer, supplier, or other concentration will have a severe impact on the entity. The information is believed relevant to all cash, modified cash, and income tax basis presentations. For example, the reasonable possibility that the loss of the source of a significant portion of the recorded cash receipts will have a severe impact is relevant to the readers of a cash basis presentation. As a practical matter, management normally knows whether there are concentrations with such a risk, and the necessary information can be gathered through inquiry. In addition, there is no requirement to quantify the effect. Instead, the significance of the concentration can be conveyed using estimated percentages, such as “approximately 60%,” a ratio, such as “approximately half,” or adjectives, such as “most.”

MAKING CASH TO ACCRUAL CONVERSIONS

Some business entities prepare financial statements using GAAP but report for income tax purposes on the cash basis. For those entities, it may be helpful to present as supplemental information to the financial statements, a conversion of pretax income to taxable income. The accountant's compilation or review report on the financial statements should include the supplementary conversion information.

SELF-STUDY QUIZ

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

24. Which of the following is a modified caption that could be used in cash basis financial statements?
- a. Excess of Revenue Collected over Expenses Paid.
 - b. Retained Earnings—Income Tax Basis.
 - c. Net Income.
 - d. Retained Earnings.
25. How would the basis of accounting be disclosed in compiled OCBOA financial statements that omit substantially all disclosures?
- a. By stating in the engagement letter that material departures from GAAP or OCBOA may exist and that their effects may not be disclosed.
 - b. By adding a note to the financial statements that discloses the basis of presentation and how it differs from GAAP.
 - c. By adding a sentence to the accountant's report that states the basis of presentation and that it is different from GAAP.
26. SAS No. 62 states that OCBOA financial statements should be "informative of matters that may affect their use, understanding, and interpretation." As part of fulfilling this objective, accountants should consider disclosing certain matters that are not specifically identified on the face of the statements. Which of the following is one of those matters?
- a. Restrictions on owners' equity and assets.
 - b. Significant accounting policies.
 - c. Similar disclosures as those required for GAAP.
 - d. The basis of accounting.
27. A variety of disclosure considerations are found in SOP 94.6, *Disclosure of Certain Significant Risks and Uncertainties*. Providing information about which of the following is relevant to all cash, modified cash, and income tax basis presentations?
- a. The nature of operations.
 - b. The general use of estimates.
 - c. The use of certain significant estimates.
28. Which of the following statements best describes the disclosure of risks and uncertainties under SOP 94-6?
- a. Providing information on the nature of operations is very time consuming.
 - b. All items that require estimates in GAAP financial statements also require estimates in tax basis statements.
 - c. Adjectives or percentages can be used when providing information on significant concentrations of risk.

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.)**

24. Which of the following is a modified caption that could be used in cash basis financial statements? **(Page 59)**
- Excess of Revenue Collected over Expenses Paid. [This answer is correct. Technical Practice Aid Section 1500 provides the following examples of modified captions for the cash basis of accounting: (1) Excess of Revenue Collected over Expenses Paid, (2) Excess of Expenses Paid over Revenue Collected, and (3) Accumulated Excess of Revenue over Expenses Paid.]**
 - Retained Earnings—Income Tax Basis. [This answer is incorrect. This caption, found in Technical Practice Aid Section 1500, has been modified for the income tax basis of accounting, not the cash basis. Another example of a caption modified for the tax basis is “Net Income—Tax Basis.”]
 - Net Income. [This answer is incorrect. This is a GAAP caption, not a caption modified for an OCBOA. However, this caption could be used in OCBOA statements, as authoritative literature does not require captions for OCBOAs to differ from those for GAAP.]
 - Retained Earnings. [This answer is incorrect. This caption has not been modified for an OCBOA. It is a GAAP caption. However, this caption could still be included in an entity's OCBOA financial statements. Authoritative literature requires financial statement titles to change for OCBOA statements, but that same requirement is not made for financial statement captions.]
25. How would the basis of accounting be disclosed in compiled OCBOA financial statements that omit substantially all disclosures? **(Page 60)**
- By stating in the engagement letter that material departures from GAAP or OCBOA may exist and that their effects may not be disclosed. [This answer is incorrect. This would be done in compiled management-use-only financial statements.]
 - By adding a note to the financial statements that discloses the basis of presentation and how it differs from GAAP. [This answer is incorrect. This type of disclosure would be appropriate for compiled financial statements that include disclosures and for reviewed financial statements.]
 - By adding a sentence to the accountant's report that states the basis of presentation and that it is different from GAAP. [This answer is correct. This modifying sentence is illustrated in SSARS No. 1, AR 100.22. This sentence does not need to describe how the basis differs from GAAP.]**
26. SAS No. 62 states that OCBOA financial statements should be “informative of matters that may affect their use, understanding, and interpretation.” As part of fulfilling this objective, accountants should consider disclosing certain matters that are not specifically identified on the face of the statements. Which of the following is one of those matters? **(Page 60)**
- Restrictions on owners' equity and assets. [This answer is correct. This is an example of a matter not specifically identified on the face of the financial statements that the accountant should consider disclosing. Other such matters include related party transactions, subsequent events, and uncertainties.]**
 - Significant accounting policies. [This answer is incorrect. According to SAS No. 62, the financial statements should include a summary of significant accounting policies; however, this is not one of the matters that is not specifically identified on the face of the statements.]
 - Similar disclosures as those required for GAAP. [This answer is incorrect. When financial statements contain items the same as, or similar to, those in financial statements prepared in conformity with GAAP, “similar informative disclosures are appropriate,” according to SAS No. 62. However, this is not one of the matters that is not specifically identified on the face of the financial statements.]
 - The basis of accounting. [This answer is incorrect. The basis of accounting and how it differs from GAAP should be discussed in the summary of significant accounting policies; however, this is not one of the matters not specifically identified on the face of the financial statements.]

27. A variety of disclosure considerations are found in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Providing information about which of the following is relevant to all cash, modified cash, and income tax basis presentations? **(Page 62)**
- a. **The nature of operations.** [This answer is correct. This disclosure provides key operating information to help the financial statement reader better understand the operations. It is believed relevant to all cash, modified cash, and income tax basis presentations.]
 - b. The general use of estimates. [This answer is incorrect. Providing this information would only be useful in presentations prepared on the modified cash or the income tax basis. It would not be useful for the pure cash basis.]
 - c. The use of certain significant estimates. [This answer is incorrect. Providing this information is designed to alert financial statement readers to the reasonable possibility that an estimated amount in the current year's statements will change with a material effect on next year's statements. It is believed relevant only to modified cash and tax basis statements that have estimates.]
28. Which of the following statements best describes the disclosure of risks and uncertainties under SOP 94-6? **(Page 62)**
- a. Providing information on the nature of operations is very time consuming. [This answer is incorrect. Providing information on the nature of operations typically takes little time and requires few changes in subsequent financial statements.]
 - b. All items that require estimates in GAAP financial statements also require estimates in tax basis statements. [This answer is incorrect. Some items that require estimates in GAAP financial statements do not require estimates in income tax basis statements. Although the requirement does not apply to those amounts, if a material loss is likely on realization of an asset recorded in the financial statements or on settlement of a recorded liability, disclosure of that likelihood may be necessary to keep the statements from being misleading.]
 - c. **Adjectives or percentages can be used when providing information on significant concentrations of risk.** [This answer is correct. There is no requirement to quantify the effect of significant concentrations of risk. Instead, the significance of the concentration can be conveyed using estimated percentages, such as "approximately 60%"; a ratio, such as "approximately half"; or adjectives, such as "most."]

EXAMINATION FOR CPE CREDIT**Lesson 2 (CARTG091)**

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.

16. List all of the following that qualify as an other comprehensive basis of accounting (OCBOA) under SSARS No. 1 (as amended).
- i. Generally accepted accounting principles (GAAP).
 - ii. A basis of accounting the entity uses to file its income tax return for the period that is covered by the financial statements.
 - iii. The cash basis of accounting and modifications of the cash basis that have substantial support.
 - iv. A basis of accounting the entity uses to comply with financial reporting provisions or requirements of a governmental regulatory agency to whose jurisdiction the entity is subject.
- a. i.
- b. ii. and iii.
- c. ii., iii., and iv.
- d. i., ii., iii., and iv.
17. Which of the following entities would be most likely to use the tax basis of accounting?
- a. A partnership.
 - b. A school activity fund.
 - c. A large corporation.
 - d. A publicly traded company.
18. Which of the following statements best describes the cash basis of accounting?
- a. In its pure basis, the income statement reflects cash disbursements as revenues and cash receipts as expenses.
 - b. In its pure basis, purchasing property and equipment or inventory would be recognized as an expense, not an asset.
 - c. The modified cash basis is considered the best solution to the standards overload problems associated with GAAP.
 - d. Do not select this answer choice.
19. List all of the following that would be considered unusual tax elections not appropriate for GAAP financial statements for which the cost of converting to GAAP would exceed the benefit.
- i. Deducting statutory depletion
 - ii. Accounting for accumulated depreciation
 - iii. Deducting intangible development costs on producing wells
 - iv. Using property valuations allowed for tax purposes that materially differ from historical cost
 - v. Accounting for property and equipment purchased as assets
 - vi. Accounting for investments in other entities at the cost that would be required to be carried on the equity basis or consolidated in GAAP financial statements

- a. ii. and v.
 - b. iii., iv., and vi.
 - c. i., iii., iv., and vi.
 - d. i., ii., iii., iv., v., and vi.
20. If a company requests an accountant to compile or review financial statements prepared using an OCBOA when GAAP financial statements for the same period have been previously compiled or reviewed, how is the report affected?
- a. Guidance requires that an explanatory paragraph be added to the report highlighting that both GAAP and OCBOA statements exist in the same period.
 - b. Accountants are allowed, but not required, to add an explanatory paragraph to their compilation or review report to describe these circumstances.
 - c. There is no effect on the report because emphasis of matter paragraphs are prohibited under these circumstances.
 - d. There is no effect on the report because having two sets of financial statements for the same period is prohibited.
21. Separate the following financial statement titles into those appropriate for GAAP financial statements and those appropriate for OCBOA financial statements.

<u>Type of Financial Statements</u>	<u>Recommended Financial Statement Titles</u>
1. GAAP financial statements	i. Statement of Income and Retained Earnings
2. OCBOA financial statements	ii. Statement of Assets, Liabilities, and Equity (Capital)—Income Tax Basis
	iii. Statement of Changes in Stockholders' Equity
	iv. Statement of Cash Flows
	v. Statement of Revenues, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Cash Basis
	vi. Statement of Operations—Income Tax Basis
	vii. Statement of Assets and Liabilities Arising from Cash Transactions
a. 1.—iv., v., and vii.; 2.—i., ii., iii., and vi.	
b. 1.—ii. and vi.; 2.—i., iii., iv., v., and vii.	
c. 1.—i., iii., iv., and vii.; 2.—ii., v., and vi.	
d. 1.—i., iii., and iv.; 2.—ii., v., vi., and vii.	

22. According to Interpretation 14 of SAS No. 62, how should the statement of cash flows be dealt with in OCBOA financial statements?
- a. A statement of cash flows is required to be presented in OCBOA financial statements.
 - b. A statement of cash flows is prohibited from being presented in OCBOA financial statements.
 - c. A statement of cash flows is allowed, but not required, in OCBOA financial statements.
 - d. A statement of cash flows in OCBOA financial statements is treated as supplemental information.
23. Typically, should an entity using an OCBOA report comprehensive income and its components?
- a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
24. Which of the following methods could be used to present nontaxable revenues and nondeductible expenses in tax basis financial statements?
- a. Present all such revenues and expenses as a single, cumulative line item on the financial statements.
 - b. Present these amounts as deductions from or additions to comprehensive income.
 - c. Include these amounts with regular income and expense categories and disclose them in the notes.
 - d. No special method is needed to present revenues and expenses in tax basis financial statements as they are recognized under income tax laws.
25. Molly, an accountant, is engaged to report on OCBOA financial statements. The statements include a note disclosing the basis of presentation and describing how that basis is different from GAAP. Based on this method of disclosing the basis of accounting, what type of financial statements is Molly reporting on?
- a. Compiled financial statements that omit substantially all disclosures.
 - b. Compiled financial statements that include disclosures.
 - c. Compiled management-use-only financial statements.
 - d. Do not select this answer choice.
26. Which of the following is required by Interpretation No. 14 of SAS No. 62?
- a. The discussion of the basis of presentation required by SAS No. 62 should quantify all the differences from GAAP.
 - b. A statement of cash flows is required in all OCBOA financial statement presentations.
 - c. If GAAP requires disclosure for amounts contained in the OCBOA statements, that disclosure is not required to be made.
 - d. If GAAP requires disclosure of other matters, making the disclosure or communicating that information should be considered.

27. Which of the following best describes the summary of significant accounting policies that is included in OCBOA financial statements?
- a. A description of the basis of accounting that names the basis should be included.
 - b. If there are no material differences between GAAP and the OCBOA, nothing needs to be disclosed.
 - c. All differences between the OCBOA and GAAP must be disclosed, including immaterial differences.
 - d. The effects of all differences between the OCBOA and GAAP must be quantified and disclosed.
28. What type of entity could find it helpful to present a conversion of pretax income to taxable income?
- a. Entities that prepare their financial statements using GAAP, but report on the cash basis for income tax purposes.
 - b. Entities that prepare their financial statements using GAAP, but report on the tax basis for income tax purposes.
 - c. All entities that prepare their statements on the cash or modified cash basis of accounting.
 - d. All entities that prepare their statements on the income tax basis of accounting.

Lesson 3: Prescribed Forms

INTRODUCTION

One of the major complications of prescribed form engagements has been the requirement in SSARS No. 1 (AR 100.56–.58) that the accountant's report disclose all material measurement principles not in conformity with GAAP. In December 1981, the ARSC issued SSARS No. 3 (AR 300), *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*. SSARS No. 3 amends SSARS Nos. 1 (AR 100) and 2 (AR 200) to provide for an alternative form of standard compilation report when the prescribed form or related instructions call for departures from GAAP. Such GAAP departures include specifying a measurement principle not in conformity with GAAP, or failing to request the disclosures required by GAAP. The alternative report form is founded on the presumption that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted it. That is, there is no need for that body to be advised of departures from GAAP required by the prescribed form or related instructions. Based on this presumption, the alternative form of report does not enumerate GAAP departures *required by the form*. In the following paragraphs, the provisions of SSARS No. 3 are reviewed and questions concerning its application in practice are answered.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the important provisions of SSARS No. 3 related to prescribed form engagements, and determine when SSARS No. 3 is applicable.
- Assess issues that may occur when SSARS No. 3 is applied in practice.

SSARS NO. 3

Definitions

Any *standard preprinted* form designed or adopted by the body to which it is to be submitted is a prescribed form. Examples include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. However, "sale or trading of securities" refers to securities issued, or to be issued, by the entity submitting the prescribed form, not to a regulatory body concerned with the sale or trading of securities.

A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form. For instance, a reporting package designed by a company for use in gathering financial statements for subsidiaries, divisions, store locations, etc., is not a prescribed form for purposes of SSARS No. 3 (AR 300). The terms *financial statement* and *nonissuer* are the same as defined in SSARS No. 1 (AR 100.04), as amended.

The Alternative Form of Standard Compilation Report

According to SSARS No. 3 (AR 300), the following alternative form of *compilation* report is appropriate when the financial statements are included in a prescribed form that calls for a departure from GAAP.

I (We) have compiled the (identification of financial statements, including period covered and name of entity) included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by (name of body) information that is the representation of management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of (name of body), which differ from generally accepted accounting principles.

Accordingly, these financial statements are not designed for those who are not informed about such differences.

Note that the first two paragraphs are similar to the standard compilation report of SSARS No. 1 (AR 100). The main differences are the references to—

- a. the prescribed form, and
- b. the body that prescribed the form.

The third paragraph indicates that the basis of accounting and disclosures required by the form are different from GAAP and cautions the reader about the limits of the financial statements. The cautionary language is similar to report language used for compiled financial statements that omit substantially all disclosures.

Departures from GAAP or from the Prescribed Form

The accountant is concerned with three types of departures in an engagement to compile financial statements to be included in a prescribed form:

- a. *Departures from GAAP Required by the Prescribed Form.* This type of departure does not require disclosure in the SSARS No. 3 (AR 300) alternative form of report.
- b. *Departures from GAAP Not Required by the Prescribed Form.* Such departures must be disclosed following the guidance of SSARS No. 1 (AR 100.56–.58).
- c. *Departures from the Requirements of the Prescribed Form.* These departures also require disclosure following the guidance of SSARS No. 1 (AR 100.56–.58).

For items b and c, the accountant must modify the compilation report to identify in a separate paragraph the departures, including the effects, if known. If not known, the accountant must include a statement that the effects have not been determined.

Signing a Preprinted Report Form

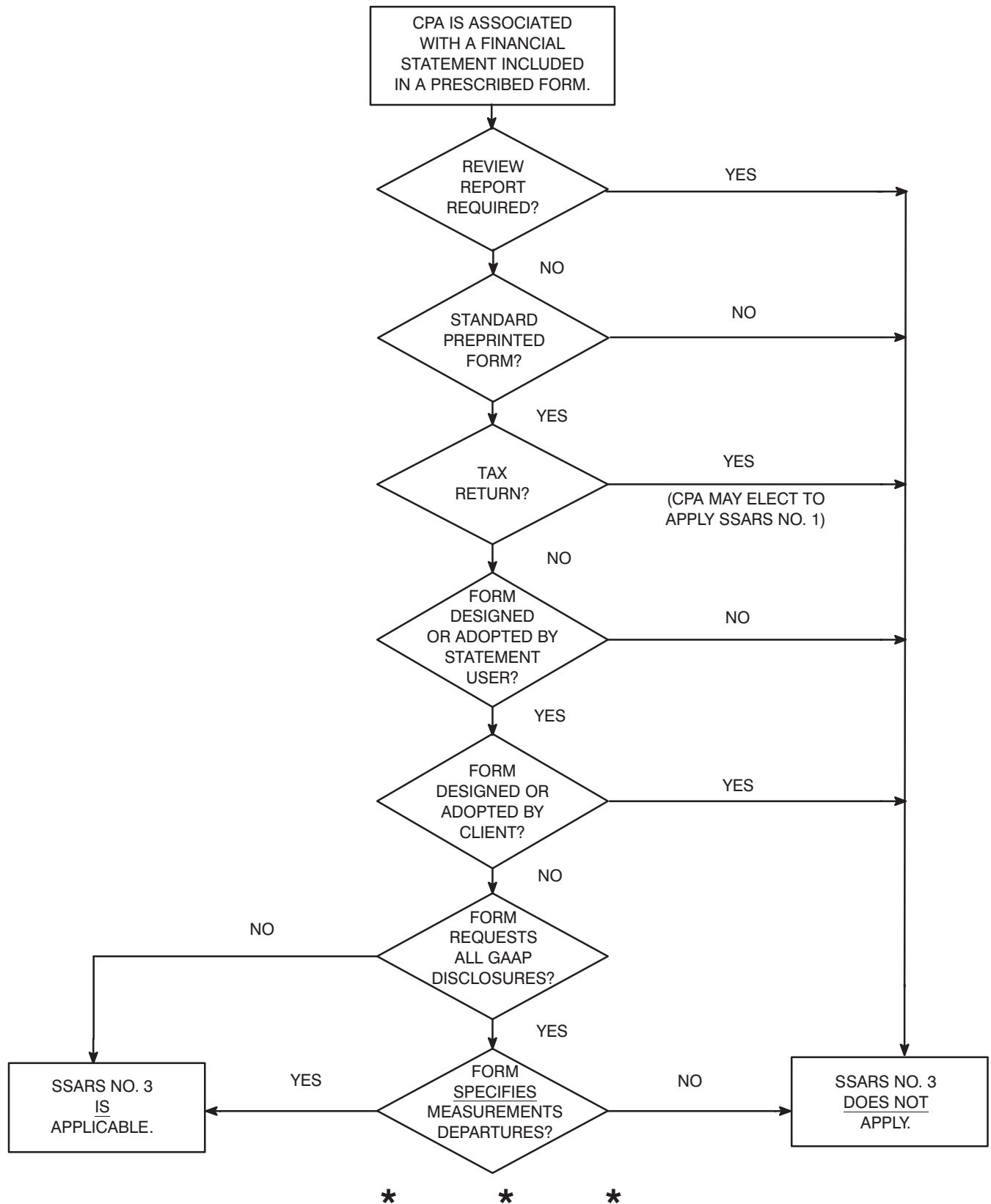
SSARS No. 3 (AR 300.05) states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in SSARS No. 3 or SSARS No. 1 (AR 100). If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form. The accountant could type “See accountant’s compilation report” in the prescribed form signature block as follows:

The above financial statement and supporting schedules, which are submitted for the purpose of establishing, obtaining, and maintaining credit, present a true, complete, and correct statement of my financial condition as of the date shown. I agree to notify the bank of any material adverse change in my financial condition, and to furnish current financial information upon request by the bank from time to time. The bank is authorized to contact any appropriate third parties for the purpose of verifying any information at any time furnished by me to the bank. Such financial statements and other information furnished shall be the property of the bank.

Witnessed by	Signature
Date	Prepared by (if other than maker) SEE ACCOUNTANT'S COMPILATION REPORT

THE APPLICABILITY OF SSARS NO. 3

Questions involving the applicability of SSARS No. 3 (AR 300) might pertain to the definition of a prescribed form, the type of service involved, or clarification of how a form calls for departures from GAAP. Some of these questions are discussed in the following paragraphs. A flowchart is also presented (in Exhibit 3-1) to summarize the decision process involved in determining whether SSARS No. 3 is applicable.

Exhibit 3-1**Flowchart—Does SSARS No. 3 Apply?**

Does SSARS No. 3 Establish Different Standards for Compiling a Prescribed Form?

No. The reporting standards of SSARS No. 1 (AR 100) require issuing a report whenever the accountant compiles financial statements expected to be used by third parties or reviews financial statements included in a prescribed form. SSARS No. 3 (AR 300) merely provides an alternative form of standard compilation report for financial statements included in certain prescribed forms. It does not expand the accountant's reporting responsibility, nor does it change the performance standards of SSARS No. 1 (AR 100). Thus, the accountant is required to—

- a. Reach an understanding of the engagement with the client (preferably in writing).
- b. Obtain an understanding of the client's business and the industry.
- c. Read the statements.
- d. Attach an appropriate report.

When accountants compile management-use-only financial statements, they may issue an engagement letter in lieu of a compilation report.

Is SSARS No. 3 Applicable to Review Engagements?

No. SSARS No. 3 (AR 300) makes no provision for an alternative *review* report on financial statements included in a prescribed form. A review report must conform to the standards of SSARS Nos. 1 (AR 100) and 2 (AR 200). The report must describe any departures from GAAP (even if the departures are called for by the form). The report must also include the effects of the departure, if known, or must include a statement that the effects have not been determined. Since the special provision of SSARS No. 1, AR 100.19, (relating to reporting on financial statements that omit substantially all disclosures) is not available for review reports, a review report on financial statements included in a prescribed form must also describe each GAAP disclosure that is omitted.

Is a Tax Return a Prescribed Form?

No. Tax returns *are* standard preprinted forms designed by the body to which they are submitted. They *are not*, however, prescribed forms. SSARS No. 3 (AR 300.02) refers to the definition of "financial statement" in SSARS No. 1 (AR 100.04) and thus excludes financial presentations included in tax returns.

The CPA is not required to attach a report even if a tax return is submitted to a third party in lieu of financial statements. However, Interpretation No. 10 of SSARS No. 1 (AR 9100.31–.32) points out that a CPA *may* attach a report to tax or information returns. Although the interpretation does not suggest a specific report, it is believed that the accountant should issue a SSARS No. 1 (AR 100) report because the tax return is for submission to a user that did not design the form. However, it is recommended that the compilation report not refer to "Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants" in the first paragraph, since compilation standards do not exist for tax or information returns. [AU 9623.47–.54 provides guidance when a CPA is requested to *audit* financial statements included in Internal Revenue Form 990 (Return of Organizations Exempt from Income Tax).]

Does a Comprehensive Set of Instructions Constitute a Prescribed Form?

No. The definition of a prescribed form in SSARS No. 3 (AR 300.02) specifically includes the words "standard preprinted form." When faced with a comprehensive set of instructions but no standard preprinted form, the accountant must follow SSARS No. 1, not SSARS No. 3. However, if such instructions are a part of a contractual agreement, the accountant may want to follow the guidance on financial statements prepared on a basis of accounting prescribed in a contractual agreement.

Is SSARS No. 3 Applicable to a Prescribed Form That Does Not Call for Departures from GAAP?

No. If the form does not call for departures from GAAP, then SSARS No. 3 (AR 300) alternative compilation reporting is not appropriate. Thus, the financial statements included in the prescribed form should be reported on in

accordance with SSARS No. 1 (AR 100). If the form does not call for departures from GAAP, the accountant should use GAAP in compiling the financial statements unless the entity customarily uses an other comprehensive basis of accounting.

How Does a Prescribed Form Call for Departures from GAAP?

SSARS No. 3 (AR 300.01) indicates that a form calls for a departure from GAAP by either—

- a. specifying a measurement principle not in conformity with GAAP, or
- b. failing to request disclosures required by GAAP.

The term *calls for* has a different meaning for measurement principles than for disclosure standards. A prescribed form that *specifies* that a business entity present its real estate at FMV is clearly a prescribed form requiring a departure from GAAP. However, a form that is silent about the basis of accounting for real estate is not “calling for” a departure. Likewise, a form that includes a section for property and equipment but fails to provide a line for capital leases is not a form *specifying* a departure from GAAP.

Under the premise of SSARS No. 3 (AR 300) that the body prescribing the form is requesting the information it wants, it is believed that the requirements of the form should be strictly followed. If the form calls for presenting real estate at market value but does not require a provision for income taxes on unrealized asset appreciation, the accountant would, generally, not provide such taxes. The measurement principles conform to GAAP except for the prescribed departure in measuring the real estate. Note that presenting the real estate at cost in this situation would require the accountant to treat this as a departure from the requirements of the *form*. This example assumes the statements being presented are not those of an individual.

In contrast to measurement departures, a standard preprinted form that is silent concerning disclosures *does* call for departures from GAAP by failing to specifically request disclosures. Application of this principle is sometimes difficult. For example, a bank's prescribed form for personal financial statements may not specifically require GAAP disclosures. However, it might have a blank final page captioned “Additional Remarks.” This final page is not intended to be a request for GAAP disclosures because the title of the page suggests that the space is provided for voluntary remarks. In some situations, the accountant and the client may wish to consult with the body prescribing the form to determine if disclosures are required.

Can a SSARS No. 1 Report Be Issued Even If SSARS No. 3 Applies?

Yes. The accountant may issue a SSARS No. 1 (AR 100) compilation report (or review report, if appropriate) on statements included in a prescribed form that calls for departures from GAAP. He must, however, comply with SSARS No. 1, including AR 100.56–.58, regarding departures from GAAP.

Is the SSARS No. 3 Report Appropriate When a Prescribed Form Is Presented to Other Third Parties?

No. The SSARS No. 3 (AR 300) alternative report presumes that the information required by a prescribed form is sufficient to meet the needs of *the body that designed or adopted the form*. Although SSARS No. 3 includes no discussion of the distribution of such reports to other third parties, it is believed that the CPA should issue only a *SSARS No. 1* (AR 100) type report when he believes that the prescribed form will be presented to a party other than the one that designed or adopted the form.

SELF-STUDY QUIZ

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

29. What is the definition of a *prescribed form*?
- a. Forms used by credit agencies, industry trade associations, banks, and governmental and regulatory bodies.
 - b. Any standard preprinted form that is designed or adopted by the body to which it is to be submitted.
 - c. Any form designed or adopted by the entity whose financial statements will be compiled.
 - d. The alternative form of a standard compilation report.
30. What type of departure does **not** require disclosure in the alternative form of the standard compilation report for prescribed form engagements?
- a. A departure from the requirements of the prescribed form.
 - b. A departure from GAAP that is not required by the prescribed form.
 - c. A departure from GAAP that is required by the prescribed form.
31. Alicia, an accountant, is hired by Baker's Dozen to perform a compilation of financial statements that are to be included with a prescribed form. The prescribed form was adopted by the company's industry trade association. The preprinted report form provided includes language that differs from that in SSARS No. 3 and SSARS No. 1. Should Alicia sign this form?
- a. Yes.
 - b. No.
32. Assuming that the CPA in question is associated with financial statements included in a prescribed form, SSARS No. 3 applies in which of the following scenarios?
- a. Josephine's client requires a review report.
 - b. Michael's client designed the prescribed form.
 - c. Ann's client presents a tax return in lieu of financial statements.
 - d. Bob's client's form does not request all GAAP disclosures.
33. How is an engagement affected if the standard form in question is a tax return?
- a. Tax returns are considered prescribed forms.
 - b. A CPA's report must be attached to a tax return.
 - c. CPAs are allowed to attach a report to either tax or information returns.
 - d. CPA reports attached to tax returns must refer to the SSARS.
34. In what case would a prescribed form that is silent on GAAP departures be considered to have *called for* those departures under SSARS No. 3?
- a. If the form fails to request disclosures.
 - b. If the firm fails to include space for a measurement principle.

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.)**

29. What is the definition of a *prescribed form*? **(Page 73)**

- a. Forms used by credit agencies, industry trade associations, banks, and governmental and regulatory bodies. [This answer is incorrect. Examples of prescribed forms include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. However, this is not the definition of *prescribed forms* found in SSARS No. 3.]
- b. **Any standard preprinted form that is designed or adopted by the body to which it is to be submitted. [This answer is correct. According to SSARS No. 3, any *standard preprinted form* designed or adopted by the body to which it is to be submitted is a *prescribed form*. The terms *financial statement* and *nonissuer* are the defined the same as they are in SSARS No. 1, as amended.]**
- c. Any form designed or adopted by the entity whose financial statements will be compiled. [This answer is incorrect. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form. For instance, a reporting package designed by a company for use in gathering financial statements for subsidiaries, divisions, store locations, etc., is not a prescribed form for purposes of SSARS No. 3.]
- d. The alternative form of a standard compilation report. [This answer is incorrect. Under SSARS No. 3, an alternative form of a *compilation report* is appropriate when the financial statements are included in a prescribed form that calls for a departure from GAAP. However, this is not the definition of a *prescribed form*.]

30. What type of departure does **not** require disclosure in the alternative form of the standard compilation report for prescribed form engagements? **(Page 74)**

- a. A departure from the requirements of the prescribed form. [This answer is incorrect. This type of departure requires disclosure following the guidance of SSARS No. 1. The accountant must modify the compilation report to identify departures that must be disclosed in a separate paragraph.]
- b. A departure from GAAP that is not required by the prescribed form. [This answer is incorrect. Following the guidance in SSARS No. 1, this type of departure must be disclosed. The effects of departures that should be disclosed should be included in the report, if known. If not known, the accountant must include a statement that the effects have not been determined.]
- c. **A departure from GAAP that is required by the prescribed form. [This answer is correct. The accountant is concerned with three types of departures in an engagement to compile financial statements to be included in a prescribed form. Of the three types, this type of departure does not require disclosure in the SSARS No. 3 alternative form of report.]**

31. Alicia, an accountant, is hired by Baker's Dozen to perform a compilation of financial statements that are to be included with a prescribed form. The prescribed form was adopted by the company's industry trade association. The preprinted report form provided includes language that differs from that in SSARS No. 3 and SSARS No. 1. Should Alicia sign this form? **(Page 74)**

- a. Yes. [This answer is incorrect. If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form. The accountant could type "See accountant's compilation report" in the prescribed form signature block.]
- b. **No. [This answer is correct. SSARS No. 3 states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in SSARS No. 3 or SSARS No. 1, so, in this scenario, Alicia should not sign the form.]**

32. Assuming that the CPA in question is associated with financial statements included in a prescribed form, SSARS No. 3 applies in which of the following scenarios? **(Page 75)**
- a. Josephine's client requires a review report. [This answer is incorrect. If the engagement requires a review report, SSARS No. 3 does not apply. The alternative form of the standard report found in SSARS No. 3 applies to a compilation report, not a review report.]
 - b. Michael's client designed the prescribed form. [This answer is incorrect. SSARS No. 3 would apply if the form was designed or adopted by the statement user, not the accountant's client.]
 - c. Ann's client presents a tax return in lieu of financial statements. [This answer is incorrect. If a tax return is submitted to a third party instead of financial statements, SSARS No. 3 would not apply; however, Ann could elect to apply SSARS No. 1 instead.]
 - d. **Bob's client's form does not request all GAAP disclosures. [This answer is correct. SSARS No. 3 is applicable when the form does not request all GAAP disclosures. If the form did request all GAAP disclosures and also specified measurements disclosures, SSARS No. 3 would still be applicable.]**
33. How is an engagement affected if the standard form in question is a tax return? **(Page 76)**
- a. Tax returns are considered prescribed forms. [This answer is incorrect. Tax returns *are* standard preprinted forms designed by the body to which they are submitted. They *are not*, however, prescribed forms. SSARS No. 3 refers to the definition of "financial statement" in SSARS No. 1 and thus excludes financial presentations included in tax returns.]
 - b. A CPA's report must be attached to a tax return. [This answer is incorrect. The CPA is not required to attach a report even if a tax return is submitted to a third party in lieu of financial statements.]
 - c. **CPAs are allowed to attach a report to either tax or information returns. [This answer is correct. Interpretation No. 10 of SSARS No. 1 points out that a CPA *may* attach a report to tax or information returns. Although the interpretation does not suggest a specific report, it is believed that the accountant should issue a SSARS No. 1 report because the tax return is for submission to a user that did not design the form.]**
 - d. CPA reports attached to tax returns must refer to the SSARS. [This answer is incorrect. It is recommended that a compilation report submitted with a tax return not refer to "Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants in the first paragraph, since compilation standards do not exist for tax or information returns.]
34. In what case would a prescribed form that is silent on GAAP departures be considered to have *called for* those departures under SSARS No. 3? **(Page 77)**
- a. **If the form fails to request disclosures. [This answer is correct. A standard preprinted form that is silent concerning disclosures *does* call for departures from GAAP by failing to specifically request disclosures. Application of this principle is sometimes difficult. In some situations, the accountant and the client may wish to consult with the body prescribing the form to determine if disclosures are required.]**
 - b. If the firm fails to include space for a measurement principle. [This answer is incorrect. SSARS No. 3 indicates that one way a form calls for departure from GAAP is by specifying a measurement principle not in conformity with GAAP. A prescribed form that *specifies* that a business entity present its real estate at FMV is clearly a prescribed form requiring a departure from GAAP. However, a form that is silent about the basis of accounting for real estate is not "calling for" a departure.]

HOW TO APPLY SSARS NO. 3 IN PRACTICE

Applying SSARS No. 3 (AR 300) in practice requires a thorough understanding of SSARS No. 1 (AR 100), SSARS No. 2 (AR 200), interpretations of SSARS, and technical practice aids. SSARS No. 3 amends SSARS Nos. 1 and 2 by carving out a specific type of engagement and providing an alternative report for such an engagement. When SSARS No. 3 is silent, the other SSARS apply. In situations not addressed in SSARS literature, it may be appropriate to consult auditing literature for guidance. The following paragraphs address questions that surface as practitioners handle prescribed form engagements.

If a CPA Previously Compiled a Financial Statement, Can He or She Compile a Prescribed Form Financial Statement for the Same Period?

Yes. SSARS No. 3 (AR 300) is silent on this issue. However, since a footnote of SSARS No. 1 (AR 100.02) permits such engagements for financial statements previously reviewed, it is logical to assume that a CPA could likewise issue a SSARS No. 3 report on financial statements previously compiled for the same period. It is also believed appropriate to issue SSARS No. 3 reports on more than one set of prescribed forms for the same entity for the same period. For instance, several different creditors may request financial statements on different forms, and each set of forms may meet the requirements of SSARS No. 3.

If a CPA Previously Reviewed a Financial Statement, Can He or She Compile a Prescribed Form Financial Statement for the Same Period?

Yes. A footnote of SSARS No. 1 (AR 100.02) permits an accountant who has reviewed the financial statements of a nonissuer to issue a compilation report on financial statements for the same period that are included in a prescribed form that calls for a departure from GAAP. [See also Interpretation No. 1 of SSARS No. 3 (AR 9300.01–.03).] This is an exception to the general rule in SSARS No. 1 (AR 100.02) which requires the accountant to issue the highest-level-of-service report.

If a CPA Previously Audited a Financial Statement, Can He or She Compile a Prescribed Form Financial Statement for the Same Period?

Yes. SSARS No. 3 (AR 300) does not address this question since it is an auditing issue. Until guidance is provided by the Auditing Standards Board, it is believed that the accountant should parallel the guidance provided by SSARS No. 3 and Interpretation No. 1 of SSARS No. 3 (AR 9300.01–.03) for previously reviewed financial statements. Thus, the accountant can issue a SSARS No. 3 compilation report on previously audited statements extracted for inclusion in a prescribed form.

If There Are Previously Issued Financial Statements, Does the CPA Have to Refer to the Previous Service in the Prescribed Form Report?

No. SSARS No. 3 (AR 300) neither requires nor prohibits referring to the previous service. The ARSC considered requiring a reference to the previous service but did not adopt such a requirement in SSARS No. 3. However, Interpretation No. 1 of SSARS No. 3 (AR 9300.01–.03) states that a CPA *may* refer to a previous review service in prescribed form engagements when the measurement principles used do not cause the compiled financial statements included in the prescribed form to be materially different from the reviewed financial statements. Accordingly, the only differences between the two sets of financial statements are in the disclosures provided and perhaps in the classification. Although the interpretation only addresses previously reviewed financial statements, the same guidance is believed to apply when the compiled financial statements are extracted from audited financial statements.

The interpretation recommends that the reference to the previous service indicate—

- a. The type of service.
- b. The date of the previous report.
- c. Any modifications or explanations indicated in the previous report.

Two examples of such a reference added to the second paragraph of a SSARS No. 3 report follow:

These financial statements were compiled by me (us) from financial statements for the same period, which I (we) previously reviewed as indicated in my (our) report dated January 25, 20XX.

or

These financial statements were compiled by me (us) from financial statements for the same period which I (we) previously reviewed. My (our) report dated January 25, 20XX, referred to a departure from generally accepted accounting principles because the company recorded its land and buildings at appraised values.

Some accountants may prefer to refer to the previous service in a separate paragraph, especially when explanation of a modification in the previous report is necessary.

Reference to the previous service *is not* appropriate when the financial statements were previously compiled with substantially all disclosures omitted because this level of service is not higher than that of the prescribed form financial statements. Likewise, when the prescribed form financial statements are based on significantly different measurement principles, no reference to the previous service should be made because the service was rendered on a substantially different set of financial statements. Differences in classification are considered to be changes in disclosure principles rather than in measurement principles. Note that the interpretation is based on the presumption that different disclosures do not result in different financial statements.

Can a CPA Attach Previously Compiled, Reviewed, or Audited Financial Statements to a Prescribed Form?

Yes. If agreeable to the body to which the form will be submitted, the accountant may attach to the prescribed form general purpose financial statements that the accountant has compiled, reviewed, or audited. He could simply make reference on the prescribed form to the attached statements and accountant's report and does not need to attach a SSARS No. 3 (AR 300) report to the prescribed form.

What Basis of Accounting Does a CPA Use If None Is Specified in the Form?

If the form is silent as to the basis desired, the basis of accounting normally used by the company appears to be the most appropriate basis on which to prepare the financial statements included in the form. For instance, a professional corporation that has adopted the cash basis of accounting would apply cash basis principles unless the form specifically requests otherwise.

However, application of SSARS No. 3 (AR 300) to financial statements prepared on an OCBOA is sometimes difficult because many prescribed forms contemplate accrual basis financial statements and do not request disclosure of use of an OCBOA. As a result, the SSARS No. 3 accountant's report on such statements is awkward because the report must disclose—

- a. The basis being used and that it is an OCBOA [SSARS No. 1 (AR 100.20)].
- b. That the statements are presented in accordance with requirements of the prescribing body [SSARS No. 3 (AR 300.03)].
- c. That those requirements differ from the OCBOA being used [SSARS No. 3 (AR 300.03)].

The report, in essence, says that the statements are presented in accordance with the requirements of the prescribing body, which is not in accordance with the OCBOA and thus not in accordance with GAAP.

When deciding which basis of accounting to use, the practitioner can weigh the objectives of the body prescribing the form, the difficulties of producing GAAP financial statements, and the special problems of application and reporting for OCBOA statements.

How Does Use of the Tax Basis or Cash Basis of Accounting Affect Financial Statements Included in Prescribed Forms?

The principles stated in SSARS No. 3 (AR 300) are equally applicable to financial statements presented on an OCBOA. Thus, a standard preprinted form that specifies a measurement principle that differs from the OCBOA, or that *fails to request disclosures*, is a prescribed form, and SSARS No. 3 reporting is appropriate. However, the OCBOA disclosure discussed previously (item a.) must be provided either in a note on the face of the financial statements, in an attached note, or in the accountant's report. The following report on cash basis financial statements illustrates disclosure in the report:

I (We) have compiled the statement of assets, liabilities, and equity—cash basis of XYZ Company, Inc. as of December 31, 20XX, and the related statement of revenues and expenses—cash basis for the year then ended included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

My (Our) compilation was limited to presenting in the form prescribed by the Texas Department of Highways information that is the representation of management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of the Texas Department of Highways, which differ from the cash basis of accounting. Accordingly, these financial statements are not designed for those who are not informed about such differences.

Application of SSARS No. 3 (AR 300) to OCBOA statements requires judgment. For example, when compiling a cash basis statement of assets and liabilities for a professional corporation for inclusion in a prescribed form that provides a line for accounts receivable, three distinct reporting situations may occur.

- a. If the cash basis company has a memo record of its accounts receivable, the company may decide to provide the information. If recording the receivable does not in reality create accrual basis statements, the accountant should issue a SSARS No. 3 report that includes the OCBOA disclosure discussed in the previous item a. Completing the accounts receivable line is a departure from the cash basis called for by the form and, thus, does not require disclosure in the report.
- b. In the above circumstance, if the statements are now essentially accrual basis statements, the accountant must then determine whether the standard preprinted form calls for a departure from GAAP. If so, SSARS No. 3 is applicable. If the form does not call for departure from GAAP, SSARS No. 1 (AR 100) is applicable. In either event, reference to the cash basis is not appropriate.
- c. The company may have accounts receivable but decide to leave the accounts receivable line on the form blank. In this situation, the accountant could issue a SSARS No. 3 report that includes the OCBOA disclosure discussed in the previous item a *and* that discloses the departure from the requirements of the form, i.e., accounts receivable not presented.

Can an Accountant Perform a Review of Financial Statements Included in a Prescribed Form That Are Presented on a Basis Other Than GAAP?

Yes. A review can be performed on the financial statements included in a prescribed form prepared under any comprehensive basis of accounting, but SSARS No. 1 reporting standards would apply, not those in SSARS No. 3. (See TIS 9150.10.)

What Does a CPA Do When Financial Statements Presented on an OCBOA Are Included in the Prescribed Form and It Uses the Terms “Balance Sheet,” “Statement of Income,” etc.?

SSARS No. 1 (AR 100.04), as amended, provides examples of suitable titles for financial statements presented on a comprehensive basis of accounting other than GAAP. See Lesson 2 for a discussion of OCBOA statement titles. In some situations, it may be appropriate for the accountant to alter the titles on the prescribed form to conform to appropriate statement titles. The report should, of course, use the titles as they finally appear on the prescribed form. However, in practice, the titles usually are not changed, and the accountant's report on the statements uses the preprinted titles. This course agrees with this practice based on the presumption stated in SSARS No. 3 (AR 300) that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form.

What Is a CPA's Reporting Obligation for Information Presented for Supplementary Analysis Purposes?

SSARS No. 3 (AR 300) does not change SSARS No. 1 (AR 100.83). SSARS No. 1 requires that, when the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the responsibility, *if any*, he assumes with respect to such information. If the accountant has compiled the data presented for supplementary analysis purposes, he should expand the SSARS No. 3 report to include the other information. He therefore might add the following sentence to the first paragraph of the report:

I (We) have also compiled the supplementary information presented in the prescribed form.

The second sentence of the second paragraph could then be revised to read, “I (We) have not audited or reviewed the financial statements *and supplementary information* referred to above. . . .” Both references in the final paragraph could read, “These financial statements and supplementary information. . . .”

It is believed that accountants should at least compile any information bound in their report cover. An alternative view is that if the supplementary information is client-prepared and the accountant has not compiled it, the accountant can so indicate in the report. In this case, the following is an example of a fourth paragraph added to the standard SSARS No. 3 report:

The supplementary information contained in the accompanying prescribed form has not been audited, reviewed, or compiled by me (us) and, accordingly, I (we) assume no responsibility for that information.

There may be occasions when the form contains information presented for supplementary analysis purposes, some of which has been compiled by the accountant and some of which has not. The accountant should clearly distinguish information he has compiled from information for which he takes no responsibility.

What Is the Definition of Information Presented for Supplementary Analysis Purposes?

The term *supplementary information* is not defined in SSARS literature. The intent of the ARSC in SSARS No. 1 (AR 100.83) regarding the accountant's responsibility for supplementary information in a compilation or review report is believed to parallel the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU 551). The information covered by SAS No. 29 includes—

- a. Additional details or explanations of items in, or related to, the basic financial statements.
- b. Consolidating information.
- c. Historical summaries of items extracted from basic financial statements.
- d. Statistical data.
- e. Other material, some of which may be from sources outside the accounting system or outside the entity.

Thus, nonaccounting information, as well as accounting information, is believed *supplementary information* for purposes of SSARS No. 1 (AR 100.83). Therefore, the accountant's report must include the degree of responsibility,

if any, that the CPA assumes with respect to *all information* in a prescribed form. The accountant should be cautious not to take responsibility for compilation of information that he may not be qualified to compile. However, in most situations the accountant should be able to compile all information in a prescribed form.

How Should a CPA Report on Projected Income Information Included in a Prescribed Form or as Supplementary Information to a Prescribed Form?

Frequently, prescribed forms require prospective salary or income information in a format such as the following:

Last Year 20X1	This Year 20X2	Projected Next Year 20X3

The CPA ordinarily reports on the 20X1 and 20X2 information as presented in “The Alternative Form of Standard Compilation Report” paragraph, or as supplementary information. The 20X3 information constitutes a partial projection. AT 301, *Financial Forecasts and Projections*, requires an accountant to report on a partial presentation whenever the accountant is *engaged to report*. Assuming that the accountant is not engaged to compile the partial presentation, it is unnecessary to report in accordance with the AICPA guide. Because the accountant is associated with the prospective information, however, adding a paragraph such as the following to the SSARS No. 3 (AR 300) compilation report is recommended:

The prospective financial information contained in the accompanying prescribed form has not been compiled or examined by me (us), and I (we) do not express any form of assurance on it. In addition, it may contain departures from guidelines for presentation of prospective financial information established by the American Institute of Certified Public Accountants. The actual results may vary from the presentation, and the variations may be material.

If the accountant is engaged to compile the partial presentation, the accountant should report in accordance with AT 301. Before agreeing to report on the information, however, the accountant should clarify whether the form is requesting *forecasted* information, even though the term *projected* is used. That is, the bank would probably want to know the client's best estimate of next year's results (a forecast) rather than the client's expectations based on some hypothetical assumption (a projection).

How Does a CPA Report on a Prescribed Form That Requires Only Elements, Accounts, or Items of a Financial Statement?

If a report is *requested*, the accountant may issue a compilation report under SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AR 110), or a review report under AT 301, *Financial Forecasts and Projections*. SAS No. 62 (AU 623), *Special Reports*, provides guidance for engagements to audit specified elements, accounts, or items of a financial statement.

When elements, accounts, or items are compiled in a prescribed form that calls for departures from GAAP, a SSARS No. 3 (AR 300) report may be used. As an example, a surety underwriter may require a construction company to present, on a form prescribed by the surety, a contract status report on the completed contract method, even though GAAP for the company requires the percentage of completion method.

If the prescribed form for the contract status report accompanies financial statements, the accountant should report on the contract status report as supplementary information, as discussed earlier. If the prescribed form for the contract status report is presented alone, the accountant may wish to issue a compilation report on the form as a specified element, even though he is not required to report under SSARS No. 1 (AR 100). It is believed that this may be done with a SSARS No. 3 (AR 300) type report by substituting a description of the specified element whenever the financial statements are described or referred to. It should be noted, however, that a SSARS No. 3 type report is appropriate only when the prescribed form *specifies* a measurement departure or *fails to require* adequate disclosures.

What If the Form Is in Accordance with GAAP Except for Disclosures?

SSARS No. 3 (AR 300.01) indicates that the scope of SSARS No. 3 includes prescribed forms that *fail to request* disclosures required by GAAP. The SSARS No. 3 alternative form of report would then be appropriate. However, the

accountant may prefer to use the report form discussed in SSARS No. 1 (AR 100.19–.21). In practice, it may be preferable to use the SSARS No. 3 type of report whenever prescribed forms are involved, except when previously prepared statements are submitted with the form and incorporated by reference.

Should a CPA Describe or Name the Form in the Scope Paragraph of the SSARS No. 3 Report?

The accountant is not required to name or describe the specific prescribed form; however, he may provide this information if he wishes. It should be noted that the second and third paragraphs of the sample report presented in SSARS No. 3 (AR 300) require the name of the body that adopted or designed the form.

How Should a CPA Report on Comparative Financial Statements Included in a Prescribed Form?

SSARS No. 3 (AR 300) does not specifically discuss comparative financial statements. However, it is apparent from SSARS No. 3 (AR 300.01) that the principles of SSARS No. 2 (AR 200) apply to comparative prescribed form engagements. Thus, the CPA must report on all periods presented. Since SSARS No. 3 is applicable only to compilations, in most instances it is believed the current CPA will assume responsibility for all periods presented [compile according to SSARS No. 1 (AR 100) and report according to SSARS Nos. 2 and 3] regardless of whether he is a continuing accountant with regard to all periods presented.

Although the CPA has the option of issuing either a SSARS No. 1 (AR 100) or SSARS No. 3 (AR 300) report on financial statements included in prescribed forms, it would not be a good idea to present the two types of reports together for separate periods presented in comparative form in a prescribed form. To do so would confuse the users of the statement.

What If a CPA Is Not Independent?

An accountant who is not independent can issue a SSARS No. 3 (AR 300) compilation report on financial statements included in a prescribed form. He must, however, comply with SSARS No. 1 (AR 100.23) and include the following as the last paragraph of his report:

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

Does a CPA Have to Mark “See Accountant’s Compilation Report” on Each Page of the Prescribed Form?

Yes. SSARS No. 3 (AR 300) did not change the requirements of SSARS No. 1 (AR 100.15) which provides that each page of financial statements compiled by the accountant should include a reference such as, “See accountant’s compilation report.”

Does SSARS No. 3 Provide the Latitude to Vary from the Wording of the Report Examples Provided?

Yes. The report examples in this lesson have been developed using the wording illustrated in SSARS No. 3 (AR 300). However, provided the reporting standards prescribed in SSARS No. 1 (AR 100.13 and AR 100.19) are met, it is believed that the wording of the compilation report can vary from illustrations in the SSARS. The following suggestions may make the prescribed form report easier for readers to understand and keep them from drawing incorrect conclusions.

The final paragraph of the report illustrated in SSARS No. 3 (AR 300) is intended to notify the reader that the measurement and disclosure principles prescribed by the body differ from GAAP (or OCBOA). The illustrated wording could be interpreted as giving positive assurance, since it says that the financial statements are presented in accordance with the body’s requirements. This appears contradictory in expressing no assurance. This becomes even more confusing when there is a departure from the prescribed requirements. In that situation, the accountant modifies the second paragraph to state that he became aware of a departure from the prescribed requirements, adds a paragraph describing that departure, but then states in the final paragraph that the financial statements are presented in accordance with the prescribed requirements. The following wording, substituted for the final paragraph of the standard SSARS No. 3 report, is believed to accomplish the same objective and clear up some of the confusion:

The requirement of (name of body) for presenting information in the prescribed form differs from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

One other source of confusion is the parenthetical phrase “including related disclosures” that is included in the final paragraph of the standard prescribed form report in SSARS No. 3 (AR 300). Should the parenthetical phrase be included in all SSARS No. 3 reports, or should it be included only when the prescribed form includes disclosures? Why is it necessary?

This course believes that the parenthetical phrase is unnecessary and can be confusing. According to SSARS No. 1 (AR 100.04), the basic financial statements include related disclosures. Thus, the related disclosures are incorporated in the scope paragraph of the report when the statements are listed. If the form includes disclosures or other information that is not considered to be part of the basic financial statements, the accountant's report should describe the degree of responsibility, if any, that the accountant assumes with regard to that information. The parenthetical phrase “including related disclosures” is not believed to relate to such supplementary information.

Therefore, the alternative compilation report for prescribed forms made available by SSARS No. 3 (AR 300.03) might be less confusing if the final paragraph did not include the parenthetical phrase “including related disclosures.” Note that the suggested wording above excludes this phrase.

Any deviations from wording illustrated in a SSARS (or any other authoritative document) should be considered carefully to ensure that all professional standards are being followed.

Is SSARS No. 3 Reporting Appropriate for Prescribed Forms Submitted to the NASD or NYSE by Privately Owned Brokers or Securities Dealers?

Yes. Here is the rationale. SSARS No. 3 (AR 300.02) excludes from the definition of a prescribed form those forms “. . . concerned with the sale or trading of securities.” This prohibition applies to the entity submitting the form. Thus, if a privately owned broker or securities dealer submits a prescribed form to the National Association of Securities Dealers or the New York Stock Exchange in connection with a regulatory requirement, SSARS No. 3 still applies. That is, the broker or securities dealer is not submitting the prescribed form in connection with the sale or trade of its securities. The prescribed form is submitted for regulatory purposes, not for purposes of selling or trading securities of the broker or securities dealer. (See also TIS 9150.09 from the AICPA *Technical Practice Aids*.)

Is SSARS No. 3 Reporting Appropriate If a Prescribed Form That Calls for GAAP Departures Is Required by a Contractual Agreement?

Yes. Interpretation No. 28 of SSARS No. 1 (AR 9100.109–.119) allows the accountant to report on special-purpose financial statements prepared to comply with contractual agreements in accordance with either Interpretation No. 28 or SSARS No. 3 (AR 300). Also, the accountant should report departures from GAAP or an OCBOA in accordance with SSARS No. 1 (AR 100).

SELF-STUDY QUIZ

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

35. When SSARS No. 3 is silent about an issue concerning a prescribed forms engagement, what authoritative literature should the accountant consult first?
- a. SSARS Nos. 1 and 2.
 - b. Interpretations of the SSARS.
 - c. Technical practice aids.
 - d. Auditing literature.
36. Which of the following accountants has correctly handled an issue with a prescribed forms engagement?
- a. Annabelle previously compiled her client's financial statements, so she must decline the engagement to compile a prescribed form financial statement for the same period.
 - b. Brandon's client has previously issued financial statements that are not materially different from those in the prescribed form. Brandon refers to the previous service in his report.
 - c. Clementine's client uses a prescribed form that is silent as to the desired basis of accounting; therefore, she uses GAAP, though her client normally prepares financial statements using the cash basis.
 - d. Donald's client prepares its financial statements using an OCBOA. The prescribed form uses statement titles such as "Balance Sheet." Donald changes all the titles, as required.
37. Which of the following statements best describes the use of information presented for supplementary analysis purposes in a prescribed form engagement?
- a. The SSARS No. 3 report must be expanded if such information is included in the engagement.
 - b. Items only qualify as supplementary information if they are specifically listed in SSARS literature.
 - c. Examples of supplementary information in question include consolidating information and statistical data.
 - d. The accountant should always be able to take responsibility for all supplementary information.
38. How would the CPA be affected if a prescribed form engagement includes projected income information?
- a. Projected information must be reported on in accordance with AT 301.
 - b. Projected information should only be reported on if the CPA is engaged to report on it.
 - c. Projected information should only be reported on if it is considered a forecast.
 - d. Projected information should only be reported on if it is considered a projection.
39. Which of the following is appropriate for a SSARS No. 3 report?
- a. Naming or describing the prescribed form in the report.
 - b. Reporting only on the current period when comparative statements are presented.
 - c. Allowing only independent CPAs to issue the report.
 - d. Eliminating the "See accountant's compilation report" references required by SSARS No. 1.
40. How strict are the wording requirements for a SSARS No. 3 report?
- a. The wording illustrated in SSARS No. 3 must be adhered to exactly.
 - b. SSARS No. 3 allows latitude in the wording of the reports.

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.)**

35. When SSARS No. 3 is silent about an issue concerning a prescribed forms engagement, what authoritative literature should the accountant consult first? **(Page 82)**
- a. **SSARS Nos. 1 and 2. [This answer is correct. Applying SSARS No. 3 in practice requires a thorough understanding of SSARS Nos. 1 and 2, among other types of authoritative literature. SSARS No. 3 amends SSARS Nos. 1 and 2 by carving out a specific type of engagement and providing an alternative report for such an engagement. When SSARS No. 3 is silent, the other SSARS apply.]**
 - b. Interpretations of the SSARS. [This answer is incorrect. A thorough understanding of the interpretations of SSARS is necessary to apply SSARS No. 3; however, this is not the first place that an accountant should look if SSARS No. 3 is silent on an issue.]
 - c. Technical practice aids. [This answer is incorrect. A thorough understanding of the technical practice aids is required for applying SSARS No. 3; however, if SSARS No. 3 is silent on an issue, the technical practice aids are not the first place that the accountant should turn to for guidance.]
 - d. Auditing literature. [This answer is incorrect. For situations not addressed in SSARS literature, it may be appropriate to consult auditing literature for guidance. However, this is not the first place an accountant would look if SSARS No. 3 was silent.]
36. Which of the following accountants has correctly handled an issue with a prescribed forms engagement? **(Page 82)**
- a. Annabelle previously compiled her client's financial statements, so she must decline the engagement to compile a prescribed form financial statement for the same period. [This answer is incorrect. If a CPA *previously compiled* a financial statement, he or she can compile a prescribed form financial statement for the same period. SSARS No. 3 is silent on this issue. However, since the footnote of SSARS No. 1 permits such engagements for financial statements previously reviewed, it is logical to assume that a CPA could likewise issue a SSARS No. 3 report on financial statements previously compiled for the same period.]
 - b. **Brandon's client has previously issued financial statements that are not materially different from those in the prescribed form. Brandon refers to the previous service in his report. [This answer is correct. SSARS No. 3 neither requires nor prohibits referring to the previous service. The ARSC considered requiring a reference to the previous service but did not adopt such a requirement in SSARS No. 3. However, Interpretation No. 1 of SSARS No. 3 states that a CPA *may* refer to a previous review service in prescribed form engagements when the measurement principles used do not cause the compiled financial statements included in the prescribed form to be materially different from the reviewed financial statements.]**
 - c. Clementine's client uses a prescribed form that is silent as to the desired basis of accounting; therefore, she uses GAAP, though her client normally prepares financial statements using the cash basis. [This answer is incorrect. If the form is silent as to the basis desired, the basis of accounting normally used by the company appears to be the most appropriate basis on which to prepare the financial statements included in the form. Thus, in this scenario, Clementine should use the cash basis, not GAAP.]
 - d. Donald's client prepares its financial statements using an OCBOA. The prescribed form uses statement titles such as "Balance Sheet." Donald changes all the titles, as required. [This answer is incorrect. SSARS No. 1, as amended, provides examples of suitable titles for financial statements presented on a comprehensive basis of accounting other than GAAP. In some situations, it may be appropriate for the accountant to alter the titles on the prescribed form to conform to appropriate statement titles. The report should, of course, use the titles as they finally appear on the prescribed form. However, in practice, the titles usually are not changed, and the accountant's report on the statements uses the preprinted titles.]

37. Which of the following statements best describes the use of information presented for supplementary analysis purposes in a prescribed form engagement? **(Page 85)**
- a. The SSARS No. 3 report must be expanded if such information is included in the engagement. [This answer is incorrect. If the accountant has compiled the data presented for supplementary analysis purposes, he should expand the SSARS No. 3 report to include the other information.]
 - b. Items only qualify as supplementary information if they are specifically listed in SSARS literature. [This answer is incorrect. The term *supplementary information* is not defined in SSARS literature. The intent of the ARSC in SSARS No. 1 regarding the accountant's responsibility for supplementary information in a compilation or review report is believed to parallel the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.]
 - c. **Examples of supplementary information in question include consolidating information and statistical data. [This answer is correct. The information covered by SAS No. 29 includes (1) additional details or explanations of items in, or related to, the basic financial statements; (2) consolidating information; (3) historical summaries of items extracted from basic financial statements; (4) statistical data; and (5) other material, some of which may be from sources outside the accounting system or outside the entity.]**
 - d. The accountant should always be able to take responsibility for all supplementary information. [This answer is incorrect. The accountant should be cautious not to take responsibility for compilation of information that he may not be qualified to compile. However, in most situations, the accountant should be able to compile all information in a prescribed form.]
38. How would the CPA be affected if a prescribed form engagement includes projected income information? **(Page 86)**
- a. Projected information must be reported on all projected information in accordance with AT 301. [This answer is incorrect. If the accountant should report on the projected information, the report should be in accordance with AT 301. However, just because a prescribed form engagement includes projected information, it does not necessarily mean that the accountant is required to report on it.]
 - b. **Projected information should only be reported on if the CPA is engaged to report on it. [This answer is correct. AT 301 requires an accountant to report on a partial presentation whenever the accountant is *engaged to report*. Assuming that the accountant is not engaged to compile the partial presentation, it is unnecessary to report in accordance with the AICPA guide.]**
 - c. Projected information should only be reported on if it is considered a forecast. [This answer is incorrect. The CPA should clarify whether the projected information is a forecast (the client's best estimate of next year's results) or a projection before reporting on the projected information. However, whether the information is a forecast is not a deciding factor for determining when the projected information should be reported on.]
 - d. Projected information should only be reported on if it is considered a projection. [This answer is incorrect. Whether the projected information is a projection (the client's expectations based on some hypothetical assumption) is not a deciding factor for determining when the projected information should be reported on. However, if the CPA must report on the information, he or she should clarify whether the projected information is a forecast or a projection.]

39. Which of the following is appropriate for a SSARS No. 3 report? **(Page 87)**

- a. **Naming or describing the prescribed form in the report. [This answer is correct. The accountant is not required to name or describe the specific prescribed form; however, he may provide this information if he wishes.]**
- b. Reporting only on the current period when comparative statements are presented. [This answer is incorrect. SSARS No. 3 does not specifically discuss comparative financial statements. However, it is apparent from SSARS No. 3 that the principles of SSARS No. 2 apply to comparative prescribed form engagements. Thus, the CPA must report on all periods presented.]
- c. Allowing only independent CPAs to issue the report. [This answer is incorrect. An accountant who is not independent can issue a SSARS No. 3 compilation report on financial statements included in a prescribed form. He must, however, comply with SSARS No. 1 and include the following as the last paragraph of his report: "I am (we are) not independent with respect to XYZ Company."]
- d. Eliminating the "See accountant's compilation report" references required by SSARS No. 1. [This answer is incorrect. SSARS No. 3 did not change the requirements of SSARS No. 1, which provides that each page of the financial statements compiled by the accountant should include a reference such as, "See accountant's compilation report."]

40. How strict are the wording requirements for a SSARS No. 3 report? **(Page 87)**

- a. The wording illustrated in SSARS No. 3 must be adhered to exactly. [This answer is incorrect. It is believed that the wording for these reports can vary, as long as the standards from SSARS No. 1 are met. However, any deviations from wording illustrated in a SSARS (or any other authoritative document) should be considered carefully to ensure that all professional standards are being followed.]
- b. **SSARS No. 3 allows latitude in the wording of the reports. [This answer is correct. The report examples in this lesson have been developed using the wording illustrated in SSARS No. 3. However, provided the reporting standards prescribed in SSARS No. 1 are met, it is believed that the wording of the compilation report can vary from the illustrations in the SSARS.]**

EXAMINATION FOR CPE CREDIT**Lesson 3 (CARTG091)**

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.

29. An alternative form of the standard compilation report is available for prescribed form engagements. What is the basic presumption upon which this alternative form is founded?
- a. The body that designed or adopted the form must be advised of all departures from GAAP in the prescribed form or the related instructions.
 - b. The information a prescribed form requires is sufficient to meet the needs of the body that designed or adopted the form.
 - c. The alternative form of the report can be used for prescribed forms designed or adopted by the body, even if that body is the entity whose financial statements are being compiled.
 - d. The alternative form of the report can be used any time a prescribed form is available, whether or not the form calls from departures from GAAP.
30. List all of the following differences that would be found in the alternative form of the standard compilation report used in prescribed form engagements.
- i. A reference to the prescribed form would be included.
 - ii. A reference to the body that prescribed the form would be included.
 - iii. Cautionary language about the differences from GAAP would be included.
- a. i. and ii.
 - b. ii. and iii.
 - c. i. and iii.
 - d. i., ii., and iii.
31. Collin, a CPA, is associated with the financial statements his client, the Johnson-Miller Company, included in a prescribed form. Collin was requested to compile the statements, not review them. The forms were standard, preprinted, and were adopted by the body to which the company was submitting its statements. A tax return was not included. The form requests all GAAP disclosures and specifies measurements departures. Does SSARS No. 3 apply in this engagement?
- a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

32. How does SSARS No. 3 affect the way the reporting standards of SSARS No. 1 apply to compiling financial statements when the engagement includes a prescribed form?
- a. SSARS No. 3 establishes different reporting standards for this type of engagement, so all of the SSARS No. 1 standards no longer apply.
 - b. SSARS No. 3 allows accountants to issue an engagement letter in lieu of a compilation report in all prescribed form engagements.
 - c. SSARS No. 3 changes neither the accountant's reporting responsibility nor the performance standards of SSARS No. 1 for this type of engagement.
 - d. SSARS No. 3 eliminates the requirement that an accountant must obtain an understanding of the client's business and industry in this type of engagement.
33. How does SSARS No. 3 affect an accountant's review report on financial statements included in a prescribed form?
- a. There is no effect. Review reports must conform to the standards found in SSARS Nos. 1 and 2.
 - b. The alternative report in SSARS No. 3 can be changed from a compilation report to a review report with a few modifications.
 - c. A SSARS No. 3 review report does not have to describe departures from GAAP that are called for by the form.
 - d. If the financial statements omit substantially all disclosures, the omissions do not have to be included in the report on a prescribed form engagement.
34. Which of the following applies during a prescribed form engagement?
- a. Alternative compilation reports are valid for prescribed forms that do not call for GAAP departures.
 - b. Alternative compilation reports are appropriate for prescribed forms presented to other third parties.
 - c. A comprehensive set of instructions is considered a prescribed form under SSARS No. 3.
 - d. SSARS No. 1 reports can be issued when SSARS No. 3 applies to the engagement.
35. In practice, in which of the following situations can an accountant compile a prescribed form financial statement in the same period?
- a. When the accountant previously compiled a financial statement.
 - b. When the accountant previously reviewed a financial statement.
 - c. When the accountant previously audited a financial statement.
 - d. When the accountant previously compiled, reviewed, or audited a financial statement.
36. In which case would it **not** be appropriate for an accountant to refer to previously issued financial statements in the prescribed form engagement?
- a. When the financial statements in the prescribed form are substantially the same as those previously issued.
 - b. When the previously issued financial statements were compiled with substantially all disclosures omitted.
 - c. When the financial statements use the tax basis or the cash basis of accounting instead of GAAP.
 - d. When the financial statements include supplementary information.

37. How does SSARS No. 3 apply to financial statements that are presented using an OCBOA?
- a. SSARS No. 3 only applies to financial statements that use GAAP, so it does not apply if an OCBOA is used.
 - b. The accountant is free to choose whether to apply SSARS No. 3 principles to OCBOA statements.
 - c. SSARS No. 3 is equally applicable to financial statements that are presented using an OCBOA.
 - d. Do not select this answer choice.
38. Belinda, a CPA, is hired by Lotus Inc. to perform a prescribed form engagement. Additional information is presented for supplementary analysis purposes. Belinda compiles some of the information for Lotus Inc., and the rest of it is prepared by the client. What level of responsibility should Belinda assume for this supplementary information?
- a. Because the information is presented with her report, Belinda must assume responsibility for all of it.
 - b. Because portions of the information were client-prepared, Belinda's responsibility is negated and she should not claim any.
 - c. Belinda should clearly distinguish what she has compiled from that for which she assumes no responsibility.
 - d. Do not select this answer choice.
39. Can a SSARS No. 3 report be used when the accountant is engaged to report on a prescribed form that requires only elements, accounts, or items of a financial statement?
- a. Yes, this type of report is always appropriate in this type of engagement.
 - b. Yes, this type of report is appropriate if the form calls for GAAP departures.
 - c. No, reports under SSARS No. 13, AT 301, or SAS No. 62 must be issued instead.
 - d. No, this type of report is prohibited for this type of engagement.
40. Carl is engaged to perform a prescribed form engagement. The form calls for GAAP departures. The form and the associated special-purpose financial statements are prepared to comply with a contractual agreement. Is it permissible for Carl to use a SSARS No. 3 report under these circumstances?
- a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

GLOSSARY

Change in accounting estimate: A change in accounting estimate results from additional information or new developments and does not require prior period adjustment. Examples of accounting estimates that periodically change are allowances for bad debts, useful lives of depreciable assets, and estimated annual tax rates. The effect of changes in estimates should be reported in the period of the change and subsequent periods. Restatement of prior periods is not appropriate. Disclosure of a change in an accounting estimate is necessary if the change affects several future periods, such as a change in the useful lives of depreciable assets, or if the effect of the change is material. The accounting treatment applicable to changes in accounting estimates in annual statements is equally applicable to interim statements.

Change in accounting principle: A change in accounting principle is generally defined as a change from one acceptable accounting principle to another or a change in the method of applying an acceptable accounting principle. For purposes of interim financial statements, an accounting change has occurred if an accounting principle or the method of application of that principle is different from that used in the preceding interim period, the prior annual period, or the comparable interim period of the prior year.

Change in reporting entity: A change in reporting entity refers to a change that results in financial statements that are, in effect, the statements of a different reporting entity. The change should be retrospectively applied to the financial statements of all prior periods presented. The financial statements of the period of change shall describe the nature of the change and the reason for it. In addition, SFAS No. 154 requires disclosure of the effect of the change on income before extraordinary items, net income, and other comprehensive income for all periods presented. The accounting treatment applicable to a change in reporting entity in annual statements applies also to interim statements.

Comparative financial statements: Financial statements presented together for one or more prior periods, as well as the current period. Notes, explanations, and auditor qualifications should be retained to the extent that they continue to be of significance. Any change which affects comparability should be disclosed. Statements for a series of periods are far more significant than those for a single period. It enhances the usefulness of financial reports and shows more clearly the nature and trends of current changes affecting the enterprise.

Compilation: Presenting, in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the statements. The accountant on a compilation engagement must show due professional care but is not required to be independent. He is not required to make inquiry or perform other procedures to verify, corroborate, or review information supplied by management.

Component of an entity: The operations and cash flows of an entity that can be clearly distinguished from the rest of the entity.

Error correction: Errors in financial statements, as defined in SFAS No. 154, *Accounting Changes and Error Corrections*, include (1) mathematical mistakes, (2) mistakes in the application of accounting principles, and (3) oversight or misuse of facts that existed at the time the financial statements were prepared.

Extraordinary items: Events and transactions that are distinguished by their *unusual* nature and by the *infrequency* of their occurrence.

Generally Accepted Accounting Principles (GAAP): Basic accounting principles and standards and specific conventions, rules, and regulations that define accepted accounting practice at a particular time by incorporation of consensus and substantial authoritative support.

Income tax basis of accounting: A 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.

Interim financial information: Financial information released prior to year-end, usually quarterly as required for publicly traded corporations by the SEC. It is not a required element of financial statements in conformity with GAAP and is usually unaudited (reviewed only).

Issuer: Any entity (e.g., corporation, the U.S. government and its agencies, state and local governments) that issues or proposes to issue a security. The issuer would receive the proceeds from the sale in this type of transaction.

Materiality: Statement on Auditing Standards (SAS) 107 defines materiality as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

Modified cash basis of accounting: Modification of the cash basis should have *substantial support*. A modification would usually have “substantial support” if the modification is equivalent to GAAP for the particular item and if the modifications taken together are not illogical.

Nonissuer: Any entity that does not issue a security or propose to issue a security. Nonissuer transactions are secondary market transactions taking place over-the-counter or on an exchange. The entity selling the securities in this type of transaction would receive the proceeds from the sale.

Other Comprehensive Basis of Accounting (OCBOA): A definite set of criteria, other than GAAP, having substantial support underlying the preparation of financial statements prepared pursuant to that basis.

Prescribed form: Any *standard preprinted* form designed or adopted by the body to which it is to be submitted. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

Prior period adjustments: SFAS No. 16 limits the definition of prior period adjustments to the correction of an error. It is appropriate to restate prior period interim financial statements only in the event that either of the following types of items is present: (1) items qualifying as *prior period adjustments* as defined in SFAS No. 16 and (2) items qualifying as *adjustments related to prior interim periods of the current fiscal year*, also defined in SFAS No. 16.

Pure cash basis of accounting: The cash basis of accounting, in its pure form, recognizes revenues and expenses based on the receipt and disbursement of cash. The pure cash basis treats all disbursements of cash as expenses; thus, the purchase of property and equipment or inventory is recognized as an expense rather than as an asset.

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

SSARS No. 3 alternative compilation report: According to SSARS No. 3, an alternative form of compilation report is appropriate when the financial statements are included in a prescribed form that calls for a departure from GAAP.

Summary of significant accounting policies: The notes to OCBOA financial statements should include a summary of accounting policies that describes the basis of accounting used to prepare the financial statements and the primary differences between the basis of accounting used and GAAP.

Unusual or infrequently occurring items: An material event or transaction that is unusual in nature or occurs infrequently, but not both, and thus does not meet both criteria for classification as an extraordinary item.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 2

SPECIAL REPORTING ISSUES FOR PROPRIETORSHIPS, PARTNERSHIPS,
AND S CORPORATIONS (CARTG092)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers special reporting issues related to proprietorships, partnerships, and S corporations and their financial statements.
PUBLICATION/REVISION DATE:	July 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Compilation and Review Engagements</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting.
CPE CREDIT:	5 QAS Hours, 5 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 September 30, 2010
KNOWLEDGE LEVEL:	Basic

Learning Objectives:**Lesson 1—Proprietorships**

Completion of this lesson will enable you to:

- Assess issues related to a proprietor's financial statements.

Lesson 2—Partnerships

Completion of this lesson will enable you to:

- Summarize the basics of the following related to partnerships: selecting an accounting basis; accounting treatments in partnership agreements and hybrid accounting methods; federal, state, and franchise taxes; guaranteed payments; and loans.
- Assess issues related to a partnership's financial statements.
- Differentiate between partnerships, limited liability companies, and limited liability partnerships.

Lesson 3—S Corporations

Completion of this lesson will enable you to:

- Summarize the basics of financial statement presentation and accounting procedures for retained earnings for S corporations.
- Illustrate the following for S corporations: tracking separate retained earnings accounts and how losses, tax/book differences, and termination of the S corporation election affect retained earnings accounts.
- Compare and contrast proprietorships, partnerships, and S corporations.

TO COMPLETE THIS LEARNING PROCESS:

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

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CARTG092 Self-study CPE
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Chicago, IL 60694-6700**

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

ADMINISTRATIVE POLICIES:

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

Lesson 1: Proprietorships

INTRODUCTION

A proprietorship is an unincorporated business enterprise wholly owned by one individual. Because it represents a specific business activity using identifiable resources, the basic purpose of proprietorship financial statements is the same as other business enterprises—to present financial position, results of operations, and cash flows. Thus, the basic principles discussed in *PPC's Guide to Compilation and Review Engagements* apply. Certain peculiarities of proprietorships are discussed in the following paragraphs.

Learning Objectives:

Completion of this lesson will enable you to:

- Assess issues related to a proprietor's financial statements.

THE SEGREGATION OF PERSONAL AND PROPRIETORSHIP ACCOUNTS

Because a proprietorship is unincorporated, it is often difficult to properly segregate the assets of the business from the personal assets and liabilities of the owner of the business. The proprietor often does not maintain separate bank accounts and books for the proprietorship and may record business cash receipts and disbursements through his personal account. If the accountant is not able to properly segregate the personal and business assets and liabilities, it is not appropriate to issue financial statements described as those of a proprietorship. In this situation, the accountant may recommend to his client that personal financial statements be issued instead. The identifiable net proprietorship assets should be presented on one line in the personal financial statements.

Even when separate books are maintained, the accountant may face some significant judgments as to what constitutes a proprietorship asset, liability, revenue, or expense. For instance, investment activities may be carried on through the business accounts. In some situations, it may be appropriate to include the investment activities in the proprietorship financial statements, e.g., the proprietor considers the funds temporarily invested until needed in the proprietorship. In other cases, investment activities unrelated to the proprietorship are transacted through the proprietorship bank accounts and should not be part of the proprietorship financial statements.

To avoid confusion about the contents of proprietorship statements, a note to the financial statements clearly stating what accounts or operations are included in the statements is recommended. The following are examples of notes clarifying the content of the statements:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Operations

The financial statements include only those assets and liabilities of the proprietor, A.B. Jones, that relate to his oil and gas operations.

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Operations

The financial statements have been prepared solely from the accounts of the XYZ Company and do not include the personal accounts of the owner or those of any other operation in which he is engaged.

Accountants sometimes question whether they should include an emphasis paragraph in the accountant's report that clarifies what accounts or operations are included in the proprietor's financial statements, particularly when the financial statements omit substantially all disclosures. It is recommended that accountants avoid using emphasis paragraphs whenever possible. Such paragraphs require the accountants to choose the information in the financial

statements that should be emphasized. Unless the omission of disclosures is intended to mislead financial statement users, the standard paragraph (such as the one discussed in *PPC's Guide to Compilation and Review Engagements*) adequately informs users of the limitations of the financial statements. Furthermore, AR 100.55 states that an accountant should not include an emphasis paragraph in an accountant's report on compiled financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements.

If the accountant decides to add such a paragraph to the compilation or review report, the accountant needs to consider whether such a disclosure could be construed as being the representation of the accountant rather than the client, and should word the emphasis paragraph accordingly. An alternative to adding an emphasis paragraph to the compilation report clarifying the content of the proprietor's financial statements may be to include selected disclosures about only a few matters in the form of notes to the compiled financial statements. The accountant should consider whether the proprietor's election to include only selected disclosures causes the financial statements to be misleading (for example, by omitting only the disclosures that contain negative information). If so, the accountant should request that the financial statements be revised to include the omitted disclosures. The accountant may include an emphasis paragraph on a matter when management has presented selected information, even though substantially all disclosures have been omitted, as long as the matter discussed in the emphasis paragraph is disclosed in the selected information.

PROPRIETORSHIPS AND FEDERAL INCOME TAXES

Proprietorships are not taxpaying entities. The income of the proprietorship is only one of the items considered when the individual proprietor pays his income taxes. Therefore, no provision for income tax expense or the related liability is included in the financial statements of a proprietorship. Although not required by GAAP, it is recommended that this fact be disclosed in the financial statements. Withdrawals subsequent to the balance sheet date to pay the proprietor's personal income taxes could also be disclosed. The following is an example of how the income tax note might read:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income Taxes

Income from the proprietorship is combined with the income and expenses of the proprietor from other sources and reported in the proprietor's individual federal and state income tax returns. The proprietorship is not a taxpaying entity for purposes of federal and state income taxes, and thus no income taxes have been recorded in the statements. The proprietor customarily makes estimated tax payments toward his personal income tax liability from the proprietorship bank account. These payments are treated as withdrawals of capital. Subsequent to the balance sheet date, the proprietor withdrew \$25,000 from the proprietorship for the purpose of making his fourth and final estimated tax payment for 20X1.

If the financial statements omit substantially all disclosures, some accountants consider including an emphasis paragraph in the accountant's report for proprietorship financial statements regarding income taxes (that is, stating that there is no provision for income tax expense included in the financial statements or that withdrawals were made subsequent to the balance sheet date to pay the proprietor's personal income taxes). As discussed previously, the accountant should not include an emphasis paragraph in an accountant's report on compiled financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements.

USING CASH OR TAX BASIS STATEMENTS

Compiled or reviewed financial statements of a proprietorship are frequently issued on either the tax or cash basis of accounting, and thus, terms such as "Balance Sheet" and "Statement of Income and Proprietor's Capital" should not be used. This course recommends that the statements be titled "Statement of Assets, Liabilities, and Capital—Cash Basis (or Income Tax Basis)" and "Statement of Revenues and Expenses—Cash Basis (or Income Tax Basis)."

THE EQUITY SECTION OF BALANCE SHEET FOR A PROPRIETORSHIP

The equity section of the balance sheet of a proprietorship should be labeled "Proprietor's Capital." Unlike corporations, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings. However, as discussed in the following paragraph, a statement of changes in proprietor's capital may be necessary.

A STATEMENT OF CHANGES IN PROPRIETOR'S CAPITAL FOR A PROPRIETORSHIP

General Requirements

According to APB Opinion No. 12, Paragraphs 9 and 10 (FASB ASC 505-10-50-2), disclosure of changes in the separate accounts comprising stockholders' equity is required when both financial position and results of operations are presented. It is believed this disclosure should be made in OCBOA financial statements. Likewise, these principles are believed equally applicable to entities other than corporations. Thus, the proprietor's capital should disclose changes such as the following:

- a. Contributions to capital.
- b. Earnings.
- c. Drawings.

Compiled financial statements that omit substantially all disclosures may not include a statement of changes in proprietor's capital and may not disclose the changes on the face of the financial statements. Some accountants have questioned whether this lack of information should be considered a departure from GAAP. According to Paragraph 10 of APB Opinion No. 12 (FASB ASC 505-10-50-2), the changes in equity accounts is considered a required disclosure but not a required statement. Therefore, such information is not required to be disclosed in compiled financial statements that omit substantially all disclosures. However, when disclosures are omitted from compiled financial statements, it is believed preferable to show the changes in equity accounts either on the income statement or face of the balance sheet.

Disclosure with Statement of Income

In many cases, these changes can be appropriately disclosed by presenting a combined statement of income and changes in proprietor's capital. The following is an excerpt from such a statement:

NET INCOME	\$ 50,000
BEGINNING PROPRIETOR'S CAPITAL	125,000
Drawings for the year	(45,000)
Additional capital contributed	<u>10,000</u>
ENDING PROPRIETOR'S CAPITAL	<u>\$ 140,000</u>

Disclosure in a Separate Statement

In other circumstances, such as when more detail or description of the changes is desired or when comparative statements are presented, it may be appropriate to present a separate Statement of Changes in Proprietor's Capital. An example of a statement of changes in proprietor's capital follows:

JOE'S GROCERY STORES
STATEMENT OF CHANGES IN PROPRIETOR'S CAPITAL
Years Ended December 31, 20X2 and 20X1

	<u>20X2</u>	<u>20X1</u>
BEGINNING PROPRIETOR'S CAPITAL	\$ 110,000	\$ 75,000
Net income for the year	90,000	60,000
Capital contributed	—	15,000
Capital withdrawn	<u>(55,000)</u>	<u>(40,000)</u>
ENDING PROPRIETOR'S CAPITAL	<u>\$ 145,000</u>	<u>\$ 110,000</u>

Disclosure in Notes to Financial Statements

Disclosure of changes in proprietor's capital in the notes to the financial statements is also acceptable and may be preferable if additional explanation of a capital transaction is necessary. An example follows:

NOTE E—CHANGES IN PROPRIETOR'S CAPITAL

Changes to Mr. Jones's capital account for 20X1 are presented below:

BEGINNING PROPRIETOR'S CAPITAL	\$ 110,000
Net income for the year	90,000
Capital contributed	150,000
Capital withdrawn	<u>(60,000)</u>
ENDING PROPRIETOR'S CAPITAL	<u>\$ 290,000</u>

During the year, Mr. Jones inherited the office building that the proprietorship formerly leased. The building was contributed to the proprietorship at its estimated fair market value of \$150,000.

Capital withdrawn includes personal expenses paid by the proprietorship on behalf of Mr. Jones, as well as direct cash withdrawals.

ISSUING CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

The same general rules concerning consolidated financial statements, the equity method of accounting, and combined financial statements that apply to other business entities are also applicable to proprietorships. Therefore, it may be appropriate, when a proprietorship owns an interest in a corporation, to issue statements that *consolidate* the accounts of the proprietorship and the owned interest. The accountant should refer to ARB No. 51; SFAS No. 160 (FASB ASC 810); and TIS 1400.02 for appropriate guidance.

It may also be appropriate to present *combined* financial statements for a group of commonly owned proprietorships or for a proprietorship and a corporation or partnership that is controlled by the proprietor. Note that combined and consolidated statements follow the same general accounting principles, and thus the distinction as to whether the proprietor or proprietorship owns the interest in the corporation has no effect other than on the title of the statements, i.e., combined or consolidated.

The accountant should also note that the equity method of accounting [APB Opinion No. 18, *Accounting Interpretation No. 2 of APB Opinion No. 18*, and SFAS No. 94 (FASB ASC 323)] is also applicable to proprietorships and may apply to unconsolidated investments in corporations or partnerships.

SELF-EMPLOYED RETIREMENT PLANS FOR PROPRIETORS

A proprietor may set up a retirement plan similar to profit sharing, pension, or other types of employee benefit plans used by corporations. There is no authoritative guidance on how to account for such plans in a proprietorship. Thus, there is diversity in practice as to whether payments to partners and related retirement benefits are treated as an expense to the proprietorship or as distribution of proprietor's capital.

Qualified retirement plans (commonly referred to as Keogh or HR-10 Plans) are required by federal income tax laws to include present and future employees other than the proprietor. Thus, it is the opinion of this course that payments to such plans should be recorded as an expense of the proprietorship rather than as a withdrawal of capital. When the proprietor makes payments to the Individual Retirement Accounts of employees as well as to his own IRA, i.e., an SEP-IRA plan, the payments should be recorded as an expense of the proprietorship.

Regardless of the method used to account for retirement plan payments, the significant provisions of the proprietor's plan (Keogh or SEP-IRA) and the accounting policy followed for the proprietor's share should be properly disclosed in the notes to the financial statements.

SELF-STUDY QUIZ

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

1. What is the term for a business enterprise that is unincorporated and wholly owned by one individual?
 - a. A partnership.
 - b. A proprietorship.
 - c. An S corporation.
 - d. A C corporation.
2. What is the best method an accountant can use to clarify any confusion about proprietorship and personal accounts in the financial statements?
 - a. Adding a note to the financial statements.
 - b. Including an emphasis paragraph in the accountant's report.
3. How should the equity section of a proprietorship's balance sheet be labeled?
 - a. Balance Sheet.
 - b. Proprietor's Capital.
 - c. Statement of Assets, Liabilities, and Capital—Cash Basis.
 - d. Statement of Revenues and Expenses—Income Tax Basis.
4. When is disclosure of changes in the separate stockholders' equity accounts required?
 - a. When both results of operations and financial position are presented.
 - b. When the financial statements use an other comprehensive basis of accounting (OCBOA).
 - c. When the financial statements belong to a corporation (i.e., not a proprietorship).
 - d. When a statement of income is included in the financial statements.
5. Baker's Dozen is a proprietorship owned by James Everett. James sets up a qualified Keogh retirement plan for himself, his employees, and his future employees. According to this course, how should payments to this plan be recorded?
 - a. As an expense of the proprietorship.
 - b. As an expense of the proprietor.

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 is the term for a business enterprise that is unincorporated and wholly owned by one individual? **(Page 105)**
 - a. A partnership. [This answer is incorrect. A partnership is an association of two or more persons to carry on as co-owners of a business for profit.]
 - b. A proprietorship. [This answer is correct. A proprietorship is an unincorporated business enterprise wholly owned by one individual. Because it represents a specific business activity using identifiable resources, the basic purpose of proprietorship financial statements is the same as other business enterprises—to present financial position, results of operations, and cash flows.]**
 - c. An S corporation. [This answer is incorrect. An S corporation is an elective provision permitting certain small-business corporations and their shareholders to elect special income tax treatment.]
 - d. A C corporation. [This answer is incorrect. A C corporation is organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level. Shareholders pay taxes on dividends paid out of earnings and profits of the corporation.]
2. What is the best method an accountant can use to clarify any confusion about proprietorship and personal accounts in the financial statements? **(Page 105)**
 - a. Adding a note to the financial statements. [This answer is correct. To avoid confusion about the contents of proprietorship statements, a note to the financial statements clearly stating what accounts or operations are included in the statements is recommended.]**
 - b. Including an emphasis paragraph in the accountant's report. [This answer is incorrect. Accountants sometimes question whether they should include an emphasis paragraph in the accountant's report that clarifies what accounts or operations are included in the proprietor's financial statements, particularly when the financial statements omit substantially all disclosures. It is recommended that accountants avoid using emphasis paragraphs whenever possible. Such paragraphs require the accountants to choose the information in the financial statements that should be emphasized. Unless the omission of disclosures is intended to mislead financial statements users, a standard paragraph adequately informs users of the limitations of the financial statements.]
3. How should the equity section of a proprietorship's balance sheet be labeled? **(Page 107)**
 - a. Balance Sheet. [This answer is incorrect. This financial statement title would be used in GAAP financial statements. It would not be used specifically for the equity section of the proprietorship's balance sheet. If the proprietorship's financial statements are prepared using an other comprehensive basis of accounting, this financial statement title should not be used.]
 - b. Proprietor's Capital. [This answer is correct. The equity section of the balance sheet of a proprietorship should be labeled "Proprietor's Capital." Unlike corporations, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings.]**
 - c. Statement of Assets, Liabilities, and Capital—Cash Basis. [This answer is incorrect. This financial statement title would be used for financial statements prepared using the cash basis of accounting. It is not specific to the equity section of a proprietorship's balance sheet.]
 - d. Statement of Revenues and Expenses—Income Tax Basis. [This answer is incorrect. This financial statement title is not specific to the equity section of a proprietorship's balance sheet. It would be used for financial statements prepared using the cash basis of accounting.]

4. When is disclosure of changes in the separate stockholders' equity accounts required? **(Page 107)**
- a. **When both results of operations and financial position are presented. [This answer is correct. According to APB Opinion No. 12, Paragraphs 9 and 10 (FASB ASC 505-10-50-2), disclosure of changes in the separate accounts comprising stockholders' equity is required when both financial position and results of operations are presented.]**
 - b. When the financial statements use an other comprehensive basis of accounting (OCBOA). [This answer is incorrect. Presenting financial statements using an OCBOA does not trigger the necessity of this disclosure; however, it is believed that this disclosure should be made in OCBOA financial statements.]
 - c. When the financial statements belong to a corporation (i.e., not a proprietorship). [This answer is incorrect. The reasons that would make this disclosure required are believed equally applicable to entities other than corporations. Thus, the proprietor's capital should disclose changes such as contributions to capital, earnings, and drawings.]
 - d. When a statement of income is included in the financial statements. [This answer is incorrect. The changes in the separate accounts comprising stockholders' equity can be appropriately disclosed by presenting a combined statement of income and changes in proprietor's capital; however, including a statement of income does not specifically trigger the need for this disclosure.]
5. Baker's Dozen is a proprietorship owned by James Everett. James sets up a qualified Keogh retirement plan for himself, his employees, and his future employees. According to this course, how should payments to this plan be recorded? **(Page 109)**
- a. **As an expense of the proprietorship. [This answer is correct. Qualified retirement plans (commonly referred to as Keogh or HR-10 Plans) are required by federal income tax laws to include present and future employees other than the proprietor. Thus, it is the opinion of this course that payments to such plans should be recorded as an expense of the proprietorship rather than as a withdrawal of capital.]**
 - b. As an expense of the proprietor. [This answer is incorrect. Based on the guidance in this course, payments to qualified retirement plans, such as Keogh plans, and payments to individual retirement accounts (IRAs) of employees and the proprietor's own IRA should be recorded as an expense of the proprietorship, not the proprietor. However, there is no authoritative guidance on how to account for such plans in a proprietorship.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (CARTG092)**

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. Kerry, a CPA, accepts an engagement with Ice Treatz, a proprietorship. Macy, the proprietor of Ice Treatz, records business cash receipts and disbursements through her personal account, which makes it difficult for Kerry to properly segregate Macy's assets from those of the proprietorship. What would be the appropriate course of action for Kerry to take in this situation?
 - a. Require Macy to retroactively create separate books for her personal and business accounts.
 - b. Segregate the assets as much as possible so financial statements can be issued for the proprietorship.
 - c. Recommend to Macy that personal financial statements be issued instead of proprietorship statements.
 - d. Withdraw from the engagement immediately.
2. Who is responsible for paying a proprietorship's federal income taxes?
 - a. The proprietorship.
 - b. The proprietor.
 - c. The business and the owner are each responsible for certain portions of income tax.
 - d. A proprietorship and its owner are both exempt from paying income taxes.
3. Cut 'N Curl is a proprietorship owned by proprietor Sally Johnson. With the help of her accountant, Lucas Mills, Sally issues compiled financial statements for her proprietorship. Which of the following applies under these circumstances?
 - a. Lucas is required to add an emphasis paragraph to his compilation report to clarify the segregation of accounts.
 - b. Cut 'N Curl's financial statements must include a provision for income tax expense and the related liability.
 - c. A statement of changes in proprietor's capital can be omitted from Cut 'N Curl's financial statements at Lucas or Sally's discretion.
 - d. Cut 'N Curl's financial statements can be issued on the income tax basis of accounting using modified statement titles.
4. If additional explanation of a capital transaction is needed, where should the disclosure of changes in proprietor's capital be located?
 - a. In the notes to the financial statements.
 - b. In a combined statement of income and changes in proprietor's capital.
 - c. In a separate statement of changes in proprietor's capital.
 - d. Do not select this answer choice.
5. Is it ever appropriate for a proprietorship to present consolidated or combined financial statements?
 - a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

Lesson 2: Partnerships

INTRODUCTION

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. Partnerships are governed in the various states of the United States by the Uniform Partnership Act (UPA). A partnership may be a general partnership, limited partnership, limited liability company, or joint venture.

The characteristics of a partnership include:

- Voluntary association of persons as individuals (the partnership has no separate legal identity).
- Simple agreement without governmental sanction.
- A fiduciary relationship (mutual agency—each partner is an agent for the others and for the partnership).
- Co-ownership.
- Mutual agency of partners.
- Joint and several liability.

This lesson discusses the basics of partnerships and their financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the basics of the following related to partnerships: selecting an accounting basis; accounting treatments in partnership agreements and hybrid accounting methods; federal, state, and franchise taxes; guaranteed payments; and loans.
- Assess issues related to a partnership's financial statements.
- Differentiate between partnerships, limited liability companies, and limited liability partnerships.

ACCOUNTING BASIS SELECTION

Generally, the partnership agreement dictates the accounting basis to be used in preparing a partnership's financial statements. Frequently, the agreement will specify the cash or income tax basis of accounting. Because of the complicated Internal Revenue Service provisions applicable to partnerships, many accountants encourage their partnership clients to use the income tax basis of accounting. Likewise, many limited partnerships are designed to provide maximum tax benefits to the partners, and great emphasis is placed on the income tax basis of the assets. Thus, most frequently, partnerships present their financial statements on the income tax basis of accounting.

Cash and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP. Thus, partnership financial statements presented on the cash or tax basis should not be described in terms that are generally applicable to accrual basis statements [see SSARS No. 1, as amended (AR 100.04)]. For example, instead of "Balance Sheet," the term "Statement of Assets, Liabilities, and Capital—Income Tax Basis" should be used. Similarly, instead of "Income Statement," the term "Statement of Revenues and Expenses—Income Tax Basis" may be used. Also, a statement of cash flows is not required for tax or cash basis partnership financial statements because the statements do not purport to present financial position and results of operations in accordance with GAAP. See *PPC's Guide to Compilation and Review Engagements* for additional details about cash and tax basis financial statements.

If the partnership agreement does not specify a basis of accounting other than GAAP, the partnership financial statements should include all statements required by GAAP, which would include:

- a. Balance Sheet.

- b. Statement of Income.
- c. Statement of Changes in Partners' Capital.
- d. Statement of Cash Flows.

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10-15-2), requires comprehensive income and its components to be reported when a company presents a full set of financial statements that report financial position, results of operations, and cash flows. Comprehensive income may be reported in the income statement, in a separate statement of comprehensive income, or in a statement of changes in owners' equity.

The basic financial statement presentation principles discussed in *PPC's Guide to Compilation and Review Engagements* should be applied to partnership financial statements presented on the accrual basis. The following paragraphs discuss some of the unique problems of partnership financial statement presentation.

THE USE OF A SPECIAL ACCOUNTING TREATMENT SPECIFIED IN AGREEMENT OR A HYBRID ACCOUNTING METHOD

It is common for a partnership agreement to specify an accounting treatment for one or more items that is not in accordance with GAAP or OCBOA. For example, the partnership agreement may specify that no depreciation is to be recorded on real property. In such situations, the accountant has two reporting options:

- a. If the distribution of the report is to be limited solely to the partners or to those with whom the partnership is negotiating directly, issue a special-purpose report.
- b. If the distribution of the report is not limited, determine the general basis of accounting being used for other items, i.e., GAAP, cash, or tax, and handle the accounting treatment of the special item or items as departures from GAAP or OCBOA.

Special-purpose Report Based on the Basis of Accounting Specified in the Partnership Agreement

Interpretation No. 28 of SSARS No. 1 (AR 9100.109–.119) provides guidance for an accountant engaged to compile or review financial statements prepared on a basis of accounting specified in a contractual agreement. It also requires that the distribution of the report be restricted. In the case of a partnership agreement, distribution would be restricted to the partners or to those with whom the partnership is negotiating directly. In this case, the term *negotiating directly* refers to those individuals who have an opportunity to ask questions about the partnership's financial statements.

Financial Statements Prepared on a Basis of Accounting Specified in the Partnership Agreement Intended for General Use

If the accountant's report on financial statements prepared on a basis of accounting specified in a partnership agreement is to be distributed to parties other than the partners or those with whom the partnership is negotiating directly, the accountant should handle any items requiring special accounting treatment as departures from GAAP or OCBOA. *PPC's Guide to Compilation and Review Engagements* discusses reporting on financial statements with departures from GAAP. (This guidance is also applicable for departures from OCBOA.) Following is an example of a note to the financial statements describing a departure specified by a partnership agreement:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The partnership agreement specifies use of the tax basis of accounting for all items of income and expense except for depreciation on real property. The agreement specifies that no depreciation will be recognized on real property. For the year ended December 31, 20X1, the partnership tax return included a deduction of \$75,000 for depreciation of buildings. Cumulative depreciation on

buildings totaled \$180,000 at December 31, 20X1. These financial statements do not reflect current or accumulated depreciation on real property and thus are not in accordance with the tax basis of accounting.

When departures from GAAP or OCBOA are significant or pervasive, the accountant should consider the need to include an explanatory paragraph in the report emphasizing the limitations of the financial statements. [See Interpretation No. 7 of SSARS No. 1 (AR 9100.23–.26).]

Client Interpretations of the Partnership Agreement

When the accountant submits compiled or reviewed special-purpose financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA, Interpretation No. 28 of SSARS No. 1 (AR 9100.109–.119) requires that the accountant's report include a description of any significant interpretations made by the client regarding provisions of the agreement. The interpretation descriptions that should be included will vary depending upon the terms of the agreement.

PARTNERSHIPS AND FEDERAL INCOME TAXES

Income from a partnership is taxed to the partners rather than to the partnership. Therefore, the financial statements of the partnership should not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP (TIS 7200.02). However, when the partnership's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial partner withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, it is recommended that the financial statements disclose (a) that the partnership does not pay income taxes and (b) any anticipated withdrawals by partners to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant should consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Federal Income Taxes

The partnership is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income from the partnership is taxed to the partners in their individual returns. The partners customarily make substantial capital withdrawals in April of each year to pay their personal income tax liabilities. At December 31, 20X1, \$75,000 has been deposited in a partnership savings account in anticipation of partner withdrawals.

SFAS No. 109 (FASB ASC 740-10-50-16) requires publicly held entities that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although SFAS No. 109 (FASB ASC 740-10) does not require nonissuers to disclose similar information, disclosing that income is taxed directly to the owners and that as a result, the partnership did not recognize a provision for income taxes, as illustrated in the preceding paragraph is recommended. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. The disclosure of the nature of temporary differences is believed to ordinarily satisfy the primary users of the financial statements and, thus, it is not necessary to disclose the amount of the basis differences.

Occasionally, a partnership agreement requires that a provision for income taxes be computed at a specified rate and be included as an expense of the partnership. The inclusion of such a tax provision is a departure from GAAP and should be reported as such.

Accounting for Uncertainty in Income Tax and Partnerships

The measurement and disclosure principles of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FASB ASC 740-10), do not affect the financial statements of an entity that is not potentially subject to income

taxes. To illustrate, assume that the IRS examines the Form 1065 of a partnership and disallows certain deductions. Any additional income taxes will be imposed on the partners rather than the partnership, and accordingly, FIN 48 (FASB ASC 740-10) would have no effect on the partnership's financial statements.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FASB ASC 740-10), was issued in July 2006 and (as issued) was effective for fiscal years beginning after December 15, 2006. However, nonpublic entities are allowed a deferral of the effective date in certain situations. FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises* (FASB ASC 740-10-15-2), defers the effective date for nonpublic entities to fiscal years beginning after December 15, 2008, unless the entity (a) is consolidated with a public entity that applies U.S. GAAP or (b) has previously issued a full set of U.S. GAAP annual financial statements in which the requirements of the Interpretation were adopted. Nonpublic entities electing the deferral are still required to provide certain disclosures.

Partnerships only need to consider the measurement and disclosure principles of FIN 48 (FASB ASC 740-10) if the entity has the potential to be subject to income taxes.

HOW STATE INCOME AND FRANCHISE TAXES AFFECT PARTNERSHIPS

If a state or other taxing authority levies a tax on the partnership and the tax is based on net income, the financial statements should show the tax as an expense of the partnership. Because the payment of income taxes by a partnership is rare, the financial statements should disclose the nature of the tax (if material).

DEALING WITH GUARANTEED PAYMENTS TO PARTNERS

Guaranteed payments to partners are often made as salary payments for services or interest on capital accounts. The conventional method of accounting for such payments is to treat them as part of the allocation of partnership net income, rather than as an expense in determining net income. However, in some situations, e.g., when the payments are designed to reflect reasonable compensation for services, it may be more meaningful to show the payments as expenses of the partnership. Whenever guaranteed payments are material, the method of accounting for them should be stated in the accounting policies disclosures.

LOANS BETWEEN THE PARTNERSHIP AND ITS PARTNERS

Loans from partners to the partnership, which are greater than the capital required to be contributed, are conventionally accounted for as loans rather than capital. In most states, such loans have preferential treatment over capital upon dissolution. Thus, they should be classified in the balance sheet as liabilities rather than capital, and interest on the loans should be recorded as an expense of the partnership. The appropriate disclosures required for related party transactions and notes payable are illustrated in the following example:

NOTE C—NOTES PAYABLE TO PARTNERS

The notes payable to partners represent unsecured demand loans payable to certain partners. Interest on the notes is payable quarterly at the prime interest rate charged by local banks.

Loans to partners, which are not intended to be withdrawals of capital or profits, are considered assets of the partnership by law in most states. These loans should be recorded in the balance sheet as an asset rather than a reduction of capital. Again, a related party disclosure, such as the following, is appropriate:

NOTE D—LOANS TO PARTNERS

Loans to partners are 180-day unsecured loans due May 31, 20X1. The loans bear interest at the rate of 10% per annum, payable at maturity.

SFAS No. 57, *Related Party Disclosures* (FASB ASC 850-10), defines related parties and sets the requirements for related party disclosures.

SELF-STUDY QUIZ

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

6. What accounting basis do accountants frequently recommend for partnership financial statements?
 - a. Cash basis.
 - b. Income tax basis.
 - c. Generally accepted accounting principles (GAAP).
7. BlingCo is a partnership that presents its financial statements using GAAP. BlingCo's partnership agreement specifies that no depreciation is to be recorded on real property. Use of the accountant's report on BlingCo's financial statements is not limited. How should BlingCo's accountant report this accounting treatment?
 - a. The treatment of depreciation aligns with GAAP, so no special handling is needed.
 - b. BlingCo's accountant must issue a special-purpose report.
 - c. The treatment of depreciation should be handled as a departure from GAAP.
 - d. Because this treatment is a departure from GAAP, the accountant should withdraw from the engagement.
8. A partnership's income is taxed to which of the following?
 - a. The partnership.
 - b. The partners.
9. Generally speaking, will the measurements and disclosure principles of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, affect a partnership's financial statements?
 - a. Yes.
 - b. No.
10. Can state income or franchise taxes affect partnerships?
 - a. Yes.
 - b. No.
11. How are loans from partners to the partnership conventionally accounted for if they are greater than the capital required to be contributed?
 - a. As partnership assets.
 - b. As partnership expenses.
 - c. As additional capital.
 - d. As liabilities.

SELF-STUDY ANSWERS

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

6. What accounting basis do accountants frequently recommend for partnership financial statements? **(Page 115)**
- a. Cash basis. [This answer is incorrect. Generally, the partnership agreement dictates the accounting basis to be used in preparing a partnership's financial statements. Frequently, the agreement will specify the cash or income tax basis of accounting. However, the cash basis is not the basis frequently recommended for partnerships by accountants.]
 - b. Income tax basis. [This answer is correct. Because of the complicated Internal Revenue Service provisions applicable to partnerships, many accountants encourage their partnership clients to use the income tax basis of accounting. Likewise, many limited partnerships are designed to provide maximum tax benefits to the partners, and great emphasis is placed on the income tax basis of the assets. Thus, most frequently, partnerships present their financial statements on the income tax basis of accounting.]**
 - c. Generally accepted accounting principles (GAAP). [This answer is incorrect. Special considerations related to partnerships cause many accountants to recommend their partnership clients use a basis of accounting that is *not* GAAP. When a partnership's financial statements are not purporting to present financial position and results of operations in accordance with GAAP, they should not be described in terms that are generally applicable to accrual basis statements.]
7. BlingCo is a partnership that presents its financial statements using GAAP. BlingCo's partnership agreement specifies that no depreciation is to be recorded on real property. Use of the accountant's report on BlingCo's financial statements is not limited. How should BlingCo's accountant report this accounting treatment? **(Page 116)**
- a. The treatment of depreciation aligns with GAAP, so no special handling is needed. [This answer is incorrect. It is common for a partnership agreement to specify an accounting treatment for one or more items that is not in accordance with GAAP or OCBOA. For example, as in the BlingCo scenario above, the partnership agreement may specify that no depreciation is to be recorded on real property. In such situations, the accountant has two reporting options.]
 - b. BlingCo's accountant must issue a special-purpose report. [This answer is incorrect. If the distribution of BlingCo's accountant's report were limited solely to the partners or to those with whom the partnership is negotiating directly, issuing a special-purpose report would be the correct reporting option. However, the report in this scenario is not limited.]
 - c. The treatment of depreciation should be handled as a departure from GAAP. [This answer is correct. Because the distribution of BlingCo's accountant's report is not limited, the partnership's accountant should first determine the general basis of accounting being used for other items in the financial statements (i.e., GAAP, in this scenario) and then handle the accounting treatment of depreciation as a departure from GAAP. The same method would be used of BlingCo used an OCBOA instead of GAAP.]**
 - d. Because this treatment is a departure from GAAP, the accountant should withdraw from the engagement. [This answer is incorrect. It would not be necessary for BlingCo's accountant to withdraw from the engagement merely because the partnership agreement specifies an accounting treatment that differs from GAAP.]

8. A partnership's income is taxed to which of the following? **(Page 117)**
- a. The partnership. [This answer is incorrect. Generally, a partnership is not a taxable entity. A note in the Summary of Significant Accounting policies is recommended as a reminder that the entity is not a taxable entity.]
 - b. The partners. [This answer is correct. Income from a partnership is taxed to the partners rather than to the partnership. Therefore, the financial statements of the partnership should not include federal income tax expense or the related liability.]**
9. Generally speaking, will the measurements and disclosure principles of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, affect a partnership's financial statements? **(Page 117)**
- a. Yes. [This answer is incorrect. The measurement and disclosure principles of FASB Interpretation No. 48 do not affect the financial statements of an entity that is not potentially subject to income taxes.]
 - b. No. [This answer is correct. Generally speaking, FASB Interpretation No. 48 will not affect the financial statements of a partnership. Partnerships only need to consider these measurement and disclosure principles if the entity has the potential to be subject to income taxes.]**
10. Can state income or franchise taxes affect partnerships? **(Page 118)**
- a. Yes. [This answer is correct. If a state or other taxing authority levies a tax on the partnership and the tax is based on net income, the financial statements should show the tax as an expense of the partnership.]**
 - b. No. [This answer is incorrect. Such taxes can affect partnerships, but it is rare. Because the payment of income taxes by a partnership is rare, the financial statements should disclose the nature of the tax (if material).]
11. How are loans from partners to the partnership conventionally accounted for if they are greater than the capital required to be contributed? **(Page 118)**
- a. As partnership assets. [This answer is incorrect. Loans to partners, which are not intended to be withdrawals of capital or profits, are considered assets of the partnership by law in most states. These loans should be recorded in the balance sheet as an asset rather than a reduction of capital.]
 - b. As partnership expenses. [This answer is incorrect. The interest of such loans should be recorded as an expense of the partnership; however, this is not the accounting treatment for the entire loan.]
 - c. As additional capital. [This answer is incorrect. Loans classified in the balance sheet as additional capital contributed would not earn interest or receive preferential treatment over capital.]
 - d. As liabilities. [This answer is correct. Loans from partners to the partnership, which are greater than the capital required to be contributed, are conventionally accounted for as loans rather than capital. In most states, such loans have preferential treatment over capital upon dissolution.]**

THE EQUITY SECTION OF THE BALANCE SHEET FOR A PARTNERSHIP

The equity section of the balance sheet of a partnership should be labeled "Partners' Capital." In some situations, it may be desirable to disclose the capital accounts of the individual partners or classes of partners. Examples of such presentations on the face of the balance sheet follow:

PARTNERS' CAPITAL	
John Jones	\$ 50,000
Jim Smith	130,000
Bill Adams	<u>85,000</u>
	<u>\$ 265,000</u>
PARTNERS' CAPITAL	
General Partner	\$ 110,000
Limited partners	<u>(1,275,000)</u>
	<u>\$ (1,165,000)</u>

The same type of presentation might also be made in a note, rather than on the face of the statements.

Generally, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings, as is done for corporations. However, as discussed in the following section, a statement of changes in partners' capital may be necessary.

A STATEMENT OF CHANGES IN PARTNERS' CAPITAL FOR A PARTNERSHIP

APB Opinion No. 12 (FASB ASC 505-10-50-2) requires changes in the stockholders' equity accounts to be *disclosed* whenever the financial statements purport to present both financial position and results of operations. While not specifically discussed in accounting literature, it is also believed that financial statements on the cash or tax basis of accounting or financial statements of entities other than corporations should disclose changes in the components of the capital or equity section of the balance sheet. Accordingly, changes in partners' capital should be disclosed. In many cases, these changes can be best disclosed by presenting a combined statement of income and changes in partners' capital as follows:

NET INCOME	\$ 150,000
BEGINNING PARTNERS' CAPITAL	225,000
Drawings for the year	(145,000)
Additional capital contributed	<u>30,000</u>
ENDING PARTNERS' CAPITAL	<u>\$ 260,000</u>

It may be preferable to present a separate statement of changes in partners' capital in circumstances such as the following:

- When more detail or description of the transactions is desired.
- When comparative statements are presented.
- When changes in individual partners' capital accounts are presented.

Exhibit 2-1 and Exhibit 2-2 show examples of separate "Statements of Changes in Partners' Capital."

Exhibit 2-1

Example Statements of Changes in Partners' Capital

ABC DISTRIBUTING PARTNERSHIP
STATEMENTS OF CHANGES IN PARTNERS' CAPITAL
Years Ended December 31, 20X2 and 20X1

	<u>20X2</u>	<u>20X1</u>
BEGINNING PARTNERS' CAPITAL	\$ 110,000	\$ 75,000
Net income for the year	90,000	60,000
Capital contributed	—	15,000
Capital withdrawn	<u>(55,000)</u>	<u>(40,000)</u>
ENDING PARTNERS' CAPITAL	<u>\$ 145,000</u>	<u>\$ 110,000</u>

See accompanying notes and accountant's report.

* * *

Exhibit 2-2

Example Statements of Changes in Partners' Capital

XYZ PARTNERSHIP
STATEMENT OF CHANGES IN PARTNERS' CAPITAL
Year Ended December 31, 20X2

	<u>Partner X</u>	<u>Partner Y</u>	<u>Partner Z</u>	<u>Total</u>
BEGINNING CAPITAL	\$ 50,000	\$ 75,000	\$ 40,000	\$ 165,000
Share of net income	85,000	60,000	45,000	190,000
Capital contributed	—	—	10,000	10,000
Drawings	<u>(80,000)</u>	<u>(70,000)</u>	<u>(40,000)</u>	<u>(190,000)</u>
ENDING CAPITAL	<u>\$ 55,000</u>	<u>\$ 65,000</u>	<u>\$ 55,000</u>	<u>\$ 175,000</u>

See accompanying notes and accountant's report.

* * *

CONSIDERATIONS FOR DEALING WITH CHANGES IN PARTNERSHIP INTEREST

EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority Voting Interest but the Minority Shareholder or Shareholders Have a Certain Approval or Veto Rights" (FASB ASC 810-10-25-1), requires the reporting entity to include in its financial statements the consolidated financial results of all entities in which it has a controlling financial interest. SFAS No. 141(R), *Business Combinations* (FASB ASC 805), provides guidance on accounting for the acquisition or disposition of a controlling financial interest. The authoritative literature on accounting for consolidations and business combinations applies to partnerships and limited liability companies, as well as corporations.

Prior to SFAS No. 141(R), *Business Combinations* (FASB ASC 805), authoritative literature did not provide guidance on accounting for partnership admissions and withdrawals. Practitioners had to rely on the bonus and goodwill methods as presented in accounting textbooks and EITF Issue No. 88-16, "Basis in Leveraged Buyout Transactions." SFAS No. 141(R) (FASB ASC 805) is effective for fiscal years beginning after December 15, 2008 (early adoption is prohibited) and nullifies the guidance in EITF Issue No. 88-16. Chapter 11 of *PPC's Guide to Preparing Financial Statements* provides detailed guidance on accounting for consolidations and business combinations.

INVESTMENTS IN PARTNERSHIPS AND JOINT VENTURES

Accounting for an investment in a partnership is a source of confusion to practitioners. Confusion exists regardless of whether the owner is an individual, corporation, or another partnership.

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (FASB ASC 323-10), is the authoritative pronouncement that comes closest to being on point. APB Opinion No. 18 (FASB ASC 323-10) requires the use of the equity method of accounting by investors holding investments in unconsolidated subsidiaries and corporate joint ventures; however, it does not address investments in partnerships and unincorporated joint ventures. But, AICPA Interpretation No. 2 of APB Opinion No. 18 (FASB ASC 323-30-15-3), while specifically stating that APB Opinion No. 18 (FASB ASC 323-10) does not address such investments, does state that many of its provisions are appropriate in accounting for a partnership interest. The same factors (a controlling financial interest and the ability to exercise significant influence over operating and financial policies) that are necessary for use of the equity method by investors in corporate common stock apply to investments in partnerships. Further guidance on the application of the equity method is provided in EITF Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock" (FASB ASC 323-10-15 and 323-10-55).

The term *investor*, as defined, refers to a business entity and specifically excludes estates, trusts, and individuals from coverage of its provisions. Thus, it appears that the equity method is appropriate for use by corporate investors, by partnerships, and by proprietorships that have investments in partnerships or joint ventures.

Corporate investors, partnerships, and proprietorships ordinarily should use the equity method of accounting for investments of 20%–50% in a partnership or unincorporated joint venture. For unincorporated joint ventures in certain industries, e.g., oil and gas ventures, it may be appropriate for the investor to record in its financial statements its pro rata share of the assets, liabilities, revenues, and expenses of the venture. (Such a presentation may be appropriate if the investor owns an undivided interest in each of the venture's assets and is proportionately liable for its share of each of the venture's liabilities. However, EITF Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," (FASB ASC 810-10-45-14) states that such a presentation is not appropriate for investments in unincorporated legal entities accounted for by the equity method unless the investee is in either the construction industry or an extractive industry that traditionally has used that presentation.) For investments of less than 20%, the cost method generally should be used.

If the equity method is used to account for an investment in a partnership, e.g., when the investor has more than a 20% interest and has the ability to exercise significant influence over partnership policies, the investor would record its prorata share of partnership profits or losses by adjusting the carrying value of its investment in the partnership.

The equity method is ordinarily discontinued if losses reduce the investment (and net advances) to zero. However, if the investor has guaranteed obligations of the partnership or is otherwise committed to provide further financial support, losses should continue to be recorded by the investor to the extent of the additional funds committed. [See TIS 2220.12 and APB Opinion No. 18, paragraph 19 (FASB ASC 323-10-35-20).] Such situations occur frequently for partnerships that use recourse financing. An investment in a partnership accounted for by the equity method that has been reduced below zero should be presented as a liability in the balance sheet.

The equity method is not a valid substitute for consolidation. Accountants should consider whether ARB No. 51 (FASB ASC 970-810-25-1) requires consolidation because the reporting entity controls the partnership through a means other than ownership of a majority voting interest. FIN 46R (FASB ASC 810-10) provides guidance on criteria for determining when looking at nominal voting rights is not effective for determining if the reporting entity has a

controlling financial interest in the partnership and also provides guidance on looking for a controlling financial interest in those situations.

In addition, EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," (FASB ASC 810-20-25) establishes a presumption that the general partners in a limited partnership control that partnership, regardless of the extent of the general partners' ownership interests. The assessment of whether the rights of the limited partners should overcome that presumption is a matter of judgment that depends on the facts and circumstances. The general partners do not control the limited partnership if the limited partners have either—

- a. the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause or
- b. substantive participating rights.

PARTNERSHIP RETIREMENT PLANS

A partnership may set up a retirement plan patterned after profit sharing, pension, or other types of employee benefit plans used by corporations. There is no authoritative guidance on how to account for such plans in a partnership. Thus, there is diversity in practice as to whether payments to partners and related retirement benefits are an expense to the partnership or a distribution of partner equity.

Retirement plans are required by federal income tax laws to include present and future employees other than the partners. Therefore, it is the opinion of this course that payments to such plans should be recorded as expenses of the partnership rather than as withdrawals of capital. When the partnership makes payments to employees' IRAs as well as to those of the partners (SEP-IRAs), the payments should be recorded as an expense of the partnership.

Regardless of the method used to account for partner payments, the significant provisions of the partnership's plan and the accounting policy for the partners' portion should be properly disclosed in the notes to the financial statements.

CHANGING THE ENTITY'S LEGAL FORM

A change in the legal form of business (for example, from or to a partnership) is not considered a change in accounting principle (or change in reporting entity) and is, therefore, not subject to the accounting and disclosure requirements of SFAS No. 154 (FASB ASC 250-10). Absent any authoritative accounting and disclosure guidance that addresses such a change, it is recommended that disclosure of the change in legal form and/or tax status be made in the notes to the financial statements.

When one or more prior years' statements are presented after a change to or from a partnership, the question often arises as to whether prior year statements should be modified. SFAS No. 154 (FASB ASC 250-10) implies that a change to or from partnership status is not viewed as a change in accounting principle. Therefore, retrospective application is inappropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note such as the one illustrated in the "Comparative Financial Statements" paragraph may be included to disclose the change.

As a practical matter, especially when a corporation is converted to a partnership, accountants may choose to recommend that their partnership clients present single-period statements for the first reporting period following the change.

SELF-STUDY QUIZ

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

12. What label should be used for the equity section of a partnership's balance sheet?
 - a. Balance Sheet.
 - b. Partners' Capital.
 - c. Statement of Changes in Partner's Capital.
 - d. Income Statement.
13. At the beginning of the year, partner A's capital was \$50,000, partner B's capital was \$75,000, and partner C's capital was \$70,000. The net income for the year was \$200,000, partner A and B's share is 25% each, while partner C's share is 50%. Partner A made a capital contribution during the year of \$20,000 and Partner C contributed \$14,000. Also during the year, Partner A withdrew \$65,000, Partner B withdrew \$40,000, and Partner C withdrew \$90,000. Prepare a statement of changes in partners' capital presenting changes in the individual partners' capital accounts. How much is the ending capital for Partner A?
 - a. \$5,000.
 - b. \$35,000.
 - c. \$55,000.
 - d. \$120,000.
14. Assuming the same facts above, how much is the total ending capital?
 - a. \$39,000.
 - b. \$200,000.
 - c. \$234,000.
 - d. \$429,000.
15. SFAS No. 141(R), *Business Combinations*, applies to partnerships, limited liability companies, and corporations.
 - a. True.
 - b. False.
16. What is the current authoritative literature for accounting for partnership admissions and withdrawals?
 - a. EITF Issue No. 88-16.
 - b. EITF Issue No. 96-16.
 - c. SFAS No. 141(R).
17. Under which of the following circumstances would the general partners **not** control the limited partnership?
 - a. The limited partners have the power to remove the general partners if there is cause.
 - b. The limited partners have substantive participating rights.
 - c. Consolidation is required.

18. When a corporation is converted into a partnership, which of the following occurs?
- a. Disclosure of the change should be made in the financial statement notes.
 - b. The change must be accounted for as a change in accounting principle.
 - c. Prior-period financial statements must be modified to be presented after the change.
 - d. Only single-period financial statements can be presented following the change.

SELF-STUDY ANSWERS

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

12. What label should be used for the equity section of a partnership's balance sheet? **(Page 122)**
- a. Balance Sheet. [This answer is incorrect. This is a financial statement heading used in GAAP financial statements; however, it is not a specific label for the equity section of a partnership's balance sheet.]
 - b. Partners' Capital. [This answer is correct. The equity section of the balance sheet of a partnership should be labeled "Partners' Capital." In some situations, it may be desirable to disclose the capital accounts of the individual partners or classes of partners.]**
 - c. Statement of Changes in Partner's Capital. [This answer is incorrect. Generally, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings, as is done for corporations. However, a statement of changes in partners' capital may be necessary. Even if this statement is necessary, this would not be the title for the equity section of the partnership's balance sheet—it would be the title of its own section.]
 - d. Income Statement. [This answer is incorrect. This is not a specific label for the equity section of a partnership's balance sheet. "Income Statement" is a title that would be used in GAAP financial statements.]
13. At the beginning of the year, partner A's capital was \$50,000, partner B's capital was \$75,000, and partner C's capital was \$70,000. The net income for the year was \$200,000, partner A and B's share is 25% each, while partner C's share is 50%. Partner A made a capital contribution during the year of \$20,000 and Partner C contributed \$14,000. Also during the year, Partner A withdrew \$65,000, Partner B withdrew \$40,000, and Partner C withdrew \$90,000. Prepare a statement of changes in partners' capital presenting changes in the individual partners' capital accounts. How much is the ending capital for Partner A? **(Exhibit 2-2)**
- a. \$5,000. [This answer is incorrect. This amount fails to include Partner A's share of net income.]
 - b. \$35,000. [This answer is incorrect. This amount fails to include the \$20,000 capital contribution that Partner A made during the year.]
 - c. \$55,000. [This answer is correct. Partner A's beginning capital was \$50,000, plus \$50,000 of net income (25% of \$200,000), plus a capital contribution of \$20,000, less \$65,000 in withdrawals to arrive at ending capital of \$55,000.]**
 - d. \$120,000. [This answer is incorrect. This amount fails to deduct Partner A's withdrawals during the year.]
14. Assuming the same facts above, how much is the total ending capital? **(Exhibit 2-2)**
- a. \$39,000. [This answer is incorrect. This amount fails to include the beginning capital.]
 - b. \$200,000. [This answer is incorrect. This amount fails to include the capital contributions.]
 - c. \$234,000. [This answer is correct. $\$195,000$ (beginning capital) + $\$200,000$ (net income) + $\$34,000$ (contributed capital) – $\$195,000$ (draws) = $\$234,000$.]**
 - d. \$429,000. [This answer is incorrect. This amount fails to include the withdrawals made during the year.]
15. SFAS No. 141(R), *Business Combinations*, applies to partnerships, limited liability companies, and corporations. **(Page 123)**
- a. True. [This answer is correct. The authoritative literature on accounting for consolidations and business combinations applies to partnerships and limited liability companies, as well as corporations.]**
 - b. False. [This answer is incorrect. The discussion in SFAS No. 141(R) concerning controlling financial interest applies to partnerships, limited liability companies, and corporations.]

16. What is the current authoritative literature for accounting for partnership admissions and withdrawals? **(Page 124)**
- a. EITF Issue No. 88-16. [This answer is incorrect. EITF Issue No. 88-16 dealt with leveraged buyout transactions and was relied on in the absence of guidance on accounting for partnership admissions and withdrawals.]
 - b. EITF Issue No. 96-16. [This answer is incorrect. EITF Issue No. 96-16 deals with reporting controlling financial interests.]
 - c. **SFAS No. 141(R). [This answer is correct. Prior to SFAS No. 141(R), authoritative literature did not provide guidance on accounting for partnership admissions and withdrawals. Practitioners had to rely on the bonus and goodwill methods as presented in accounting textbooks and EITF Issue No. 88-16.]**
17. Under which of the following circumstances would the general partners **not** control the limited partnership? **(Page 125)**
- a. The limited partners have the power to remove the general partners if there is cause. [This answer is incorrect. There are two instances in which the general partners will not control the limited partnership. One such instance is when the limited partners have the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.]
 - b. **The limited partners have substantive participating rights. [This answer is correct. EITF Issue No. 04-5 establishes a presumption that the general partners in a limited partnership control that partnership, regardless of the extent of the general partners' ownership interests. There are two instances in which the general partners do not control the limited partnership. One of those instances is when the limited partners have substantive participating rights.]**
 - c. Consolidation is required. [This answer is incorrect. Use of the equity method when accounting for a partnership's investments in partnerships and joint ventures is not a valid substitute for consolidation. Accountants should consider whether ARB No. 51 requires consolidation because the reporting entity controls the partnership through a means other than ownership of a majority voting interest. However, consolidation is not one of the two instances under EITF Issue No. 04-5 in which the general partners do not control the limited partnership. Consolidation is a separate consideration.]
18. When a corporation is converted into a partnership, which of the following occurs? **(Page 125)**
- a. **Disclosure of the change should be made in the financial statement notes. [This answer is correct. Absent any authoritative accounting and disclosure guidance that addresses such a change, it is recommended that disclosure of the change in legal form and/or tax status be made in the notes to the financial statements.]**
 - b. The change must be accounted for as a change in accounting principle. [This answer is incorrect. A change in the legal form of business is not considered a change in accounting principle (or a change in reporting entity) and is, therefore, not subject to the accounting and disclosure requirements of SFAS No. 154.]
 - c. Prior-period financial statements must be modified to be presented after the change. [This answer is incorrect. Based on SFAS No. 154, retrospective application of the change in the entity's legal form to prior-period statements is inappropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note may be included to disclose the change.]
 - d. Only single-period financial statements can be presented following the change. [This answer is incorrect. As a practical matter, especially when a corporation is converted to a partnership, accountants may choose to recommend that their partnership clients present single-period statements for the first reporting period following the change.]

THE BASICS OF LIMITED LIABILITY COMPANIES

Limited liability companies (LLCs) are business entities created under state law that can be used in all states. Limited liability companies are owned by members and combine many of the tax advantages of a partnership with the liability protection of a corporation. In many cases, LLCs are more flexible than S corporations. Each state establishes its own LLC rules and characteristics.

Advantages and Disadvantages of LLCs

Advantages. Advantages of LLCs include the following:

- They have limited liability (that is, members are not personally liable for the LLC's debts or liabilities, except to the extent of their investment and any remaining capital commitment to the LLC).
- The number of members is not limited.
- Members may be corporations, trusts, partnerships, other LLCs, or others.
- Double taxation affecting most C corporations is avoided. Income is passed through to the members for taxation purposes.
- Members can participate in managing the LLC.
- Distributions to members do not have to be directly proportional to the members' ownership percentages as they do for S corporations.
- They can have different classes of ownership.

Disadvantages. Disadvantages of LLCs include the following:

- They sometimes have a limited life, such as by termination on the death or bankruptcy of a member.
- Transfer of interests is more difficult. (Under most LLC statutes, a member can assign his or her interest to a nonmember, but the assignee cannot become a substitute member and acquire all of the attributes of the assigning member's interest unless the remaining members consent to the transfer. Without such approval, the assignee is entitled only to receive the share of profits or other compensation by way of income and return of contributions to which the assigning member otherwise would be entitled. Accordingly, interests in LLCs formed under those statutes are not freely transferable.)
- The enacted laws vary from state to state. Therefore, the LLC must determine how it will be treated for both tax and liability purposes in other states.
- LLC statutes are recent creations, and the interpretation of those statutes remains somewhat uncertain.

Assisting Clients. Accountants with clients considering establishing a new business as an LLC or converting an existing entity into an LLC should carefully consider the advantages and disadvantages of LLCs, as previously discussed. Accountants should then research the LLC statutes of the states in which the client plans to do (or does) business. Knowledge of those factors, along with an understanding of the basic characteristics of an LLC, should allow accountants to assist their clients in making the best decision. (Note that when researching LLC statutes, accountants often consult with the client's attorney.)

Organization

Although there is a Uniform Limited Liability Company Act, most states have not adopted it as the model for state LLC statutes. Instead, the state statutes typically represent a mix of provisions derived from state business corporation acts and limited partnership acts. Accordingly, considerable differences exist among the various state statutes.

By necessity, this discussion of LLCs is general in nature and should not be considered a substitute for obtaining a thorough understanding of applicable state LLC statutes.

Articles of Organization. An LLC is established by filing articles of organization with the appropriate state agency. Generally, an LLC can conduct any lawful business except for those expressly prohibited by the applicable LLC statute or which are prohibited under other state statutes regulating particular business activities. Most state LLC laws require that the company's name include a designation of its legal status. Examples of such required designations include "Limited Liability Company," "LLC," "Limited Company," and "LC."

Operating Agreement. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.

General Tax Treatment

The attractiveness of LLCs depends on their treatment as partnerships for federal income tax purposes. Under the *check the box* regulations, LLCs with more than one member are by default treated as partnerships for federal income tax purposes, even though they have corporate characteristics. (LLCs also can elect to be treated as corporations; however, that option is attractive only in limited circumstances, such as when S corporation status is desired to minimize the owners' liability for payroll taxes on their earnings.)

Single-member LLCs. A single-member LLC is a disregarded entity by default. That means its existence will be ignored for federal income tax purposes, and the income and expenses of the LLC will be taxed to the LLC's owner. Alternatively, a single-member LLC can elect to be taxed as a corporation. For example, an LLC business owned by a single individual is treated as a sole proprietorship. An LLC business wholly owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity. A corporation owning a single-member LLC is not required to file a consolidated return, but merely reports the LLC's income and expenses as if they were the corporation's.

Default Classification Rules. Domestic LLCs in existence before January 1, 1997, generally retain their existing tax status by default. However, existing single-member LLCs that claimed partnership status under the former tax rules are classified by default as sole proprietorships or unincorporated branches of a parent entity, rather than as partnerships. New domestic LLCs are automatically treated as partnerships if they have more than one member, or as disregarded entities if there is only a single member. Alternatively, LLCs can choose to be treated as corporations by making an affirmative *check the box* election. An LLC wishing to elect a classification different from its initial default classification must file an affirmative *check the box* election. The same is true when an LLC later wishes to change its existing classification. An entity that elects to change its classification cannot change its classification again during the 60 months after the effective date of the election [Reg. 301.7701-3(c)(1)(iv)]. This rule does not apply to a newly formed entity's election out of its default classification at inception or if the organization's business is actually transferred to another entity.

Conversion of an Existing Entity to an LLC. Internal Revenue Service private letter rulings generally have held that the conversion of a partnership to an LLC (whether by merger or otherwise) is treated as a continuation of the partnership with no tax consequences, unless the conversion causes a shift in the allocation of liabilities among the partners/members. If a shift in liabilities causes a deemed distribution of cash in excess of a member's basis in the LLC, a gain will be recognized. A shift in liabilities may also result in the recognition of gain if a member's amount at risk is reduced below zero because of the liability shift. The conversion of a corporation to an LLC (assuming the LLC is treated as a partnership) will result in the recognized liquidation of the corporation and the formation of a new partnership for federal income tax purposes, with all of the accompanying tax consequences. Gain or loss will be recognized by the shareholders, as well as by the corporation on the disposition of its property upon liquidation.

Accounting and Reporting Issues

While LLCs are unique legal entities, they do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. Practice Bulletin 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (FASB ASC 272-10) (PB 14) provides guidance on applying existing accounting literature to LLCs. [That guidance also applies to limited liability partnerships (LLPs).]

The remainder of this section discusses some of the unique issues accountants typically address when compiling or reviewing the financial statements of LLCs.

Financial Statement Headings. The headings of an LLC's financial statements should clearly identify the entity as an LLC. PB 14 (FASB ASC 272-10-45-2) requires this even in jurisdictions where LLCs are not required by law to include the LLC designation in their names.

Federal Income Taxes. If the LLC is considered a partnership for federal income tax purposes, income is taxed to the members rather than to the LLC. As noted previously regarding partnerships, the financial statements of the LLC should not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP. However, if the LLC's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial member withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, it is recommended that the financial statements disclose (a) that the LLC does not pay federal income taxes and (b) any anticipated withdrawals by members to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant should consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Federal Income Taxes

The Company is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income of the Company is taxed to the members in their respective returns. The members customarily make substantial capital withdrawals in April of each year to pay their federal income tax liabilities. At December 31, 20X1, \$75,000 has been deposited in a Company savings account in anticipation of member withdrawals.

SFAS No. 109 (FASB ASC 740-10) requires issuers that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although SFAS No. 109 (FASB ASC 740-10) does not require nonissuers to disclose similar information, disclosing that income is taxed directly to the owners and that as a result, the company did not recognize a provision for income taxes, as illustrated in the preceding paragraph is recommended. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. The disclosure of the nature of temporary differences is believed to ordinarily satisfy the primary users of the financial statements and, thus, it will not be necessary to disclose the amount of the basis differences.

An LLC's operating agreement may also require that a provision for income taxes be computed at a specified rate and be included as an expense of the LLC. The inclusion of such a tax provision is a departure from GAAP and should be reported as such.

State Income and Franchise Taxes. Depending on the state of organization, an LLC may be subject to significant state income or franchise taxes. If a state or other taxing authority levies a tax on the LLC and the tax is based on net income, as discussed previously regarding partnerships, the financial statements should show the tax as an expense of the LLC. (The expensed taxes include those based on net income, taxable capital, or similar amounts.) Furthermore, if taxable income differs significantly from book income, deferred taxes should be recorded in accordance with SFAS No. 109 (FASB ASC 740-10). [LLCs are generally treated as partnerships for federal income tax purposes. However, if the LLC is subject to federal income taxes, the LLC should account for the federal income taxes in accordance with SFAS No. 109 (FASB ASC 740-10).] The financial statements also should disclose the nature of the tax (if material). If the LLC's tax status in a jurisdiction changes from taxable to nontaxable, any deferred tax assets and liabilities related to that jurisdiction should be eliminated.

Equity Section of the Balance Sheet. Since owners of a limited liability company are referred to as members, PB 14 (FASB ASC 272-10) states that the equity section of the balance sheet should be labeled "Members' Equity."

Ownership interests may be represented by membership certificates or shares. For example, an LLC may issue Class I shares that have unlimited voting rights and Class II shares that have only limited rights and privileges.

Different classes of shares may also have different rights as to the distribution of assets upon dissolution of the company. If ownership interests are represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a corporation.

If ownership interests are not represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a partnership. Generally, only a single amount will be shown. However, if it is desirable to disclose separately the equity accounts of those members who have been designated as managers, a presentation such as the following can be made:

MEMBERS' EQUITY	
Managing members	\$ 75,000
Nonmanaging members	<u>25,000</u>
	<u>\$ 100,000</u>

PB 14 (FASB ASC 272-10-45-1) states that the components of members' equity may be presented on the face of the balance sheet or in the notes.

The operating agreement of some LLCs may provide that unless the transfer (for example, by assignment or inheritance) of a member's interest is approved by the remaining members, the transferee will not be permitted to participate in the management of the LLC or become a member. Instead, the transferee is entitled only to receive the share of profits or other compensation by way of income and return of contributions to which the assigning member otherwise would be entitled. If desired, it is believed that the portion of members' capital owned by such non-approved transferees could also be disclosed.

PB 14 (FASB ASC 272-10-45-4 and 45-5) states that if a member's equity account is less than zero, a deficit should be reported even though the member's liability may be limited. In addition, if the LLC records amounts due from members for capital contributions, those amounts should be presented as deductions from members' equity rather than as assets.

Conversion of an Existing Entity to an LLC. LLCs frequently are formed when an existing entity is converted to LLC status. The converting entity often is a partnership. However, C corporations and S corporations may also merge with an LLC or convert to LLC status. An LLC formed by the conversion of a partnership generally is considered a continuation of the partnership, and no new taxable entity comes into being. However, the conversion of a corporation to LLC status results in the creation of a new entity for tax purposes. [According to SFAS No. 154 (FASB ASC 250-10), a change in the legal form of business is not considered a change in reporting entity.] *PPC's Guide to Preparing Financial Statements* provides guidance on the accounting issues surrounding the conversion of a corporation to a partnership. That guide can be ordered by calling (800) 323-8724 or at ppc.thomson.com.

Comparative Financial Statements. When one or more prior years' financial statements are presented after a change to an LLC, the question arises whether the prior year statements should be modified. Changes in the legal form of business, for example, from an S corporation or partnership to an LLC, are not changes in the reporting entity. Consequently, retrospective application is not appropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note such as the following can be included to disclose the change:

NOTE X—RECLASSIFICATIONS

Certain accounts in the prior-year financial statements have been reclassified for comparative purposes to conform with the presentation in the current-year financial statements.

As a practical matter, especially when a corporation is converted to an LLC, accountants may choose to recommend that their LLC clients present single-period statements for the first reporting period following the change.

While changing the legal form of an entity to an LLC does not constitute a change in reporting entity, formation of an LLC may in some cases result in a change in reporting entity. For example, if commonly-owned companies for which combined financial statements had not previously been presented were combined into a single LLC, a

change in reporting entity would occur. In that case, the disclosures required by SFAS No. 154 (FASB ASC 250-10) should be made and the change should be retrospectively applied to the financial statements for all prior periods presented.

LLC Disclosure Requirements. An LLC should disclose the following:

- A description of any limitation of members' liability. (The identification of the entity as a limited liability company or partnership alerts financial statement readers to the general limitation of members' liability. Therefore, the additional requirement of PB 14 (FASB ASC 272-10-50) to describe limitations is believed to only relate to *special* limitations, such as those imposed by some states on the managing member's liability or the special liability considerations for members of professional limited liability entities.)
- The amount of each class of members' interests if more than one class exists, each having varying rights, preferences, and privileges of each class. (If the LLC does not report the equity amount of each class separately in the equity section of the balance sheet, the equity amounts must be disclosed in the notes.)
- The date the LLC will cease to exist if it has a finite life.
- The separate components of members' equity, such as undistributed earnings, earnings available for withdrawal, or unallocated capital, if the LLC maintains such components. (This disclosure is permitted but not required.)
- The fact that the company's assets and liabilities previously were held by a predecessor entity or entities (for LLCs formed by combining entities under common control or by converting from another type of entity). These LLCs are also encouraged to make the relevant disclosures in paragraph 68 of SFAS No. 141R, *Business Combinations* (FASB ASC 805-10-50).
- Any relevant income tax disclosures required by SFAS No. 109 (FASB ASC 740-10).

Formation of an LLC. If an LLC is formed by combining entities under common control or by converting from another form of entity, an LLC should initially record its assets and liabilities based on amounts recorded by the predecessor entity (or entities) in a manner similar to a pooling of interests. In addition, in the year of formation, the LLC should disclose that the assets and liabilities were previously held by a predecessor entity or entities.

Disclosure of Change in Legal Form and/or Tax Status. It is the opinion of this course that disclosure of the change in legal form and/or tax status should also be made. Conversion of an existing entity to an LLC was discussed previously.

Single-member LLCs. For accounting and reporting purposes, a single-member LLC should follow the rules for LLCs, not proprietorships. There may, however, be a few presentation differences that should be considered. For example, for a single-member LLC, the report should be addressed to the *member* of XYZ LLC versus to the *members* of XYZ LLC. In addition, the equity statement for a single-member LLC should be called the "Statement of *Member's* Equity" versus the "Statement of *Members'* Equity." Practitioners may also want to consider adding a footnote to single-member LLC statements noting that the statements do not include personal accounts (as in the case of a proprietorship).

THE BASICS OF LIMITED LIABILITY PARTNERSHIPS

Limited liability partnerships (LLPs) are a special type of partnership that exist under state laws. LLPs were enacted in response to the concern that a partner of a professional firm can be held liable for the malpractice of another partner in the same firm.

The partners in an LLP remain personally liable for the commercial and other obligations of the entity, their own acts and omissions, and the acts and omissions of persons under their supervision. However, LLP partners are not liable for acts and omissions by the other LLP partners or nonsupervised employees. In many states, the LLP statutes provide that LLP partners are not personally liable for the LLP's contract liabilities unless they are personally

guaranteed. In such states, LLPs are similar to LLCs with regard to the issue of owner exposure to the entity's liabilities.

Advantages and Disadvantages of LLPs

Advantages. The major advantages of LLPs are favorable pass-through taxation rules; the flexibility to structure ownership interests with varying rights to cash flow, liquidation proceeds, and tax allocations; and the low cost of converting to LLP status. Most states only require the filing of a registration statement and payment of a fee (which can be significant) to form an LLP. No new partnership agreement is required.

Disadvantages. The primary disadvantage of LLPs is the liability in some states of the partners for the debts and other obligations of the LLP (exclusive of liability for professional acts and omissions of others). Thus, an LLP sometimes provides its partners with less liability protection than is available to members of an LLC but more than is available under a general partnership. In addition, the annual registration fee in some states is significant (as much as \$5,000) and some states require significant levels of malpractice insurance.

LLPs Compared to LLCs. From a liability limitation standpoint, the use of an LLC is sometimes preferable to the use of an LLP. However, LLPs are available for professional practices in some states where LLCs are not.

The administrative aspects of adopting LLP status for a professional practice (for example, meeting the state board of accountancy rules) should be minimal in comparison to obtaining permission to operate as an LLC, especially in the case of a multistate practice.

Accounting and Reporting Issues

Similar to LLCs, LLPs do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. PB 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships* (FASB ASC 272-10), provides guidance on applying existing accounting literature to LLPs (as well as LLCs). In fact, PB 14 (FASB ASC 272-10) states in its guidance that the collective term "limited liability companies" includes both LLCs and LLPs. Therefore, the unique accounting and reporting issues for LLCs discussed in the previous section also apply to LLPs.

SELF-STUDY QUIZ

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

19. Which of the following is an advantage of a limited liability company (LLC)?
 - a. Sometimes, LLCs have a limited life.
 - b. LLCs can only have a limited number of members.
 - c. Unlike C corporations, double taxation is avoided.
 - d. LLC statutes were created recently.
20. When an LLC is organized, what important information is provided by the operating agreement?
 - a. Applicable state statutes affecting the LLC.
 - b. The rights and powers of the LLC members.
 - c. The articles of organization that establish the LLC.
 - d. The LLC's official name and designation.
21. Pennywise LLC is a single-member LLC owned by Penny Jones. What is the default type of tax treatment for this business entity?
 - a. Pennywise will be treated as a partnership.
 - b. Pennywise will be treated as a corporation.
 - c. Pennywise is a disregarded entity, so Penny will be taxed.
 - d. Pennywise will be treated as an unincorporated branch of a parent entity.
22. Which of the following statements best describes an issue that an accountant might encounter when compiling or reviewing an LLC's financial statements?
 - a. If the LLC is considered a partnership for the purposes of federal income taxes, its financial statements should include the federal income tax expense and the related liability.
 - b. If applicable, GAAP and SFAS No. 109 require an LLC to disclose the fact that it does not pay federal income tax in its financial statements.
 - c. If a state or other taxing authority levies a tax on the LLC that is based on net income, the LLC's financial statements should show this tax as an expense of the LLC.
23. If an LLC's ownership interests are represented by membership certificates or shares, how will the equity section of the balance sheet be affected?
 - a. It will resemble a corporation's.
 - b. It will resemble a partnership's.
24. What type of entity can convert to an LLC without triggering the formation of a new taxable entity?
 - a. A C corporation.
 - b. An S corporation.
 - c. A partnership.

25. Which of the following is a required disclosure for LLC financial statements?
- a. The date the LLC comes into existence.
 - b. Separate components of members' equity.
 - c. The general limitation of the members' liability.
 - d. That the liabilities and assets were previously held by a predecessor entity.
26. What is the primary disadvantage of an LLP?
- a. The cost of LLP conversion.
 - b. The amount of liability protection.
 - c. The taxation rules.
 - d. The rules for structuring ownership interests.

SELF-STUDY ANSWERS

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

19. Which of the following is an advantage of a limited liability company (LLC)? **(Page 131)**
- a. Sometimes, LLCs have a limited life. [This answer is incorrect. This limited life is a disadvantage of an LLC. The limited life can be caused by termination on the death or bankruptcy of a member.]
 - b. LLCs can only have a limited number of members. [This answer is incorrect. One of the advantages of an LLC is that the number of members is not limited.]
 - c. **Unlike C corporations, double taxation is avoided. [This answer is correct. One of the advantages of using the LLC business entity is that the double taxation affecting most C corporations is avoided. Income is passed through to the members for taxation purposes.]**
 - d. LLC statutes were created recently. [This answer is incorrect. This is a disadvantage of using the LLC business entity. Because the statutes were created recently, their interpretation remains somewhat uncertain.]
20. When an LLC is organized, what important information is provided by the operating agreement? **(Page 132)**
- a. Applicable state statutes affecting the LLC. [This answer is incorrect. Although there is a Uniform Limited Liability Company Act, most states have not adopted it as the model for state LLC statutes. Instead, state statutes typically represent a mix of provisions derived from state business corporation acts and limited partnership acts. However, applicable statutes are not part of the operating agreement.]
 - b. **The rights and powers of the LLC members. [This answer is correct. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.]**
 - c. The articles of organization that establish the LLC. [This answer is incorrect. An LLC is established by filing articles of organization with the appropriate state agency. However, the articles of organization are separate from the LLC's operating agreement.]
 - d. The LLC's official name and designation. [This answer is incorrect. Most state or LLC laws require that the company's name include a designation of its legal status. Examples of such required designations include "Limited Liability Company," "LLC," "Limited Company," and "LC." However, this designation is required to be included elsewhere when an LLC is organized, not in the operating agreement.]
21. Pennywise LLC is a single-member LLC owned by Penny Jones. What is the default type of tax treatment for this business entity? **(Page 132)**
- a. Pennywise will be treated as a partnership. [This answer is incorrect. Under the *check the box* regulations, LLCs with more than one member are by default treated as partnerships for federal income tax purposes, even though they have corporate characteristics. However, because Pennywise is a single-member LLC, it does not qualify for this default option.]
 - b. Pennywise will be treated as a corporation. [This answer is incorrect. Single member LLCs and LLCs with more than one member can elect to be treated as a corporation for tax purposes, depending on the circumstances. However, this is not the default tax treatment for either type of LLC.]
 - c. **Pennywise is a disregarded entity, so Penny will be taxed. [This answer is correct. A single-member LLC is a disregarded entity by default. That means its existence will be ignored for federal income tax purposes, and the income and expenses of the LLC will be taxed to the LLC's owner. In this scenario, the income and expenses will be taxed to Penny. An LLC business owned by a single individual is treated as a sole proprietorship.]**

- d. Pennywise will be treated as an unincorporated branch of a parent entity. [This answer is incorrect. An LLC business wholly owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity. A corporation owning a single-member LLC is not required to file a consolidated return, but merely reports the LLC's income and expenses as if they were the corporation. However, this tax treatment is not valid for Pennywise, as Pennywise is owned by Penny Jones, not by a corporation.]
22. Which of the following statements best describes an issue that an accountant might encounter when compiling or reviewing an LLC's financial statements? **(Page 133)**
- a. If the LLC is considered a partnership for the purposes of federal income taxes, its financial statements should include the federal income tax expense and the related liability. [This answer is incorrect. If the LLC is considered a partnership for federal income tax purposes, income is taxed to members rather than to the LLC. The financial statements of the LLC should not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP. However, if the LLC's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial member withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date.]
- b. If applicable, GAAP and SFAS No. 109 require an LLC to disclose the fact that it does not pay federal income tax in its financial statements. [This answer is incorrect. Although not required by GAAP, it is recommended by this course that the financial statements for this type of LLC disclose (a) that the LLC does not pay federal income taxes and (b) any anticipated withdrawals by members to pay income taxes, whether or not recorded as a liability in the financial statements. SFAS No. 109 requires issuers that are not subject to income taxes because income is taxed directly to their owners to disclose that fact. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although SFAS No. 109 does not require nonissuers to disclose similar information, disclosing that income is taxed directly to the owners is recommended by this course.]
- c. **If a state or other taxing authority levies a tax on the LLC that is based on net income, the LLC's financial statements should show this tax as an expense of the LLC. [This answer is correct. Depending on the state of organization, an LLC may be subject to significant state income or franchise taxes. If a state or other taxing authority levies a tax on the LLC and the tax is based on net income, the financial statements should show the tax as an expense of the LLC. Furthermore, if taxable income differs significantly from book income, deferred taxes should be recorded in accordance with SFAS No. 109.]**
23. If an LLC's ownership interests are represented by membership certificates or shares, how will the equity section of the balance sheet be affected? **(Page 133)**
- a. **It will resemble a corporation's. [This answer is correct. The ownership interests of an LLC can be represented by membership certificates or shares. For example, an LLC may issue Class I shares that have unlimited voting rights and Class II shares that have only limited rights and privileges. Different classes of shares may also have different rights as to the distribution of assets upon dissolution of the company. If ownership interests are represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a corporation.]**
- b. It will resemble a partnership's. [This answer is incorrect. If ownership interests are not represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a partnership. Generally, only a single amount will be shown.]
24. What type of entity can convert to an LLC without triggering the formation of a new taxable entity? **(Page 134)**
- a. A C corporation. [This answer is incorrect. C corporations can merge with an LLC or convert to LLC status. If a C corporation becomes an LLC, however, the change in status results in a new entity for tax purposes.]
- b. An S corporation. [This answer is incorrect. Though an S corporation is allowed to merge with an LLC or convert to LLC status, the change in status will result in a new taxable entity.]

- c. **A partnership. [This answer is correct. LLCs are frequently formed when an existing entity is converted to LLC status. The converting entity often is a partnership. An LLC formed by the conversion of a partnership generally is considered a continuation of the partnership, and no new taxable entity comes into being.]**

25. Which of the following is a required disclosure for LLC financial statements? (Page 135)

- a. The date the LLC comes into existence. [This answer is incorrect. The required disclosure is the date the LLC will cease to exist if it has a finite life.]
- b. Separate components of members' equity. [This answer is incorrect. Separate components of member's equity, such as undistributed earnings, earnings available for withdrawal, and unallocated capital, can be disclosed. This disclosure is permitted but not required.]
- c. The general limitation of the members' liability. [This answer is incorrect. A description of any limitation of members' liability is required. The identification of the entity as an LLC or LLP alerts financial statement readers to the general limitation of members' liability. Therefore, the additional requirement of PB 14 to describe limitations is believed to only relate to *special* limitations, such as those imposed by some states on the managing member's liability or the special liability considerations for members of professional limited liability entities.]
- d. **That the liabilities and assets were previously held by a predecessor entity. [This answer is correct. One LLC disclosure requirement is disclosure of the fact that the company's assets and liabilities previously were held by a predecessor entity or entities (for LLCs formed by combining entities under common control or by converting from another type of entity). These LLCs are also encouraged to make the relevant disclosures in paragraph 68 of SFAS No. 141, *Business Combinations*.]**

26. What is the primary disadvantage of an LLP? (Page 136)

- a. The cost of LLP conversion. [This answer is incorrect. The low cost of converting to LLP status is one of the advantages of LLPs. Most states only require the filing of a registration statement and payment of a fee (which can be significant) to form an LLP. No new partnership agreement is required.]
- b. **The amount of liability protection. [This answer is correct. The primary disadvantage of LLPs is the liability in some states of the partners for the debts and other obligations of the LLP (exclusive of liability for professional acts and omissions of others). Thus, an LLP sometimes provides its partners with less liability protection than is available to members of an LLC but more than is available under a general partnership.]**
- c. The taxation rules. [This answer is incorrect. One of the major advantages of LLPs is the favorable pass-through taxation rules.]
- d. The rules for structuring ownership interests. [This answer is incorrect. The flexibility to structure ownership interests with varying rights to cash flow, liquidation proceeds, and tax allocations is one of the major advantages to becoming an LLP.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (CARTG092)**

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.

6. What type of business entity most frequently presents its financial statements using the income tax basis of accounting?
 - a. A proprietorship.
 - b. A partnership.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
7. The partnership agreement of Banner & Lane does not specify use of a basis of accounting other than GAAP. List all of the following statements that should be included in Banner & Lane's financial statements.
 - i. Statement of Assets, Liabilities, and Capital—Income Tax Basis
 - ii. Statement of Revenues and Expenses—Income Tax Basis
 - iii. Balance Sheet
 - iv. Statement of Income
 - v. Statement of Changes in Partner's Capital
 - vi. Statement of Cash Flows
 - a. i. and ii.
 - b. iii., iv., and v.
 - c. iii., iv., v., and vi.
 - d. i., ii., iii., iv., v., and vi.
8. Which of the following statements best describes an aspect of using a special accounting method in partnership financial statements that is not in accordance with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA)?
 - a. Any individuals in business with or associated with the partnership are considered those with whom the partnership is negotiating directly.
 - b. A special-purpose report must be issued when departures from GAAP or an OCBOA in the financial statements are either significant or pervasive.
 - c. A note about significant accounting policies never needs to be included in the financial statements regarding special accounting treatments.
 - d. The accountant's report should describe any significant interpretations made by the client about provisions of the agreement.
9. Although it is not required by GAAP, this course recommends that a partnership's financial statements disclose which of the following?
 - a. The amount of income taxes that the partnership has paid during the period covered by the statements.
 - b. Any anticipated withdrawals made by partners to pay income taxes.
 - c. The net difference between the tax and financial bases of the partnership's assets and liabilities.
 - d. Do not select this answer choice.

10. What is the conventional method for dealing with guaranteed payments to partners in a partnership's financial statements?
- To treat the payments as part of the allocation of the partnership's net income.
 - To show the payments as partnership expenses when determining net income.
 - To account for the payments as if they were loans.
 - Such payments would appear only on the partners' financial statements.
11. The Bumper Joe partnership makes loans to its partners. The loans are not intended as withdrawals of capital or profits. How should these loans be recorded in the balance sheet?
- As a loan.
 - As a reduction of capital.
 - As an asset of the partnership.
 - The accountant can choose any reasonable recording method as long as a related-party disclosure appears.
12. The following excerpt from a partnership's financial statements is an example of what type of presentation?

NET INCOME	\$ 200,000
BEGINNING PARTNERS' CAPITAL	250,000
Drawings for the year	(175,000)
Additional capital contributed	<u>50,000</u>
ENDING PARTNERS' CAPITAL	<u>\$ 325,000</u>

- Partners' capital.
 - Changes in partners' capital.
 - Combined statement of income and changes in partners' capital.
 - Do not select this answer choice.
13. At the beginning of the year, partner D's capital was \$72, partner E's capital was \$35, and partner F's capital was \$63. The net income for the year was \$100, partner D and E's share is 30% each, while partner F's share is 40%. Partner E made a capital contribution during the year of \$20. Also during the year, Partner D withdrew \$38, Partner E withdrew \$25, and Partner F withdrew \$42. Prepare a statement of changes in partners' capital presenting changes in the individual partners' capital accounts. How much is the ending capital for Partner E?
- \$40.
 - \$60.
 - \$61.
 - \$64.
14. Assuming the same facts above, how much is the total ending capital?
- \$165.
 - \$185.
 - \$205.
 - \$290.

15. Which of the following is correct regarding SFAS No. 141(R)?
- a. It is effective for fiscal years beginning after December 31, 2008.
 - b. It is effective for fiscal years beginning after December 31, 2009.
 - c. It nullifies the guidance in EITF Issue No. 96-16.
 - d. Early adoption is prohibited.
16. List all of the following for which use of the equity method is appropriate under APB Opinion No. 18 when accounting for investments in partnerships or joint ventures.
- i. Estates
 - ii. Trusts
 - iii. Partnerships
 - iv. Individuals
 - v. Proprietorships
 - vi. Corporate investors
- a. i., ii., and iv.
 - b. iii., v., and vi.
 - c. iii., iv., v., and vi.
 - d. i., ii., iii., iv., v., and vi.
17. Under the equity method, what happens if a partnership's investment in another partnership or joint venture is reduced to zero?
- a. The use of the equity method would be discontinued.
 - b. Related guaranteed obligations would be accounted for using the cost method.
 - c. The investment would be accounted for as an asset on the balance sheet.
 - d. The prorata share of the losses are recorded by adjusting the carrying value of the investment.
18. When a partnership pays into the IRAs of its employees and its partners, how should those payments be recorded?
- a. As withdrawals of capital.
 - b. As an expense of the partnership.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
19. A limited liability company (LLC) combines elements of what two entities?
- a. A proprietorship and a partnership.
 - b. A proprietorship and an S corporation.
 - c. A partnership and a corporation.
 - d. A corporation and a limited liability partnership (LLP).

20. Which of the following is a disadvantage of an LLC?
- a. They are less flexible than S corporations.
 - b. Members have no management role.
 - c. Enacted LLC laws are similar from state to state.
 - d. Interest transfers are more difficult.
21. A new domestic LLC is formed from an existing partnership. The members would like to be treated as a corporation for tax purposes. What step(s) will allow LLC accomplish this goal?
- a. The LLC must make an affirmative *check the box* election.
 - b. The LLC must make an affirmative *check the box* election and not change its classification for 60 months.
 - c. The LLC does not have to perform any additional steps; it will be treated as the continuation of the partnership.
 - d. The LLC does not have to perform any additional steps; this is the default tax classification for an LLC.
22. If an LLC is considered a partnership for federal tax purposes, how will its income be taxed?
- a. It will be taxed to the LLC.
 - b. It will be taxed to the members.
 - c. Double taxation (to both the LLC and the members) will occur.
 - d. The LLC can specify federal tax treatment in its operating agreement.
23. Which business entities may be subject to state income or franchise taxes?
- a. Partnerships.
 - b. LLCs.
 - c. LLPs.
 - d. All three could be subject to such taxes, but, depending on the state statutes, it is more likely to occur for an LLC or an LLP.
24. Lola is a member of Cheer Corps, LLC. In the period covered by the most recent financial statements, Lola's equity account has dropped to less than zero. Lola's liability is limited. How are the LLC's financial statements affected?
- a. A deficit should be reported in the LLC's financial statements.
 - b. The amount less than zero should be presented as an asset on the financial statements.
 - c. The financial statements are not affected because of Lola's limited liability.
 - d. The financial statements will not be affected, but Lola will not be able to participate in management until the deficit is eliminated.

25. Does conversion to an LLC require prior periods presented in the financial statements to be modified for the change?
- a. Any time an existing entity converts to an LLC, restatement of prior periods is required.
 - b. Restatement would only be required if the conversion also included a change in reporting entity.
 - c. Conversion to an LLC is never a change in reporting entity, so restatement is never required.
 - d. Only single-period financial statements can be presented after an entity converts to an LLC.
26. List all of the following for which a partner in an LLP is personally liable.
- i. Commercial and other obligations of the entity.
 - ii. The partner's own acts and omissions.
 - iii. The acts and omissions of those under the partner's supervision.
 - iv. The acts and omissions of other LLP partners.
 - v. The acts and omissions of unsupervised employees.
- a. ii. and iii.
 - b. i., ii., and iii.
 - c. i., ii., iii., and iv.
 - d. i., ii., iii., iv., and v.

Lesson 3: S Corporations

INTRODUCTION

An S corporation is an elective provision permitting certain small-business corporations and their shareholders to elect special income tax treatment. If the corporations meet specified requirements, under this election they will be taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). Of major significance is the fact that S corporation status usually avoids the corporate income tax and that corporate losses can be claimed by the shareholders. A conventional corporation (hereafter referred to as a "C corporation") is organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level. Shareholders pay taxes on dividends paid out of earnings and profits of the corporation.

Because they are viewed legally as corporations, authoritative literature has not addressed accounting, presentation, and reporting issues of S corporations separate from those of C corporations. For most general ledger account groupings, the accounting treatment is, indeed, the same as that for a C corporation. However, for the federal income tax (normally absent in S corporations) and retained earnings account groupings, subtle and sometimes major differences are caused by the unique federal income tax treatment of S corporations.

With the liability protection and pass-through taxation they provide, S corporation status became more common. Therefore, practitioners should be aware of the unique accounting issues of S corporations. This lesson explores these issues and develops guidance based on (a) the Subchapter S Revision Act of 1982 and subsequent amendments, acts, and technical corrections affecting that guidance, (b) logical extensions and inferences of GAAP, and (c) state corporation law. Much of GAAP for shareholders' equity is traditional and taken from leading textbooks. Discussions relating to state corporation law are based on the Model Business Corporation Act that has been adopted, at least in part, in most states. Because corporation law may vary among states, procedures presented in this lesson may require adaptation to conform to a particular state's law.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the basics of financial statement presentation and accounting procedures for retained earnings for S corporations.
- Illustrate the following for S corporations: tracking separate retained earnings accounts and how losses, tax/book differences, and termination of the S corporation election affect retained earnings accounts.
- Compare and contrast proprietorships, partnerships, and S corporations.

PRESENTING FINANCIAL STATEMENTS

Balance Sheet

The balance sheet of an S corporation is the same as for a C corporation. Accordingly, the balance sheet should generally report a single retained earnings amount. The components of retained earnings can be disclosed in the notes to financial statements or in a separate statement of retained earnings if the information would be meaningful to the users.

Statement of Income

The details of the statement are the same as for a C corporation except that, as a general rule, no federal income tax expense is reported. A supplementary schedule showing the allocation of taxable income to shareholders and reconciling the total taxable income to net income can be used to provide additional informative disclosures to shareholders.

Statement of Retained Earnings

Although not required by GAAP, some practitioners use a statement of retained earnings to disclose the changes in components of retained earnings of S corporations. Each component of retained earnings can be identified

separately with disclosure of its beginning balance, transactions or events that caused changes, and ending balance. As an alternative to this statement, disclosure is sometimes made in the notes.

Statement of Comprehensive Income

The statement of comprehensive income of an S corporation is the same as for a C corporation. Comprehensive income may be reported in a single statement of income and comprehensive income, in a separate statement of comprehensive income, or in a statement of changes in equity that includes comprehensive income. Regardless of the method used, the statement displaying comprehensive income must include net income, the components of other comprehensive income, and a total comprehensive income amount.

Statement of Cash Flows

This statement is the same as for a C corporation.

Comparative Financial Statements

When one or more prior years' statements are presented after a change to or from S corporation status, the question arises whether prior year statements should be modified. A change in the legal form of business (for example, from or to an S corporation) is not a change in reporting entity according to SFAS No. 154 (FASB ASC 250). Also, SFAS No. 154 (FASB ASC 250) implies that a change to or from S corporation status is not viewed as a change in accounting principle. Therefore, retrospective application is inappropriate. However, in order to enhance comparability, it may be necessary to modify the format of the C corporation's income statements to focus on income before taxes as well as on net income. Disclosure of the change in legal form and/or tax status should also be made.

Summary of Unique Disclosures

The following is a list of recommended disclosures that are unique to S corporations (this list may not be all-inclusive):

- a. The S corporation status of the corporation should be disclosed either in the notes or the accountant's report. This course recommends disclosing S corporation status parenthetically in the accountant's report.
- b. A description of the tax consequences of the S corporation election should be presented in the notes. Sample wording follows.

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Income taxes

The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Under those provisions, the Company does not pay federal corporate income taxes on its taxable income (. . . is not allowed a net operating loss carryover or carryback as a deduction). Instead, the stockholders are liable for individual federal income taxes on their respective shares (. . . include their respective shares of the Company's net operating loss in their individual income tax returns).

- c. Dividends paid after the S corporation election terminates, e.g., special post-termination distributions of the *Accumulated Adjustments Account* should be disclosed as a subsequent event.
- d. If there is a danger that the S election could be retroactively terminated by the IRS, the contingency (federal income taxes) should be evaluated in the context of SFAS No. 5 (FASB ASC 450). Consideration should also be given to FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes* (FASB ASC 740).
- e. Material tax/book differences and their treatment in the financial statements should be disclosed.

- f. The amount of accumulated earnings not distributed but previously taxed to the stockholders (AAA and PTI as defined later in this lesson) should be disclosed in financial statements designed primarily for stockholder use.
- g. Although not required, the details of the various retained earnings accounts are sometimes disclosed in the statement of retained earnings or in a note.

GAAP has no requirement to *disclose* separate retained earnings accounts, and some practitioners no longer do so. *Maintaining* the separate accounts is generally useful for reasons described in the next section.

The Impact of FIN 48 on S Corporations

The measurement and disclosure principles of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) (FASB ASC 740), normally cannot affect the financial statements of an entity that is not potentially subject to income taxes. Since many S corporations do not have the potential to be subject to income taxes, their financial statements are not impacted by FIN 48 (FASB ASC 740).

However, some S corporations have the potential to be subject to income taxes on taxable income generated after conversion from a regular corporation. Additionally, an S corporation is required to pay taxes such as the built-in gains tax, the tax on excess net passive income, and certain state and local taxes. These S corporations, to the extent they are subject to federal, state, or local taxation, need to consider the measurement and disclosure principles of FIN 48 (FASB ASC 740).

FIN 48 was issued in July 2006 and (as issued) was effective for fiscal years beginning after December 15, 2006. However, nonpublic entities are allowed a deferral of the effective date in certain situations. FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, defers the effective date of the Interpretation for nonpublic entities to fiscal years beginning after December 15, 2008, unless the entity (a) is consolidated with a public entity that applies U.S. GAAP or (b) has previously issued a full set of U.S. GAAP annual financial statements in which the requirements of the Interpretation were adopted. Nonpublic entities electing the deferral are still required to provide certain disclosures.

A GENERAL DISCUSSION ABOUT RETAINED EARNINGS ACCOUNTING PROCEDURES

General Requirements

Although practitioners may show a single balance sheet caption and amount for retained earnings of an S corporation, this course recommends maintenance of separate retained earnings accounts in the books as a good accounting practice for the following reasons:

- a. Maintenance of separate retained earnings accounts is generally necessary for proper tax accounting of an S corporation.
- b. More often than not, the primary users of financial statements of S corporations are shareholders who are interested in the impact of the corporate earnings on their personal tax returns.

Terminology and Definitions

Because many of the terms and concepts of S corporation accounting have novel and specific meanings, it is helpful to clarify them before describing accounting procedures. The following definitions of terms and associated abbreviations are used throughout the remainder of this lesson.

- a. *Accumulated Adjustments Account (AAA)*. An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to the shareholders after 1982. The AAA is increased by taxable income and by separately stated items of income such as net capital gains; it is *not* increased by tax-exempt income. The AAA is reduced by tax losses and separately stated items

of deduction such as charitable contributions and net capital losses, and it is also reduced by such nondeductible items as fines and penalties. However, expenses related to tax-exempt income do *not* reduce the AAA. Distributions paid to shareholders reduce the AAA to the extent that such distributions do not exceed the adjusted AAA balance at year-end (before considering distributions for the year). The amounts included in the AAA also affect the shareholders' tax bases in the shares.

- b. *Previously Taxed Income (PTI)*. An amount defined under the old Subchapter S federal tax regulations and applicable only to corporations that were electing Subchapter S status for tax years beginning before 1983. PTI represents the accumulated taxable income that was not paid as cash dividends prior to March 15, 1983, but was earned in Subchapter S tax years beginning prior to January 1, 1983. (If a corporation filed tax returns on a fiscal-year basis, these dates should be adjusted accordingly.) Previous Subchapter S tax regulations viewed PTI as "belonging" to individual shareholders, and this provision has not changed. Therefore, PTI is reduced when distributions in excess of the AAA are paid to shareholders and when shareholders sell their shares or otherwise withdraw from the corporation. PTI will never increase for S corporations. Distributions of PTI reduce the shareholders' tax bases in their shares, and PTI is permanently extinguished if the S corporation election is terminated.

PTI will be negative if past tax losses exceed taxable income. Negative PTI does not affect the tax status of future distributions to shareholders. However, its existence may limit the total amount of dividends that may be declared because of state laws. Negative PTI remains on the books indefinitely or until S corporation status is terminated. As a practical matter, negative PTI can be merged with other retained earnings, if any (see item e.).

- c. *Accumulated Earnings and Profits (AEP)*. An amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status; it generally does not apply to corporations that immediately elect S corporation status. AEP generally represents retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations (for example, in calculating AEP, straight-line depreciation must be used in place of accelerated depreciation methods). AEP may be reduced only by dividends to shareholders after the AAA and PTI have been distributed, unless the corporation elects otherwise as provided by the income tax rules. As with PTI, no new AEP may be generated by S corporations (unless another corporation with AEP is merged). Distributions of AEP do not reduce the shareholders' tax bases in the shares.

The Small Business Jobs Protection Act of 1996 previously eliminated AEP accumulated during any pre-1983 S corporation tax year, provided the corporation was an S corporation during its first tax year beginning after 1996. The Small Business and Work Opportunity Tax Act of 2007 completes the process and eliminates such AEP accumulated during any pre-1983 S corporation tax year, effective for the S corporation's first tax year beginning after May 25, 2007, even though the S corporation was not an S corporation for its first tax year beginning after 1996. As a result of these changes, an S corporation can only have AEP accumulated during a prior C corporation year or acquired from a C corporation through a tax-free corporate reorganization.

AEP will be negative if past C corporation losses exceed income; negative AEP does not affect the tax status of future distributions to shareholders. However, its existence may limit the total amount of dividends that may be declared because of state laws. Negative AEP remains on the books indefinitely.

- d. *Tax Temporary Adjustments (TTA)*. A term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations. Unlike other retained earnings (see item e.), TTA are not viewed as part of shareholders' tax bases in their shares. The use of the TTA account is necessary to maintain a double-entry financial accounting system while maintaining the AAA, AEP, and shareholders' bases at amounts recognized for tax purposes. This account will usually return to zero when timing differences completely reverse. In some cases, though, TTA will remain on the books indefinitely, particularly if the status of the S corporation changes.
- e. *Other Retained Earnings (ORE)*. Any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the

specific definitions above. The amount of ORE is increased by tax-exempt income and is reduced by expenses incurred to generate this tax-exempt income and by dividends paid to shareholders in excess of aggregate distributions from the AAA, PTI, and AEP. This account is also used by S corporations with PTI because a source of ORE would be PTI that remains with the corporation when a shareholder sells shares or otherwise withdraws. Although this account is treated as paid-in capital for tax purposes, i.e., the items affect the shareholders' bases, GAAP and state corporation law imply that it should be viewed as retained earnings for accounting purposes.

The ORE generally tracks changes in the other adjustments account (OAA), which is maintained for tax purposes. [For a comprehensive discussion of the OAA, see the IRS instructions to Form 1120S relating to Schedule M-2, columns (a) and (b).] However, as discussed in the previous paragraph, the ORE is a broader account maintained for financial accounting purposes.

The next several sections of this lesson describe and illustrate accounting procedures designed to maintain these separate components of retained earnings for tax purposes and yet in total equal GAAP retained earnings.

SELF-STUDY QUIZ

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

27. Which of the following parts of an S corporation's financial statements differs from those normally presented by a C corporation?
- a. The balance sheet.
 - b. The statement of income.
 - c. The statement of comprehensive income.
 - d. The statement of cash flows.
28. Which of the following is **not** a unique S corporation disclosure?
- a. The corporation's S corporation status.
 - b. Material tax/book differences.
 - c. All dividends paid by the S corporation.
 - d. A description of the election's tax consequences.
29. Generally, will FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) affect an S corporation's financial statements?
- a. Yes.
 - b. No.

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.)**

27. Which of the following parts of an S corporation's financial statements differs from those normally presented by a C corporation? **(Page 147)**
- a. The balance sheet. [This answer is incorrect. The balance sheet of an S corporation is the same as for a C corporation. Accordingly, the balance sheet should generally report a single retained earnings amount.]
 - b. The statement of income. [This answer is correct. The details of the statement are the same as for a C corporation except that, as a general rule, no federal income tax expense is reported.]**
 - c. The statement of comprehensive income. [This answer is incorrect. The statement of comprehensive income of an S corporation is the same as for a C corporation. Comprehensive income may be reported in a single statement of income and comprehensive income, in a separate statement of comprehensive income, or in a statement of changes in equity that includes comprehensive income.]
 - d. The statement of cash flows. [This answer is incorrect. The statement of cash flows for an S corporation is the same as for a C corporation.]
28. Which of the following is **not** a unique S corporation disclosure? **(Page 148)**
- a. The corporation's S corporation status. [This answer is incorrect. The S corporation status of the corporation should be disclosed either in the notes or the accountant's report. This course recommends disclosing the S corporation status in parenthetically in the accountant's report.]
 - b. Material tax/book differences. [This answer is incorrect. Material tax/book differences and their treatment in the financial statements should be disclosed.]
 - c. All dividends paid by the S corporation. [This answer is correct. Dividends paid after the S corporation election terminates, e.g., special post-termination distributions of the *Accumulated Adjustments Account*, should be disclosed as a subsequent event. Only disclosures relating to post-termination distributions are unique to S corporations.]**
 - d. A description of the election's tax consequences. [This answer is incorrect. A description of the tax consequences of the S corporation election should be presented in the notes.]
29. Generally, will FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) affect an S corporation's financial statements? **(Page 149)**
- a. Yes. [This answer is incorrect. The measurement and disclosure principles of FIN 48 normally cannot affect the financial statements of an entity that is not potentially subject to income taxes. Since many S corporations do not have the potential to be subject to income taxes, their financial statements are not impacted by FIN 48.]
 - b. No. [This answer is correct. FIN 48 will not normally affect the financial statements of S corporations, as many of them do not have the potential to be subject to income taxes. However, some S corporations have the potential to be subject to income taxes on taxable income generated after conversion from a regular corporation. Additionally, an S corporation is required to pay taxes such as the built-in gains tax, the tax on excess net passive income, and certain state and local taxes. These S corporations, to the extent they are subject to federal, state, or local taxation, need to consider the measurement and disclosure principles of FIN 48.]**

TRACKING SEPARATE RETAINED EARNINGS ACCOUNTS

Although separate retained earnings accounts may be maintained for the reasons discussed previously, the balance sheet of an S corporation generally reflects a single retained earnings account. As noted previously, there is no requirement to disclose separate retained earnings accounts, and many practitioners no longer do so. Consequently, the examples in the following sections illustrate the accounting entries tracking the separate retained earnings accounts, but do not illustrate separate statements of retained earnings.

Accounting procedures for tracking retained earnings of S corporations are illustrated by considering three hypothetical companies reflecting three different situations (the year, 20X3, is assumed to be a tax year after December 31, 1982):

- Brand NU Company, a newly formed corporation that elected S corporation status on January 1, 20X3.
- Ceecorp Company, a previously existing conventional corporation that elected S corporation status on January 1, 20X3.
- Wassub Company, a previously existing Subchapter S corporation that became an S corporation on January 1, 1983.

Each firm has four 25% shareholders: Mr. Able, Ms. Baker, Dr. Cole, and Mr. Dale. Each corporation uses the calendar year for tax and financial reporting purposes.

Procedures for Newly Formed S Corporations

Selected accounts from the Brand NU Company adjusted trial balance as of December 31, 20X3, are presented in Exhibit 3-1. During the accounting period following incorporation and election, the company has recorded transactions and made adjusting entries in accordance with GAAP. Distributions of \$60,000 paid during the period are recorded in an account titled "Dividends."

State corporation laws generally refer to distributions from a corporation to its shareholders as "dividends." However, for federal tax purposes, only distributions of the corporation's accumulated earnings and profits (AEP) are considered "dividends" subject to tax at the shareholder level. For financial accounting purposes, a distribution from an S corporation can be a distribution from the AAA, PTI, or AEP as discussed previously. Furthermore, corporate distributions are generally recorded in an account titled "Dividends."

Exhibit 3-1

Selected Accounts from Adjusted Trial Balance

BRAND NU COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X3
(Selected Accounts Only)

	Debit	Credit
Retained earnings		\$ 0
Sales		2,000,000
Cost of goods sold	\$ 1,200,000	
Officer and employee salaries	250,000	
Operating expenses	350,000	
State income taxes	40,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	60,000	

* * *

The various revenue and expense accounts are closed to an income summary account at the end of the accounting period. The entry to record income would be as shown in Exhibit 3-2. The \$180,000 balance in the income summary account represents net income as computed under GAAP. Taxable income that flows through to shareholders, however, is only \$160,000 because of the \$20,000 net permanent difference between tax-exempt interest income (\$50,000) and nondeductible officer life insurance premiums (\$30,000). The taxable income of \$160,000 is credited to the AAA, and the \$20,000 difference between tax-exempt income and nondeductible life insurance premiums is credited to ORE. [AAA is not reduced by premiums paid by an S corporation if the corporation owns the life insurance contract and the S corporation is directly or indirectly a beneficiary of the policy. Furthermore, the tax-exempt life insurance benefits that an S corporation receives from an employer-owned life insurance contract do not increase the S corporation's AAA (Rev. Rul. 2008-42).] The dividends of \$60,000 are less than taxable income and would thus be deducted entirely from the AAA. If tax/book timing differences exist, a third retained earnings account (TTA) is necessary as discussed in a later section. Closing entries to allocate income and dividends to retained earnings are shown in Exhibit 3-3.

Exhibit 3-2

Entry to Record Income

	<u>DR</u>	<u>CR</u>
Sales	\$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		\$ 1,200,000
Officer and employee salaries		250,000
Operating expenses		350,000
State income taxes		40,000
Officer life insurance premiums		30,000
Income summary		180,000
	*	*

Exhibit 3-3

Closing Entries

	<u>DR</u>	<u>CR</u>
Income summary	\$ 180,000	
Retained earnings—AAA		\$ 160,000
ORE		20,000
Retained earnings—AAA	60,000	
Dividends		60,000
	*	*

Practitioners may wish to present, as supplementary information, a schedule of income allocation similar to Exhibit 3-4, which reconciles net income and taxable income allocated to shareholders. Such presentations are useful to shareholders in understanding the relationship of the financial statement income of the company to their personal tax consequences.

Exhibit 3-4**Schedule of Income Allocation**

BRAND NU COMPANY
 SCHEDULE OF INCOME ALLOCATION
 Year Ended December 31, 20X3

TAXABLE INCOME ALLOCATED TO SHAREHOLDERS	
Able	\$ 40,000
Baker	40,000
Cole	40,000
Dale	<u>40,000</u>
TOTAL TAXABLE INCOME	160,000
TAX-EXEMPT INCOME	50,000
NONDEDUCTIBLE EXPENSES	<u>(30,000)</u>
NET INCOME	<u>\$ 180,000</u>

See accountant's report.

* * *

Recommended disclosures for S corporation financial statements were summarized at the beginning of this lesson.

Procedures for Previous Conventional Corporations

Selected accounts from Ceecorp Company's adjusted trial balance at December 31, 20X3, are shown in Exhibit 3-5. The conventional corporate retained earnings account at December 31, 20X2, in the amount of \$100,000, became AEP on January 1, 20X3. (In this illustration, Ceecorp Company's AEP account includes accumulated earnings and profits generated when the company was a conventional C corporation. This example ignores tax/book temporary differences arising before S corporation status is attained. These differences are discussed later in this lesson.)

Exhibit 3-5**Selected Accounts from Adjusted Trial Balance**

CEECORP COMPANY
 ADJUSTED TRIAL BALANCE
 December 31, 20X3
 (Selected Accounts Only)

	Debit	Credit
Retained earnings—AEP		\$ 100,000
Sales		2,000,000
Cost of goods sold	\$ 1,200,000	
Officer and employee salaries	300,000	
Operating expenses	461,000	
State income taxes	2,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	6,000	

* * *

The revenue and expense accounts are closed to the income summary account as shown in Exhibit 3-6 with a resulting net income computed under GAAP of \$57,000.

Exhibit 3-6

Entry to Record Income

	<u>DR</u>	<u>CR</u>
Sales	\$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		\$ 1,200,000
Officer and employee salaries		300,000
Operating expenses		461,000
State income taxes		2,000
Officer life insurance premiums		30,000
Income summary		57,000
* * *		

Income would be allocated as shown in Exhibit 3-7. The \$37,000 taxable income would flow through to the shareholders. This amount is recorded as the AAA. The \$50,000 of tax-exempt interest income less the nondeductible life insurance premiums of \$30,000 becomes part of ORE because this amount is added directly to shareholders' bases in the shares. If tax/book timing differences exist, adjustments of the AAA and ORE accounts are necessary. This topic is discussed later in this lesson.

Exhibit 3-7

Closing Entry to Allocate Income to Retained Earnings

	<u>DR</u>	<u>CR</u>
Income summary	\$ 57,000	
Retained earnings—AAA		\$ 37,000
ORE		20,000
* * *		

Assume that Ceecorp had a poor financial year in 20X2, so that only \$6,000 in distributions were paid—\$1,500 to each shareholder. This amount is less than taxable income; hence, it reduces only the AAA as shown in Exhibit 3-8.

Exhibit 3-8

Closing Entry to Allocate Dividends to Retained Earnings

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA	\$ 6,000	
Dividends		\$ 6,000
* * *		

Procedures for Previous Subchapter S Corporations (before January 1, 1983)

Selected accounts from Wassub Company's adjusted trial balance at December 31, 20X3, are shown in Exhibit 3-9. PTI of \$9,000 for each shareholder was brought forward when the corporation changed from Subchapter S to S

corporation status on January 1, 1983. The AEP represents retained earnings on the books when the corporation changed from Subchapter C to Subchapter S status. In this illustration, Wassub Company's AEP account includes accumulated earnings and profits generated when the company was a conventional C corporation. Assume there were no tax/book timing differences at that time and that no changes in PTI or AEP have occurred since January 1, 1983. (See the section labeled "Differences Originating before S Corporation Status is Attained" later in this lesson.)

Exhibit 3-9

Selected Accounts from Adjusted Trial Balance

WASSUB COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X3
(Selected Accounts Only)

	<u>Debit</u>	<u>Credit</u>
Retained earnings—PTI		\$ 36,000
Retained earnings—AEP		180,000
Sales		2,000,000
Cost of goods sold	\$ 1,200,000	
Officer and employee salaries	300,000	
Operating expenses	420,000	
State income taxes	2,000	
Officer life insurance premiums	30,000	
Interest income (tax-exempt)		50,000
Dividends	40,000	
* * *		

The entry to close the revenue and expense accounts is similar to those illustrated in the previous cases and is not illustrated here. The company would report net income of \$98,000 computed under GAAP, an excess of tax-exempt income over nondeductible expenses of \$20,000, and taxable income of \$78,000. The entry to allocate net income is shown in Exhibit 3-10. The procedures are the same as discussed above for previous C corporations. Because the dividends of \$40,000 are less than taxable income, the entire amount reduces the AAA as shown in Exhibit 3-11.

Exhibit 3-10

Closing Entry to Allocate Income to Retained Earnings

	<u>DR</u>	<u>CR</u>
Income summary	\$ 98,000	
Retained earnings—AAA		\$ 78,000
ORE		20,000
* * *		

Exhibit 3-11

Closing Entry to Allocate Dividends to Retained Earnings

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA	\$ 40,000	
Dividends		\$ 40,000
* * *		

Assume instead that distributions of \$80,000 (\$20,000 to each shareholder) were paid. IRC Sec. 1379(c), applicable to tax years beginning after December 31, 1982, states that provisions of previous law continue to apply with respect to distribution of PTI. This fact implies that distributions reduce the AAA, PTI, AEP, and ORE in that order. The entry to allocate distributions from the various retained earnings accounts would now be as shown in Exhibit 3-12.

Exhibit 3-12

Closing Entry to Allocate Dividends to Retained Earnings

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA	\$ 78,000	
Retained earnings—PTI	2,000	
Dividends		\$ 80,000

* * *

Recommended S corporation disclosures are summarized at the beginning of this lesson.

Tax rules viewed PTI as “belonging” to individual shareholders under the previous act, and this feature has not been changed. Therefore, each shareholder’s PTI would be reduced by \$500, and practitioners may wish to disclose the changes in each shareholder’s PTI in a supplementary schedule. See Exhibit 3-13.

Exhibit 3-13

Supplementary Schedule to Disclose Changes in Each Shareholder’s PTI

WASSUB COMPANY
SCHEDULE OF PREVIOUSLY TAXED INCOME
Year Ended December 31, 20X3

	<u>Jan. 1</u>	<u>Dividends</u>	<u>Dec. 31</u>
ABLE	\$ 9,000	\$ (500)	\$ 8,500
BAKER	9,000	(500)	8,500
COLE	9,000	(500)	8,500
DALE	<u>9,000</u>	<u>(500)</u>	<u>8,500</u>
TOTALS	<u>\$ 36,000</u>	<u>\$ (2,000)</u>	<u>\$ 34,000</u>

* * *

Should any shareholders sell their shares, they cannot take with them the PTI previously viewed as theirs. Such PTI remains with the corporation because federal tax regulations prohibit both the transfer of PTI to new shareholders who buy the shares and the reallocation of PTI to remaining shareholders. Furthermore, tax regulations do not allow S corporations to add withdrawing-shareholder PTI to AEP.

Under most state corporation laws, PTI of withdrawing shareholders is viewed as retained earnings. Therefore, an entry would be required to transfer the remaining PTI to ORE. To illustrate, assume that Ms. Baker sells her shares to Mr. Eanes early in 20X4. The entry to record the transfer is presented in Exhibit 3-14.

Exhibit 3-14**Entry to Transfer PTI to ORE**

	<u>DR</u>	<u>CR</u>
Retained earnings—PTI	\$ 8,500	
ORE		\$ 8,500
* * *		

HOW LOSSES AFFECT RETAINED EARNINGS ACCOUNTS

S corporation losses passed through to shareholders are deductible to the extent of shareholders' adjusted bases in the corporation's stock plus debt due them from the corporation. Losses that exceed shareholders' stock and debt bases may be carried over and deducted by them in succeeding years when the corporation has income until completely absorbed or the S corporation election is terminated.

Accounting procedures for S corporation losses parallel the procedures previously illustrated for profits. The AAA is reduced (debited) for the amount of loss that is passed through to the shareholders. The AAA is also reduced for nondeductible expenses not related to tax-exempt income. Tax-exempt income less related expenses is credited to ORE. Existing PTI or AEP accounts are not affected by S corporation losses. The AAA may carry a debit balance as a result of losses. Following the normal order of priority, distributions made while the AAA has a debit balance would be considered made first from PTI and then from AEP, assuming that total retained earnings has a credit balance. If total retained earnings amounts to a deficit, dividends cannot normally be legally declared even though PTI and AEP may have credit balances. State corporation law generally recognizes retained earnings as a single amount.

To illustrate loss accounting procedures, refer to the examples for Ceecorp Company for the year 20X3 (Exhibit 3-5 through Exhibit 3-8). Procedures are essentially the same for all S corporations; hence, they are not illustrated separately. At the end of 20X3, Ceecorp has AAA with a \$31,000 balance and ORE with a \$20,000 balance. Assume that shareholders had paid \$40,000 (\$10,000 each) for their shares. Therefore, shareholders' bases in the shares would be \$91,000 (\$22,750 each). Also assume that Dr. Cole has a note payable from the corporation of \$5,000.

Assume further that Ceecorp realizes a net loss of \$200,000 in 20X4, and that there are no tax/book differences. In this case, the income summary account would have a debit balance of \$200,000. The entry to close the net loss is shown in Exhibit 3-15. As a result, the AAA now has a debit balance of \$199,000. The capital stock, paid-in capital, and notes payable accounts are not reduced because these items are not legally canceled.

Exhibit 3-15**Closing Entry to Allocate Net Loss to Retained Earnings**

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA	\$ 200,000	
Income summary		\$ 200,000
* * *		

The entire \$200,000 loss is allocated to shareholders (\$50,000 each). The maximum loss that can be deducted by the shareholders in 20X4, however, is \$96,000 (\$22,750 each to Able, Baker, and Dale, and \$27,750 to Cole). The remaining \$104,000 loss can be deducted in future profitable years (\$26,000 to each shareholder). (Disclosure of the future tax effect for shareholders should be considered.)

HOW TAX/BOOK DIFFERENCES AFFECT RETAINED EARNINGS ACCOUNTS

S corporations do not normally pay federal income taxes and thus do not report federal tax liabilities and deferred taxes. Nevertheless, it may be necessary to record originating and reversing tax/book temporary differences because these differences affect the various retained earnings accounts and sometimes require that additional retained earnings accounts be established. The accounting procedures vary depending on the origin of the S corporation and whether the temporary differences originated before or after S corporation status was attained.

Many tax/book differences originate with income under GAAP in excess of taxable income. Therefore, the following discussions and illustrations incorporate this presumption. All of the illustrations are based on the following data: assume that during 20X3, a company purchased assets for \$50,000. For tax purposes, the cost will be recovered using three-year MACRS. For accounting purposes, the company records straight-line depreciation over five years with no residual value. A summary of the relevant data is as follows:

Year	Cost Recovered	Depreciation	Difference	Cumulative Difference
20X3	\$ 16,665 (33.33%)	\$ 10,000 (20%)	\$ 6,665	\$ 6,665
20X4	22,225 (44.45%)	10,000	12,225	18,890
20X5	7,405 (14.81%)	10,000	(2,595)	16,295
20X6	3,705 (7.41%)	10,000	(6,295)	10,000
20X7	—	10,000	(10,000)	—
TOTALS	<u>\$ 50,000</u>	<u>\$ 50,000</u>	<u>\$ -0-</u>	

Differences Originating after S Corporation Status Is Attained

To illustrate accounting procedures for newly created corporations that immediately elect S corporation status, refer to the adjusted trial balance for Brand NU Company for the year 20X3 in Exhibit 3-1 and assume:

- Depreciation expense of \$10,000 is included in operating expenses.
- GAAP net income for 20X3 is \$180,000.
- GAAP net income includes \$50,000 of nontaxable income and \$30,000 of nondeductible expenses.
- Taxable income for 20X3 is \$153,335 (\$180,000 GAAP income – \$6,665 excess MACRS depreciation – \$50,000 nontaxable income + \$30,000 nondeductible expenses).

When closing the income summary account, it is necessary to use an additional retained earnings account called TTA to record the tax/book temporary difference. This is illustrated in Exhibit 3-16.

Exhibit 3-16

Closing Entry to Allocate Income to Retained Earnings

	<u>DR</u>	<u>CR</u>
Income Summary	\$ 180,000	
Retained earnings—AAA		\$ 153,335
ORE		20,000
Retained earnings—TTA		6,665

* * *

The amount of TTA represents taxable income that will be allocated to shareholders in future years and thus should be disclosed separately. The supplementary schedule of income allocation for 20X3 is shown in Exhibit 3-17. An explanatory note, describing the nature of material differences between book and taxable income, is recommended by this course.

Exhibit 3-17**Supplementary Schedule of Income Allocation**

BRAND NU COMPANY
 SCHEDULE OF INCOME ALLOCATION
 Year Ended December 31, 20X3

TAXABLE TO SHAREHOLDERS IN 20X3

Able	\$ 38,334
Baker	38,334
Cole	38,334
Dale	<u>38,333</u>

TOTAL TAXABLE INCOME 153,335

TAXABLE TO SHAREHOLDERS IN FUTURE YEARS 6,665

TAX-EXEMPT INCOME 50,000

NONDEDUCTIBLE EXPENSES (30,000)

NET INCOME \$ 180,000

See accountant's report.

* * *

Assume net income computed under GAAP for years 20X4 through 20X7 is as follows:

20X4	\$ 200,000
20X5	250,000
20X6	150,000
20X7	190,000

Assume further that there are no tax/book differences except for the difference between cost recovery and straight-line depreciation expense. Entries to close net income for each of these years are presented in Exhibit 3-18. Observe that the TTA account is reduced to zero when the temporary difference completely reverses in 20X7.

Exhibit 3-18**Entries to Close Net Income to Retained Earnings**

	<u>DR</u>	<u>CR</u>
20X4 Income summary	\$ 200,000	
Retained earnings—TTA		\$ 12,225
Retained earnings—AAA		187,775
20X5 Income summary	250,000	
Retained earnings—TTA	2,595	
Retained earnings—AAA		252,595
20X6 Income summary	150,000	
Retained earnings—TTA	6,295	
Retained earnings—AAA		156,295
20X7 Income summary	190,000	
Retained earnings—TTA	10,000	
Retained earnings—AAA		200,000

* * *

Differences Originating before S Corporation Status Is Attained

Tax/book temporary differences originating before S corporation status is attained produce some interesting questions:

- a. How should pre-S corporation temporary differences be reflected in the retained earnings accounts?
- b. How should the reversal of these pre-S corporation differences be recorded?
- c. What should be done with existing deferred taxes, if any?

Because temporary differences produce a difference between GAAP income and taxable income, the GAAP retained earnings will differ from the tax concept of AEP for C corporations.

At the time of conversion to S corporation status, AEP, as defined for tax purposes, is frozen. It is believed that the GAAP retained earnings balance should be segregated into two or more parts at the time a corporation converts to an S corporation.

- a. *AEP*. As defined for tax purposes.
- b. *TTA*. The net temporary differences.
- c. *ORE*. Permanent differences, etc., that do not enter the calculation of AEP.

These separate component accounts for retained earnings preserve the tax concept of AEP yet maintain a GAAP retained earnings balance.

When a Subchapter S corporation (not referring to a C corporation here) converts to S corporation status (before January 1, 1983, for calendar year Subchapter S corporations), PTI (representing undistributed taxable income) is frozen. Temporary differences in PTI should be segregated out into TTA as illustrated above for former C corporations. Reversals of the temporary differences in the TTA account should be accounted for as previously illustrated.

Although the temporary differences originating before attaining S corporation status will reverse, they will not generate a tax liability so long as S corporation status is maintained. Thus, deferred taxes previously recorded will not become due. SFAS No. 109, *Accounting for Income Taxes* (FASB ASC 740), requires that existing deferred tax assets and liabilities be eliminated through a charge or credit to income tax expense for the period in which the enterprise ceases to be a taxable enterprise.

Because the concept of a TTA account is not commonly known, many existing S corporations may include within their various retained earnings accounts elements of tax/book differences and/or deferred taxes. A TTA account can be established and any material amounts of tax/book differences reallocated within the retained earnings accounts. This will allow the accounting records to properly reflect GAAP and yet maintain retained earnings accounts for the tax concepts of AEP, PTI, AAA, etc.

Tax/Book Differences Existing When S Corporation Status Terminates

The tax/book temporary differences existing when S corporation status terminates are discussed in the next section.

Tax Basis of Accounting

Converting from GAAP to the tax basis of accounting at the time of conversion to S corporation status will eliminate the need to account for tax/book temporary differences. Practitioners should consider this option in light of the intended uses of the financial statements.

HOW TERMINATION OF THE S CORPORATION ELECTION AFFECTS RETAINED EARNINGS ACCOUNTS

When an S corporation election is terminated, it is necessary for financial accounting purposes to merge retained earnings items that have resulted from income that has flowed through and been taxed to shareholders (AAA and

PTI) with ORE. The merged retained earnings account should then be separated from retained earnings such as AEP that have resulted from earnings that were taxable to the corporation. Distributions from the former are generally viewed as tax-free returns of capital for tax purposes, whereas distributions from the latter are generally taxable to shareholders as are any other dividends.

When a corporation terminates its S corporation election, it has a specified period during which it can distribute all of the AAA; any AAA *not* distributed becomes part of ORE. Alternatively, the corporation (to avoid the accumulated earnings tax or personal holding company tax) can elect to have all of its distributions during this period taxed as dividends and not reduce the basis of the shares. If this treatment is elected, the distribution is recorded as a debit to AEP. The PTI on the date of termination also becomes part of ORE; however, special post-termination distribution provisions do not apply to PTI. In subsequent periods, once S corporation status has ended, all income becomes part of AEP, and any dividends paid must first come from AEP before tax-free distributions can be made from ORE. It is beneficial, therefore, for the corporation to reduce the AAA by the maximum extent possible during the post-termination period through dividend distributions, considering its cash position and borrowing ability. Otherwise, the AAA could be effectively "frozen" when it becomes ORE.

This period during which all the AAA can be distributed ends on the *latter* of (a) one year after the last day of the corporation's last taxable year as an S corporation or (b) the date the last S corporation tax return is due (including extensions). S corporations are generally required to file a short year S corporation return for the part of the year prior to termination and a short year return as a conventional corporation for the portion of the year after termination. It is not necessary, however, to close the books. Income is allocated between the S corporation and the C corporation year on a pro rata basis. However, several exceptions to this allocation procedure are available.

General Accounting Procedures

To illustrate accounting procedures, assume that management of Term Company, an S corporation with the same ownership structure as described in the "Tracking Separate Retained Earnings Accounts" discussion, terminated its S corporation election on July 1, 20X5. The adjusted trial balance for the year 20X5 is presented in Exhibit 3-19. Note that retained earnings amounts are beginning-of-year amounts. It is assumed that the distributions of \$200,000 were paid before September 15, 20X5, and that this amount was the largest possible reduction in the AAA based on the company's financial position. The company filed a short-year tax return as an S corporation on September 15, 20X5, covering the period January 1 through June 30, 20X5. It will file another short-year return as a conventional corporation on March 15, 20X6, for the period July 1 through December 31, 20X5. It made no additional distributions in 20X5.

Exhibit 3-19

Selected Accounts from Adjusted Trial Balance

TERM COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X5
(Selected Accounts Only)

	Debit	Credit
Retained earnings—AAA		\$ 250,000
Retained earnings—PTI		40,000
Retained earnings—AEP		200,000
ORE		50,000
Sales		2,000,000
Cost of goods sold	\$ 1,200,000	
Operating expenses	580,000	
Federal income taxes	40,000	
Dividends	200,000	

* * *

The company did not close its books when it terminated its S corporation election, but it did calculate its taxable income through June 30, 20X5, to be \$120,000. There are no tax/book differences for the year. Taxable income for the period July 1 to December 31 is \$100,000. Therefore, income before taxes for the year is \$220,000. Tax expense for the last half of the year is \$40,000 (assume a 40% tax rate). Net income would thus be \$180,000 (\$120,000 + \$100,000 – \$40,000). The entry to allocate income to retained earnings is shown in Exhibit 3-20. Earnings after June 30, 20X5, are recorded as increases of AEP because they are taxable to the corporation.

Exhibit 3-20**Closing Entry to Allocate Income to Retained Earnings**

	<u>DR</u>	<u>CR</u>
Income summary	\$ 180,000	
Retained earnings—AAA		\$ 120,000
Retained earnings—AEP (100,000 – 40,000)		60,000
* *		*

Distributions, although after termination of S corporation status, are within the post-termination period, and thus are not distributions of the C corporation's earnings but instead reduce the AAA (unless the corporation elected the alternative method described previously). Exhibit 3-21 illustrates the entry to record the distributions.

Exhibit 3-21**Entry to Record Distributions**

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA	\$ 200,000	
Dividends		\$ 200,000
* *		*

An additional entry is needed as shown in Exhibit 3-22 to merge PTI and the undistributed portion of the AAA into ORE.

Exhibit 3-22**Entry to Merge PTI and AAA into ORE**

	<u>DR</u>	<u>CR</u>
Retained earnings—AAA (250,000 + 120,000 – 200,000)	\$ 170,000	
Retained earnings—PTI	40,000	
ORE		\$ 210,000
* *		*

Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted. In practice, however, it may be impossible to distribute AEP without impairing the financial condition of the company. Pre-termination earnings of terminated S corporations may thus be effectively frozen.

Because federal tax rules view ORE as paid-in capital, a terminated S corporation may wish to transfer it to paid-in capital. State corporation law generally *permits* boards of directors to transfer retained earnings to paid-in capital but does not *require* such a transfer. If the board of directors of Term Company complies with state law and explicitly transfers ORE to paid-in capital, the accounting entry to record the transfer would be as shown in Exhibit 3-23. The resulting statement of retained earnings follows logically and is not illustrated. A note to the financial statements describing the transfer would normally be required to disclose the change in legal status to shareholders.

Exhibit 3-23

Entry to Transfer ORE to Paid-in Capital

	<u>DR</u>	<u>CR</u>
ORE	\$ 260,000	
Additional paid-in capital from transfer of retained earnings		\$ 260,000
* * *		

A transfer of ORE to paid-in capital may give corporations less flexibility in managing its shareholders' equity because state corporation law generally places greater restrictions on paid-in capital than on retained earnings. Therefore, a terminated S corporation may choose not to make this transfer. If a transfer is not made, financial statements prepared in accordance with GAAP should continue to report pretermination earnings as ORE. Note disclosure would normally be required to inform shareholders that distributions from this item can be made tax free after other earnings have been distributed.

Tax/Book Differences and Termination

The procedures illustrated in the preceding paragraphs illustrate how to account for AEP, AAA, PTI, and ORE in the event of termination of the S corporation election. If unreversed tax/book temporary differences exist, how should the TTA account be accounted for? Closing the TTA account and transferring it to ORE is suggested. SFAS No. 109, *Accounting for Income Taxes* (FASB ASC 740), requires the reinstatement of deferred tax assets and liabilities on existing differences.

S CORPORATIONS COMPILATION AND REVIEW REPORTS

The only policy adopted by this course as uniquely applicable to S corporations is that the S corporation status be disclosed in the accountant's report parenthetically after the name of the company. Additional reporting guidance is contained in *PPC's Guide to Compilation and Review*.

SELF-STUDY QUIZ

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

30. Which of the following is **not** one of the two reasons that maintaining separate retained earnings accounts is a good accounting practice for an S corporation?
- a. GAAP requires S corporations to disclose separate retained earnings accounts.
 - b. Maintaining separate accounts is generally needed for proper S corporation tax accounting.
 - c. Often, the primary users of S corporation financial statements are shareholders.
31. Which of the following accounts would **not** be considered part of an S corporation's shareholders' tax bases in their shares?
- a. Accumulated Adjustments Account (AAA).
 - b. Tax Temporary Adjustments (TTA).
 - c. Other Retained Earnings (ORE).
32. Which of the following entities could have AEP?
- a. A new corporation that immediately elects S corporation status.
 - b. An S corporation that previously had Subchapter C status.
 - c. A corporation that currently maintains Subchapter C status.
 - d. No entities can have AEP because of recent legal changes.
33. Breaker Company, a newly formed S corporation, has \$80,000 of taxable income that flows through to shareholders after the \$10,000 net permanent difference between tax-exempt interest income (\$25,000) and nondeductible officer life insurance premiums (\$15,000) are accounted for. To what account should the taxable income be credited?
- a. AAA.
 - b. ORE.
 - c. TTA.
 - d. Previously Taxed Income (PTI).
34. Assume the same details as in the question above. Should Breaker Company present a schedule of income allocation to help shareholders understand the relationship of the financial statement income of the company to their personal tax consequences?
- a. Yes.
 - b. Possibly.
 - c. No.

35. SurfCo became an S corporation on January 1, 1983. Prior to that, SurfCo was a Subchapter S corporation. After its conversion to an S corporation, SurfCo still had \$100,000 of PTI. Gigi, one of SurfCo's shareholders, decides to sell her shares to Tom, who has never held shares in SurfCo before. What happens to Gigi's portion of the PTI?
- a. Gigi retains the PTI after the sale.
 - b. The PTI is transferred to Tom.
 - c. The PTI remains with SurfCo.
 - d. The PTI becomes part of SurfCo's AEP.
36. Which of the following statements best describes the treatment of S corporation losses?
- a. Losses that pass through to shareholders can be deducted to the extent of their adjusted stock and debt bases.
 - b. Losses that exceed the shareholders' adjusted stock and debt bases cannot be deducted by the shareholders.
 - c. Losses first reduce the S corporation's PTI and AEP accounts, and then they reduce AAA and ORE accounts.
 - d. As long as the PTI and AEP accounts have credit balances, dividends can be declared despite a deficit in retained earnings.
37. At the time a C corporation converts to an S corporation, the GAAP retained earnings balance can be segregated into multiple parts. The permanent differences would be categorized into which account?
- a. AEP.
 - b. TTA.
 - c. ORE.
38. When an S corporation election is terminated, the entity has a specified period during which it can distribute all of what amount?
- a. ORE.
 - b. PTI.
 - c. AEP.
 - d. AAA.
39. Which of the following best describes an accounting procedure for a terminated S corporation election?
- a. Unreversed tax/book temporary differences should be accounted for by closing TTA and transferring it to AEP.
 - b. In years subsequent to a termination, all distributions must be allocated first to AEP.
 - c. In practice, distributing ORE after the post-termination period should not be difficult.
 - d. Transfer ORE to paid-in capital will give corporations more flexibility to manage shareholder's equity.

40. Which of the following financial statement elements is present for proprietorships, partnerships, and S corporations?
- a. Statement of changes in proprietor's capital.
 - b. Statement of changes in partner's capital.
 - c. Balance sheet.
 - d. Statement of retained earnings.

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.)**

30. Which of the following is **not** one of the two reasons that maintaining separate retained earnings accounts is a good accounting practice for an S corporation? **(Page 149)**
- GAAP requires S corporations to disclose separate retained earnings accounts. [This answer is correct. GAAP has no requirement to disclose separate retained earnings accounts, and some practitioners no longer do so.]**
 - Maintaining separate accounts is generally needed for proper S corporation tax accounting. [This answer is incorrect. Although practitioners may show a single balance sheet caption and amount for retained earnings of an S corporation, this course recommends maintenance of separate retained earnings accounts in the books as a good accounting practice for two reasons. One of those reasons is that maintenance of separate retained earnings accounts is generally necessary for proper tax accounting of an S corporation.]
 - Often, the primary users of S corporation financial statements are shareholders. [This answer is incorrect. There are two reasons that this course recommends maintenance of separate retained earnings accounts. One of those reasons is that, more often than not, the primary users of financial statements of S corporations are shareholders who are interested in the impact of the corporate earnings on their personal tax returns.]
31. Which of the following accounts would **not** be considered part of an S corporation's shareholders' tax bases in their shares? **(Page 149)**
- Accumulated Adjustments Account (AAA). [This answer is incorrect. The amounts included in the AAA affect the shareholders' tax bases in the shares.]
 - Tax Temporary Adjustments (TTA). [This answer is correct. TTA (the retained earnings changes that result when tax/book differences originate and then reverse) are not recognized for tax purposes in the AAA and AEP calculations. Unlike other retained earnings, TTA are not viewed as part of shareholders' tax bases in their shares. The use of the TTA account is necessary to maintain a double-entry financial accounting system while maintaining the AAA, AEP, and shareholders' bases at amounts recognized for tax purposes.]**
 - Other Retained Earnings (ORE). [This answer is incorrect. Although the ORE account is treated as paid-in capital for tax purposes, i.e., the items affect the shareholders' bases, GAAP and state corporation law imply that it should be viewed as retained earnings for accounting purposes.]
32. Which of the following entities could have AEP? **(Page 149)**
- A new corporation that immediately elects S corporation status. [This answer is incorrect. AEP does not apply to corporations that immediately elect S corporation status.]
 - An S corporation that previously had Subchapter C status. [This answer is correct. AEP is an amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status. AEP will be negative if past C corporation losses exceed income.]**
 - A corporation that currently maintains Subchapter C status. [This answer is incorrect. The term AEP, as defined in this lesson, specifically applies to S corporations, so a C corporation would not have AEP under these circumstances.]
 - No entities can have AEP because of recent legal changes. [This answer is incorrect. The Small Business Jobs Protection Act of 1996 and the Small Business and Work Opportunity Tax Act of 2007 eliminate AEP accumulated during pre-1983 tax years. However, despite these legal changes, it is still possible for certain entities to have AEP.]

33. Breaker Company, a newly formed S corporation, has \$80,000 of taxable income that flows through to shareholders after the \$10,000 net permanent difference between tax-exempt interest income (\$25,000) and nondeductible officer life insurance premiums (\$15,000) are accounted for. To what account should the taxable income be credited? **(Page 156)**
- a. **AAA. [This answer is correct. In this scenario, the taxable income would be credited to AAA. If Breaker Company had dividends that were less than the taxable income, those would be deducted entirely from the AAA.]**
 - b. ORE. [This answer is incorrect. The \$10,000 difference between the tax-exempt income and the nondeductible life insurance premiums would be credited to ORE.]
 - c. TTA. [This answer is incorrect. If tax/book timing differences exist, a third retained earnings account (TTA) would be necessary.]
 - d. Previously Taxed Income (PTI). [This answer is incorrect. PTI would not apply to this scenario, as it is only applicable to corporations that were electing Subchapter S status for tax years beginning before 1983. Breaker Company is a newly formed S corporation, so it was not in existence in 1983.]
34. Assume the same details as in the question above. Should Breaker Company present a schedule of income allocation to help shareholders understand the relationship of the financial statement income of the company to their personal tax consequences? **(Page 156)**
- a. Yes. [This answer is incorrect. Breaker Company is not required by authoritative guidance to present a schedule of income allocation in the scenario above.]
 - b. **Possibly. [This answer is correct. Breaker Company's practitioners may wish to present a schedule of income allocation, which reconciles net income and taxable income allocated to shareholders. Such presentations are useful to shareholders in understanding the relationship of the financial statement income of the company to their personal tax consequences.]**
 - c. No. [This answer is incorrect. Breaker Company is not prohibited from presenting a schedule of income allocation in the scenario above. If the S corporation does present such a schedule, it should be presented as supplementary information.]
35. SurfCo became an S corporation on January 1, 1983. Prior to that, SurfCo was a Subchapter S corporation. After its conversion to an S corporation, SurfCo still had \$100,000 of PTI. Gigi, one of SurfCo's shareholders, decides to sell her shares to Tom, who has never held shares in SurfCo before. What happens to Gigi's portion of the PTI? **(Page 160)**
- a. Gigi retains the PTI after the sale. [This answer is incorrect. Tax rules view PTI as "belonging" to individual shareholders. However, when a shareholder in this type of S corporation sells his or her shares, they cannot take with them the PTI that was previously viewed as theirs.]
 - b. The PTI is transferred to Tom. [This answer is incorrect. Federal tax regulations prohibit both the transfer of PTI to new shareholders who buy the shares and the reallocation of PTI to remaining shareholders.]
 - c. **The PTI remains with SurfCo. [This answer is correct. In this scenario, the PTI remains with the corporation. Under most state corporation laws, PTI of withdrawing shareholders is viewed as retained earnings. Therefore, an entry would be required to transfer the remaining PTI to ORE.]**
 - d. The PTI becomes part of SurfCo's AEP. [This answer is incorrect. Tax regulations do not allow S corporations to add withdrawing-shareholder PTI to AEP, so SurfCo cannot take this course of action.]

36. Which of the following statements best describes the treatment of S corporation losses? **(Page 161)**
- a. **Losses that pass through to shareholders can be deducted to the extent of their adjusted stock and debt bases. [This answer is correct. S corporation losses passed through to shareholders are deductible to the extent of the shareholders' adjusted bases in the stock plus debt due them from the corporation. Accounting procedures for S corporation losses parallel the procedures this course illustrated for profits.]**
 - b. Losses that exceed the shareholders' adjusted stock and debt bases cannot be deducted by the shareholders. [This answer is incorrect. Losses that exceed shareholders' stock and debt bases may be carried over and deducted by them in succeeding years when the corporation has income until completely absorbed or the S corporation election is terminated.]
 - c. Losses first reduce the S corporation's PTI and AEP accounts, and then they reduce AAA and ORE accounts. [This answer is incorrect. Existing PTI or AEP accounts are not affected by S corporation losses. The AAA is reduced for the amount of loss that is passed through to the shareholders. The AAA is also reduced for nondeductible expenses not related to tax-exempt income. Tax-exempt income less related expenses is credited to ORE.]
 - d. As long as the PTI and AEP accounts have credit balances, dividends can be declared despite a deficit in retained earnings. [This answer is incorrect. If total retained earnings amounts to a deficit, dividends cannot normally be legally declared even though PTI and AEP may have credit balances. State corporation law generally recognizes retained earnings as a single amount.]
37. At the time a C corporation converts to an S corporation, the GAAP retained earnings balance can be segregated into multiple parts. The permanent differences would be categorized into which account? **(Page 164)**
- a. AEP. [This answer is incorrect. At the time of conversion to S corporation status, AEP, as defined for tax purposes, is frozen. It is believed that the GAAP retained earnings balance should be segregated into two or more parts at the time a corporation converts into an S corporation. Amounts in AEP would be categorized as defined for tax purposes.]
 - b. TTA. [This answer is incorrect. The net temporary differences would be categories in the TTA account.]
 - c. **ORE. [This answer is correct. The permanent differences, etc., that do not enter the calculation of AEP would be categorized as ORE. The separate component accounts for retained earnings preserve the tax concept of AEP, yet maintain a GAAP retained earnings balance.]**
38. When an S corporation election is terminated, the entity has a specified period during which it can distribute all of what amount? **(Page 165)**
- a. ORE. [This answer is incorrect. Any of the amount in question that is *not* distributed at the end of the specified period becomes part of ORE.]
 - b. PTI. [This answer is incorrect. Special post-termination distribution provisions do not apply to PTI. On the date of termination, PTI becomes part of ORE.]
 - c. AEP. [This answer is incorrect. As an alternative to the distribution scenario, the corporation can elect to have all of its distributions during this period taxed as dividends and not reduce the basis of the shares. If this treatment is elected, the distribution is recorded as a debit to AEP.]
 - d. **AAA. [This answer is correct. When a corporation terminates its S election, it has a specified period during which it can distribute all of the AAA. This period end on the *latter* of (a) one year after the last day of the corporation's last taxable year as an S corporation or (b) the date the last S corporation tax return is due (including extensions).]**

39. Which of the following best describes an accounting procedure for a terminated S corporation election? **(Page 166)**
- a. Unreversed tax/book temporary differences should be accounted for by closing TTA and transferring it to AEP. [This answer is incorrect. If unreversed tax/book temporary differences exist, this course suggests closing the TTA account and transferring it to ORE.]
 - b. In years subsequent to a termination, all distributions must be allocated first to AEP. [This answer is correct. Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted.]**
 - c. In practice, distributing ORE after the post-termination period should not be difficult. [This answer is incorrect. Because, after the post-termination period, ORE cannot be distributed until another amount is exhausted, pretermination earnings of terminated S corporations maybe be effectively frozen.]
 - d. Transfer ORE to paid-in capital will give corporations more flexibility to manage shareholder's equity. [This answer is incorrect. A transfer of ORE to paid-in capital may give corporations less flexibility in managing its shareholders' equity because state corporation law generally places greater restrictions on paid-in capital than on retained earnings.]
40. Which of the following financial statement elements is present for proprietorships, partnerships, and S corporations? **(Page 107, Page 122, and Page 147)**
- a. Statement of changes in proprietor's capital. [This answer is incorrect. This statement is only appropriate for a proprietorship.]
 - b. Statement of changes in partner's capital. [This answer is incorrect. This statement is only appropriate for a partnership.]
 - c. Balance sheet. [This answer is correct. Proprietorships, partnerships, and S corporations must all present a balance sheet with their financial statements. Each has its own requirements for the equity section.]**
 - d. Statement of retained earnings. [This answer is incorrect. This statement is not required by GAAP, but some practitioners use a statement of retained earnings to disclose the changes in components of retained earnings of S corporations.]

EXAMINATION FOR CPE CREDIT**Lesson 3 (CARTG092)**

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.

27. Define *S Corporation*.
- An association of two or more persons to carry on as co-owners of a business for profit.
 - An unincorporated business enterprise that is wholly owned by a single individual.
 - An election allowing certain small-business corporations and their shareholders to be taxed as a partnership.
 - A corporation in which income taxes affect both the entity and the shareholders.
28. Which of the following statements is not required by GAAP to be part of the presentation for an S corporation?
- The statement of retained earnings.
 - The balance sheet.
 - The statement of cash flows.
 - The statement of income.
29. Once an entity has changed to or from an S corporation, if one or more prior-year financial statements are presented, is retrospective application of the change required?
- Yes.
 - No.
 - Do not select this answer choice.
 - Do not select this answer choice.
30. Match the following S corporation terms with the correct definition.

<u>Terms</u>	<u>Definitions</u>
1. Accumulated Adjustments Account (AAA)	i. The accumulated taxable income not paid as cash dividends prior to March 15, 1983, but earned in Subchapter S tax years beginning prior to January 1, 1983.
2. Previously Taxed Income (PTI)	ii. The retained earnings changes that are the result when tax/book differences originate and then reverse.
3. Accumulated Earnings and Profits (AEP)	iii. The aggregate amount of undistributed income and gains taxed to shareholders after 1982.

4. Tax Temporary Adjustments (TTA)

iv. Any amount that would be considered retained earnings under GAAP and state corporation law and is included in shareholders' bases for tax purposes, but that is not included in the other four specific definitions.

5. Other Retained Earnings (ORE)

v. Retained earnings that existed when S corporation status was attained, with certain adjustments that were required by the federal tax regulations.

a. 1., ii.; 2., iii.; 3., iv.; 4., v.; 5., i.

b. 1., v.; 2., iv.; 3., i.; 4., iii.; 5., ii.

c. 1., i.; 2., v.; 3., ii.; 4., iv.; 5., iii.

d. 1., iii.; 2., i.; 3., v.; 4., ii.; 5., iv.

31. Which of the following amounts will never increase for S corporations?

a. AAA.

b. PTI.

c. AEP.

d. ORE.

32. Generally, how would an S corporation's balance sheet reflect retained earnings if separate accounts are maintained?

a. If separate accounts are maintained, they are required to be separately disclosed on the balance sheet.

b. The balance sheet usually reflects a single retained earnings account, as separate disclosure is not required.

c. Do not select this answer choice.

d. Do not select this answer choice.

33. Though state corporation laws may refer to distributions from a corporation to its shareholders as dividends, for federal tax purposes, only distributions of what type are considered dividends?

a. AAA.

b. PTI.

c. AEP.

d. TTA.

34. Alston Enterprises, a C corporation, elects S corporation status on January 1, 20X9. As of December 31, 20X8, the company had \$250,000 in its conventional corporate retained earnings account. After the S election, how will the \$250,000 be classified?
- a. All \$250,000 will become AEP.
 - b. The \$250,000 will be split between AAA and ORE based on the income summary.
 - c. All \$250,000 will be classified as dividends and become AAA.
 - d. The \$250,000 will be split equally between AEP, AAA, and ORE.
35. The Weatherford Company became an S corporation on January 1, 1983. Prior to that date, it was a Subchapter S corporation (not a C corporation). Which of the following could the Weatherford Company have on its financial statements, that a company newly formed S corporation would not?
- a. AEP.
 - b. ORE.
 - c. PTI.
 - d. AAA.
36. How do tax/book differences affect an S corporation's retained earnings accounts?
- a. Because S corporations normally do not pay federal income taxes, tax/book differences have no effect.
 - b. Such differences can affect retained earnings accounts or require additional retained earnings accounts be established.
 - c. Only tax/book differences that originated after S corporation status was elected affect retained earnings.
 - d. Do not select this answer choice.
37. Which of the following statements best describes an aspect of accounting for an S corporation's tax/book differences?
- a. PTI that exists when a Subchapter S corporation converts to S corporation status (before January 1, 1983) is frozen, and its temporary differences become TTA.
 - b. Temporary differences originating before the S conversion that reverse generate a tax liability whether or not S corporation status is maintained.
 - c. The concept of a TTA account is widely known and used by many S corporations when accounting for retained earnings.
 - d. Converting from GAAP to the tax basis of accounting when converting to S status creates many tax/book differences, requiring a TTA account.
38. When an S corporation election is terminated, which retained earnings items should be merged?
- a. AAA should be merged with AEP.
 - b. ORE should be merged with AEP.
 - c. AEP and PTI should be merged with ORE.
 - d. AAA and PTI should be merged with ORE.

39. Under federal tax rules, a terminated S corporation can transfer ORE to what?
- a. AAA.
 - b. AEP.
 - c. PTI.
 - d. Paid-in capital.
40. What is one common element shared by proprietorships, partnerships, and S corporations?
- a. Generally, taxes flow through to proprietors, partners, and shareholders.
 - b. None of them are allowed to present financial statements using an OCBOA (the cash or tax basis).
 - c. All three types of entities provide limited liability to their members/partners/shareholders.
 - d. It is recommended that all three entities present segregated retained earnings accounts.

GLOSSARY

Accumulated Adjustments Account (AAA): An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to the shareholders after 1982.

Accumulated Earnings and Profits (AEP): Retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations.

Bonus method: An accounting method used to account for changes in partnership interests. Under this method, assets contributed for an admission are valued at their fair market value at the date of contribution, but assets distributed for a withdrawal are not revalued.

C corporation: A conventional corporation organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level. Shareholders pay taxes on dividends paid out of earnings and profits of the corporation.

Goodwill method: An accounting method used to account for changes in partnership interests. Under this method, the value of the partnership as a whole is imputed based on the price of the partnership interest being sold or acquired, and assets are adjusted to reflect the imputed value.

Other Comprehensive Basis of Accounting (OCBOA): Financial records are maintained and reported according to a basis other than GAAP. A comprehensive basis of accounting other than GAAP is one of the following:

- A basis of accounting that the entity used to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (e.g., pursuant to the rules of a state insurance commission).
- A basis of accounting used to file income tax returns for the period covered by the financial statements.
- The cash receipts and disbursements basis of accounting, and modifications of the cash basis when such modifications are substantially supported, such as recording depreciation on fixed assets or accruing income taxes.
- A definite set of criteria having substantial support that is applied to all items appearing in financial statements, such as the price level basis of accounting.

Other Retained Earnings (ORE): Any amount that would be viewed as earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the specific definitions for AAA, AEP, PTI, and TTA.

Partnership: An association of two or more persons to carry on as co-owners of a business for profit.

Previously Taxed Income (PTI): The accumulated taxable income that was not paid as cash dividends prior to March 15, 1983, but was earned in Subchapter S tax years beginning prior to January 1, 1983.

Proprietorship: An unincorporated business enterprise wholly owned by one individual.

Push down method: An accounting method used to account for changes in partnership interests. This method permits a partial revaluation to the extent that the price of the acquired interest differs from the book value of the interest.

S corporation: An elective provision permitting certain small-business corporations and their shareholders to elect special income tax treatment. If the corporations meet specified requirements, under this election they will be taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns).

Tax Temporary Adjustments: A term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 3

FORECASTS, PROJECTIONS, AND SIMILAR ITEMS (CARTG093)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course will give the user basic knowledge about forecasts, projections, and similar items. Lesson 1 breaks down the authoritative literature that applies to prospective financial information, gives an overview of guidance on the subject, and discusses key factors and significant assumptions that are a part of such an engagement. Lesson 2 covers format and presentation guidelines and gives users more specific details on some types of prospective financial engagements, including plain paper engagements, assemblies, compilations, and other matters.

PUBLICATION/REVISION DATE: July 2009

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

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 **September 30, 2010**

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—An Overview of Forecasts, Projections, and Similar Engagements

Completion of this lesson will enable you to:

- Compare and contrast the various pieces of authoritative literature related to prospective financial presentations.
- Identify the various types of prospective financial presentations and when they would be appropriate.
- Summarize other basic components of prospective financial presentations, including related terms, note disclosure, and the engagement understanding.
- Identify the key factors and significant assumptions relevant to prospective financial presentations.

Lesson 2—Format and Presentation and Specific Types of Prospective Financial Presentation Engagements

Completion of this lesson will enable you to:

- Prepare prospective financial presentations that follow the correct format and presentation guidelines.
- Assess issues related to plain paper engagements, assembly engagements, and budgets.
- Summarize the fundamentals of performing a compilation engagement on prospective financial information.
- Describe agreed-upon procedures, partial presentations, and other miscellaneous matters related to forecasts, projections, and similar engagements.

TO COMPLETE THIS LEARNING PROCESS:

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

**Thomson Reuters
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CARTG093 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: An Overview of Forecasts, Projections, and Similar Engagements

INTRODUCTION

CPAs are providing more and more services that include some type of prospective (future-looking) financial information. For example, practitioners are preparing income tax projections, analyzing the possible effects of future changes in operations, helping clients develop budgets, assisting individuals with personal financial planning, and preparing prospective financial statements for submission to lending institutions such as banks and the Small Business Administration.

Learning Objectives:

Completion of this lesson will enable you to:

- Compare and contrast the various pieces of authoritative literature related to prospective financial presentations.
- Identify the various types of prospective financial presentations and when they would be appropriate.
- Summarize other basic components of prospective financial presentations, including related terms, note disclosure, and the engagement understanding.
- Identify the key factors and significant assumptions relevant to prospective financial presentations.

AUTHORITATIVE LITERATURE RELATED TO PROSPECTIVE FINANCIAL INFORMATION

Exhibit 1-1 summarizes the current AICPA technical literature that applies to accountants' services on prospective financial information as of July 2009. The next section describes the scope and authority of the documents.

Exhibit 1-1

AICPA Literature on Prospective Financial Information

Statement on Standards for Attestation Engagements No. 10 (AT 301), as amended by SSAE No. 11, *Attest Documentation*, SSAE No. 12, *Amendment to SSAE No. 10*, and SSAE No. 14, *SSAE Hierarchy* (discussed below)—establishes procedural and reporting standards for three types of engagements on prospective financial statements that are reasonably expected to be used by third parties—compilation, examination, and applying agreed-upon procedures.

SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements (AT 20)*—defines the degree of responsibility imposed on the practitioner when certain imperatives (such as *must*, *is required*, and *should*) are used in the attest standards.

SSAE No. 14, *SSAE Hierarchy (AT 50)*—identifies the body of attestation literature and clarifies the authority of attestation publications issued by the AICPA and others. It specifies the attestation publications that the practitioner must comply with and those that the practitioner should be aware of when performing an engagement. The Standard also amends the 11 attestation standards to conform them to the terms used in SSAE No. 13.

Guide for Prospective Financial Information (the AICPA guide)—establishes AICPA presentation guidelines for and provides illustrative guidance on prospective financial information (prospective financial statements and partial presentations). It incorporates SOPs 89-3, 90-1, and 92-2, SSAE No. 10, as amended, SSAE No. 13, and SSAE No. 14.

Statement of Position 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements*—provides guidance on six frequently encountered situations in which questions arise.

Statement of Position 90-1, *Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*—provides authoritative procedural and reporting guidance on internal use presentations and partial presentations.

Statement of Position 92-2, *Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements*—provides guidance on how to determine whether there is a reasonably objective basis for a forecast, the length of the forecast period, and disclosure of long-term results beyond the forecast period.

SUPERSEDED LITERATURE

Authoritative Statement, *Financial Forecasts and Projections* (the AICPA Statement or the Statement)—established procedural and reporting standards for three types of engagements on prospective financial statements that are reasonably expected to be used by third parties—compilation, examination, and applying agreed-upon procedures. The AICPA Statement was incorporated into SSAE No. 1 (AT 200).

Statement on Standards for Attestation Engagements No. 4 (SSAE No. 4, *Agreed-Upon Procedures Engagements*)—provided guidance for engagements to apply agreed-upon procedures to financial information, including prospective financial information. Appendix A of SSAE No. 4 amended the sections of the AICPA Statement that dealt with agreed-upon procedures.

Ethics Rule of Conduct 201E—prohibited vouching for the achievability of a forecast (or projection).

Ethics Interpretation 201-2—provided guidance for prospective presentations not covered by the technical literature, i.e., partial presentations and internal use presentations.

MAS Guideline No. 3—provided guidelines for preparing forecasts. The guidance in that document was expanded to include projections, and that expanded guidance was incorporated in the AICPA *Guide for Prospective Financial Statements*.

SOP 75-4—established AICPA presentation guidelines for a forecast. The guidance in that document was revised and expanded to include projections, and that expanded guidance was incorporated in the AICPA *Guide for Prospective Financial Statements*.

Guide for a Review of a Financial Forecast—established guidelines for one level of service—a review—for one type of prospective financial statement—a forecast. The AICPA *Guide for Prospective Financial Statements* renamed the service “examination” and expanded the guidance to projections.

SOP, Report on a Financial Feasibility Study—required a review report on a forecast contained in a feasibility study to be consistent with the review report established in the forecast guide. The guidance was carried forward to the AICPA *Guide for Prospective Financial Statements*.

Guide for Prospective Financial Statements—established AICPA presentation guidelines for prospective financial statements and provided illustrative guidance on the three types of services described in the AICPA Statement.

* * *

Statement on Standards for Attestation Engagements No. 10

Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification*, as amended by SSAE No. 11, *Attest Documentation*, SSAE No. 12, *Amendment of SSAE No. 10*, and SSAE No. 14, *SSAE Hierarchy*, establishes procedural and reporting standards for examination, compilation, and agreed-upon procedures engagements on prospective financial statements that are reasonably expected to be used by third parties. The attestation standards are organized into the following sections:

- AT 101, *Attest Engagements*. (This is the umbrella standard that governs all types of attestation engagements.)
- AT 201, *Agreed-Upon Procedures Engagements*.
- AT 301, *Financial Forecasts and Projections*.
- AT 401, *Reporting on Pro Forma Financial Information*.
- AT 501, *An Examination of an Entity's Internal Control over Financial Reporting That is Integrated With an Audit of Its Financial Statements*.
- AT 601, *Compliance Attestation*.
- AT 701, *Management's Discussion and Analysis*.

SSAE Nos. 11 and 12 amend SSAE No. 10 and are not separately codified in the AT sections of the authoritative standards. SSAE No. 14 is codified separately as AT 50, but Appendix A of SSAE No. 14 revises the 11 attestation

standards in SSAE No. 10. All references to SSAE No. 10 in this course are to SSAE No. 10, as amended. The codification of the attestation standards also includes AT 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*, and AT 50, *SSAE Hierarchy*.

SSAE No. 15 superseded extant SSAE No. 10 (AT 501, *Reporting on an Entity's Internal Control Over Financial Reporting*) and was effective for integrated audits for periods ending on or after December 15, 2008.

AT 101, *Attest Engagements*. AT 101 is the umbrella standard that governs all types of attestation engagements, including engagements on prospective financial statements. It contains a discussion of the general, fieldwork, and reporting standards for attest engagements as amended by SSAE No. 14. AT 101 also contains the attest documentation requirements. As discussed in the next paragraph, AT 301 contains the specific requirements for engagements related to prospective financial statements. However, accountants should comply with the requirements in AT 101 in addition to those in AT 301.

AT 301, *Financial Forecasts and Projections*. AT 301 contains specific guidance for compilation, examination, and agreed-upon procedures engagements related to forecasts and projections. The principal provisions of AT 301 establish the following:

- a. *Definitions of Forecasts and Projections.* Forecasts and projections are the two types of prospective financial statements. In essence, AT 301 defines a *forecast* as management's estimate of future results and defines a *projection* as the answer to a "what if" question.
- b. *Appropriate Uses of Prospective Financial Information.* AT 301 states that, ordinarily, only forecasts are appropriate for general use; projections and other types of prospective information, e.g., partial presentations, ordinarily are appropriate only for limited use.
- c. *Three Levels of Service Accountants May Provide on Prospective Financial Statements for Third-party Use.* AT 301 states that, whenever the prospective financial statements are for third-party use and accountants either assemble and submit the prospective financial statements or report on them, they should examine, compile, or apply agreed-upon procedures to them. AT 301 also establishes procedural and reporting standards for each type of service. (Current-year budgets presented with interim historical financial statements are exempt from those requirements.)
- d. *Instances When Accountants Should Not Provide Services on Prospective Financial Statements for Third-party Use.* AT 301 states that accountants should not provide services on prospective statements that are liable to be misleading, for example, statements that do not include the underlying assumptions or projections that will be distributed to other than limited users.

Does AT 301 Require Companies to Prepare Prospective Financial Statements? No. AT 301 does not require or recommend presentation of prospective financial statements. Companies decide whether to present such information. AT 301 establishes (a) the form of the prospective information if clients decide to present it and (b) standards for accountants who perform services on prospective financial statements that clients have decided to present.

Does AT 301 Apply to Litigation Support Services? Generally, AT 301 does not apply to litigation support services, which are defined as "engagements involving pending or potential formal legal proceedings before a trier of fact in connection with the resolution of a dispute between two or more parties, for example, when a practitioner acts as an expert witness." (AT 301.05) According to AT 301, that exception is provided because "among other things, the practitioner's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute." AT 301 does apply, however, when (a) accountants are specifically engaged to issue or do issue a compilation, agreed-upon procedures, or examination report on prospective financial statements or (b) prospective financial statements are used by third parties who are not able to analyze and challenge accountants' work, for instance, creditors who are presented with prospective financial statements to secure their agreement to a plan of reorganization.

AT 201, *Agreed-Upon Procedures Engagements*. AT 201 contains specific guidance for practitioners performing agreed-upon procedures engagements. For agreed-upon procedures engagements related to forecasts and projections, practitioners will need to follow the guidance in both AT 201 and AT 301.

AT 401, Reporting on Pro Forma Financial Statements. AT 401 provides performance and reporting guidance to practitioners who are engaged to issue or do issue an examination or review report on pro forma financial information.

SSAE No. 13, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AT 20). This standard clarifies the meaning of certain terms used in SSAEs and defines the terminology that the ASB will use to describe the degrees of responsibility that the professional requirements impose on practitioners.

This standard defines the degree of responsibility imposed on the practitioner when certain imperatives (such as *must*, *is required*, and *should*) are used in the attestation standards. (The contents of the SSAEs contain professional requirements along with explanatory material.) The practitioner's degree of responsibility in complying with professional requirements can be identified through two categories:

- **Unconditional requirements.** Unconditional requirements are those that a practitioner must follow in all cases if the circumstances apply to the requirement. These requirements use the words *must* or *is required*.
- **Presumptively mandatory requirements.** Practitioners 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 practitioner 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 a SSAE uses the words *should consider* for a procedure, the consideration of the procedure is presumptively required.

Explanatory material represents material that provides additional guidance on professional requirements or identifies other procedures or actions. A practitioner is not required to perform other procedures or actions that are identified through explanatory material. These items require the practitioner's understanding and professional judgment regarding their applicability. Explanatory material is identified through the words *may*, *might*, and *could*.

SSAE No. 14, SSAE Hierarchy (AT 50). SSAE No. 14, *SSAE Hierarchy*, identifies the body of attestation literature and clarifies the authority of attestation publications issued by the AICPA and others. It specifies the attestation publications that the practitioner must comply with and those that the practitioner should be aware of when performing an attestation engagement.

SSAE No. 14 establishes three levels in the SSAE hierarchy:

- a. **Attestation Standards.** Attestation standards consist of the 11 general, field work, and reporting standards and Statements on Standards for Attestation Engagements (SSAEs) issued by the AICPA's Auditing Standards Board (ASB). SSAEs are codified within the framework of the eleven standards. The AICPA Code of Professional Conduct requires members to comply with SSAEs. SSAE No. 14 also states that when a practitioner departs from a presumptively mandatory requirement, the practitioner must document the justification for the departure and how alternative procedures that were performed achieved the objectives of the requirement.
- b. **Attestation Interpretations.** Attestation interpretations are not attestation standards, but rather recommendations on applying the SSAEs. Attestation interpretations include Interpretations of the SSAEs, appendixes to the SSAEs, and attestation guidance in AICPA Audit and Accounting Guides and AICPA attestation Statements of Position. SSAE No. 14 states that practitioners should be aware of and consider applicable attestation interpretations. If the practitioner does not apply an attestation interpretation, the practitioner should be prepared to explain how he or she complied with the underlying SSAE provisions.
- c. **Other Attestation Publications.** Other attestation publications have no authoritative status but may help practitioners understand and apply the SSAEs. Other attestation publications include AICPA attestation publications not referred to in items a and b; attestation articles in the *Journal of Accountancy*, other professional journals and the AICPA *CPA Letter*; continuing professional education programs and other instructional materials, textbooks, guide books, attest programs and checklists; and attestation literature published by state CPA societies, other organizations, and individuals. If practitioners apply the guidance in other attestation publications, they should satisfy themselves that the guidance is both relevant and

appropriate. Relevance refers to whether the guidance is applicable to the circumstances of a particular engagement. Indicators of appropriateness include the extent to which the publication is recognized as being helpful and the professional qualifications of its author or issuer relating to attestation matters. There is a presumption that other attestation publications reviewed by the AICPA Audit and Attest Standards staff are appropriate.

SSAE No. 14 also amends the 11 attestation standards to conform them to the terms used in SSAE No. 13. Under SSAE No. 14, all 11 attestation standards use the word *must* and are therefore unconditional requirements. Those standards, as amended, are as follows:

General Standards

- a. The practitioner must have adequate technical training and proficiency to perform the attestation engagement.
- b. The practitioner must have adequate knowledge of the subject matter.
- c. The practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.
- d. The practitioner must maintain independence in mental attitude in all matters relating to the engagement.
- e. The practitioner must exercise due professional care in the planning and performance of the engagement and the preparation of the report.

Standards of Fieldwork

- f. The practitioner must adequately plan the work and must properly supervise any assistants.
- g. The practitioner must obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report.

Standards of Reporting

- h. The practitioner must identify the subject matter or the assertion being reported on and state the character of the engagement in the report.
- i. The practitioner must state the practitioner's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated in the report.
- j. The practitioner must state all of the practitioner's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report.
- k. The practitioner must state in the report that the report is intended solely for the information and use of the specified parties under the following circumstances:
 - When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.
 - When the criteria used to evaluate the subject matter are available only to specified parties.
 - When reporting on subject matter and a written assertion has not been provided by the responsible party.
 - When the report is on an attestation engagement to apply agreed-upon procedures to the subject matter.

The reporting standards apply only when the practitioner issues a report.

AICPA Guide for Prospective Financial Information

The AICPA *Guide for Prospective Financial Information* (the AICPA guide or guide) incorporates and supplements the guidance in SSAE No. 10 (AT 301). The guide—

- a. *Provides Guidance on Preparing Prospective Financial Statements.* It provides suggestions for improving effectiveness when preparing prospective financial statements. The AICPA guide does not require either accountants or clients to follow the suggestions.
- b. *Establishes Presentation Guidelines.* The AICPA guide establishes the equivalent of GAAP for prospective financial statements. Since the FASB has not expressed any intention of dealing with prospective financial statements, the accounting and disclosure guidance in the AICPA guide is the highest level of guidance that is expected to be issued.
- c. *Provides Illustrative Material for the Matters Covered in AT 301.* The guide provides additional illustrative material on topics contained in AT 301. It also discusses some areas not covered by AT 301 (for example, internal use only presentations).
- d. *Provides Additional Guidance on Partial Presentations.* The guide describes how the preparation and presentation guidelines for prospective financial statements apply to the unique aspects of partial presentations.

SOP 89-3, Questions Concerning Accountants' Services on Prospective Financial Statements

SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements*, addresses six common practice problems. Specifically, the SOP covers the following:

- *The Periods Covered by the Accountants' Report.* The SOP states that when more than one period is presented (such as columns for monthly or annual results), the accountants' report should apply to each of the periods presented.
- *Information Accompanying a Financial Forecast in an Accountant-submitted Document.* The SOP discusses how accountants should report on other information, such as details of forecasted information, that accompanies the prospective financial statements in an *accountant-submitted* document.
- *Forecasts That Include a Projected Sale of the Entity's Real Estate Investment.* The document discusses how accountants report on projected information accompanying a forecast. The form of report depends on how the projected information is presented (for example, as a separate statement or as a note to the forecast).
- *Financial Projections Included in General Use Documents.* The SOP emphasizes that accountants cannot submit projections that will be used in general use documents to their clients (unless they supplement forecasts for the same period), even if the clients agree not to refer to the accountants in the documents.
- *Sales Prices Assumed in a Projection of the Sale of an Entity's Real Estate Investment.* The document indicates that, when a hypothetical sale of real estate is shown as additional information supplementing a forecast, the sales price hypothesized should be consistent with the purpose of the presentation and, accordingly, should be consistent with the assumptions used in the forecast and with the entity's and the industry's experience.
- *Support for Tax Assumptions.* The SOP discusses what procedures accountants should apply when they receive tax opinions from other professionals.

SOP 89-3 has been incorporated into the AICPA guide.

SOP 90-1, Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations

SOP 90-1, *Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*, provides authoritative guidance in two areas: (a) prospective financial statements for internal use only and (b) partial presentations.

The section of the SOP on internal use presentations has been incorporated into Chapter 22 of the AICPA guide and provides accountants with authoritative procedural and reporting guidance for prospective presentations intended for internal use. The SOP states that accountants who compile, examine, or apply agreed-upon procedures to internal use forecasts or projections should comply with the AICPA standards for those services and provides guidance for other services that they may render on those presentations.

The guidance on partial presentations has been incorporated into AT 301 and Chapter 23 of the AICPA guide. They provide authoritative procedural and reporting guidance to accountants who are engaged to compile, examine, or apply agreed-upon procedures to those presentations.

SOP 92-2, Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements

Statement of Position 92-2, which has been incorporated into the AICPA guide,—

- a. Clarifies the requirement that a responsible party have a reasonably objective basis to present a financial forecast by defining the concept.
- b. Provides guidance for accountants when considering whether a responsible party has a reasonably objective basis to present a forecast.
- c. Provides guidance for accountants when evaluating the length of the forecast period. It also encourages the presentation of financial forecasts that do not exceed three to five years except under specific conditions.
- d. Provides examples of how responsible parties might disclose in the forecast the effects of events and circumstances expected to occur beyond the forecast period. It also provides guidance to accountants who are engaged to compile or examine a forecast that includes such disclosures.

SELF-STUDY QUIZ

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

1. The AICPA has released many pieces of technical literature that apply to services accountants provide on prospective financial information. Which of these is an example of current AICPA literature on the subject?
 - a. Ethics Rule of Conduct 201E.
 - b. *Guide for a Review of a Financial Forecast*.
 - c. Statement on Standards for Attestation Engagements (SSAE) No. 4.
 - d. *Guide for Prospective Financial Information*.
2. According to AT 301 of SSAE No. 10, what is the definition of a *forecast*?
 - a. The answer to a what if question.
 - b. Management's estimate of future results.
3. What are the three levels of SSAE hierarchy described in SSAE No. 14?
 - a. Attestation standards, attestation interpretations, and other attestation publications.
 - b. Unconditional requirements, presumptively mandatory requirements, and explanatory material.
 - c. General standards, standards of fieldwork, and standards of reporting.
 - d. Guidance on prospective financial statement preparation, presentation guidelines, and illustrative material.

SELF-STUDY ANSWERS

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

1. The AICPA has released many pieces of technical literature that apply to services accountants provide on prospective financial information. Which of these is an example of current AICPA literature on the subject? **(Page 187)**
 - a. Ethics Rule of Conduct 201E. [This answer is incorrect. This piece of literature has been superseded. Before being superseded, it prohibited vouching for the achievability of a forecast (or projection).]
 - b. *Guide for a Review of a Financial Forecast*. [This answer is incorrect. This piece of literature established guidelines for one level of service—a review—for one type of prospective financial statement—a forecast; however, it has now been superseded.]
 - c. Statement on Standards for Attestation Engagements (SSAE) No. 4. [This answer is incorrect. Other SSAEs are currently effective for prospective financial engagements, but this one has been superseded. Before being superseded, this SSAE provided guidance for engagements to apply agreed-upon procedures to financial information, including prospective financial information.]
 - d. ***Guide for Prospective Financial Information*. [This answer is correct. The *Guide for Prospective Financial Information* (the AICPA guide) is current literature that affects prospective financial information. It establishes AICPA presentation guidelines for and provides illustrative guidance on prospective financial information.]**
2. According to AT 301 of SSAE No. 10, what is the definition of a *forecast*? **(Page 189)**
 - a. The answer to a what if question. [This answer is incorrect. This is the definition of a *projection*, as described in AT 301.]
 - b. **Management's estimate of future results. [This answer is correct. AT 301 does define a forecast in this way. Other guidance found in AT 301 includes appropriate uses of financial information, levels of service accountants may provide on prospective financial statements for third-party use, and instances when accountants should not provide services on prospective financial statements for third-party use.]**
3. What are the three levels of SSAE hierarchy described in SSAE No. 14? **(Page 190)**
 - a. **Attestation standards, attestation interpretations, and other attestation publications. [This answer is correct. The attestation standards consist of 11 general, field work, and reporting standards and SSAEs issued by the AICPA's Auditing Standards Board (ASB). Attestation interpretations are not attestation standards, but rather recommendations on applying the SSAEs. Other attestation publications have no authoritative status, but may help practitioners understand and apply the SSAEs.]**
 - b. Unconditional requirements, presumptively mandatory requirements, and explanatory material. [This answer is incorrect. The method for identifying where guidance in the SSAEs falls in this hierarchy is found in SSAE No. 13, not SSAE No. 14. Unconditional requirements must be followed in all cases. Presumptively mandatory requirements should be complied with if the circumstances apply, but departures are allowed in rare cases. Explanatory material provides additional guidance, but practitioners are not required to comply with such suggested procedures.]
 - c. General standards, standards of fieldwork, and standards of reporting. [This answer is incorrect. These are the three categories of the 11 attestation standards, as amended by SSAE No. 14. The standards that are grouped in these three categories are all unconditional requirements that must be followed, so the descriptions are not a hierarchy.]
 - d. Guidance on prospective financial statement preparation, presentation guidelines, and illustrative material. [This answer is incorrect. This list covers some of the guidance that is included in the AICPA *Guide for Prospective Financial Information*. These things are not part of SSAE No. 14.]

OVERVIEW OF GUIDANCE ON PROSPECTIVE FINANCIAL INFORMATION

There is no easy way to master the literature on prospective financial information because it is complex and voluminous. (Some may even view the guidance as overwhelming.) There is comprehensive guidance on most facets of an engagement: (a) procedures, (b) presentation and disclosure, and (c) reporting. To avoid getting bogged down immediately with the detailed requirements of each stage of an engagement, it is helpful to start with a general overview of the guidance. More detailed discussions of the various elements are included in Lesson 2.

What Are the Various Engagements?

Based on the AICPA's *Guide for Prospective Financial Information* (the AICPA guide), there are two broad categories of prospective financial information engagements—internal use and third-party use. Within these broad categories, accountants ordinarily provide several levels of service. The services listed here apply to complete presentations. Services for partial presentations are discussed in Lesson 2.

The types of services are as follows:

- a. Internal Use.
 - (1) Assembly without a report or written communication (plain paper).
 - (2) Assembly with a written communication.
 - (3) Assembly with a report (assembly engagement).
- b. Third-party Use.
 - (1) Special disclaimer on current-year budgets presented with interim historical financial statements.
 - (2) Compilation [not a SSARS No. 1 (AR 100) compilation].
 - (3) Agreed-upon procedures.
 - (4) Examination.

Although technically not a type of service, Treasury Department Circular 230 engagements are unique from other typical third party engagements.

Internal Use Engagements. An accountant may provide a variety of services in connection with prospective financial statements for internal use only, including compilation, agreed-upon procedures, and examination. However, the most common level of service is believed to be an assembly. An assembly is the performance of mathematical or other clerical functions related to the presentation of prospective financial information. It does not include consideration of whether, in the accountant's judgment, the underlying assumptions are appropriate. For example, if an accountant's services are limited to entering client data, assumptions, or hypothetical data in a computer spreadsheet application, he has performed an assembly.

In practice, the procedures performed in an internal use engagement may be narrower or broader than those commonly performed in an assembly, depending on the circumstances. Nevertheless, professional literature does not distinguish the types of internal use services by the level of service but rather by whether the accountant reports on the service performed.

Plain Paper. If the accountant is not associated with the presentation, he is not required to report and may provide *plain paper services*. To be defined as a plain paper engagement, it is believed that all of the following conditions must be met. The prospective financial information—

- a. Is not accompanied by an accountant's report or transmittal letter.

- b. Is typed or printed on plain paper, that is, paper that does not contain the accountant's or his firm's name, watermark, or logo.
- c. Is not presented in the accountant's report cover.
- d. Does not refer to the accountant in the presentation.
- e. Is not shown alongside or bound with historical financial statements that are audited, reviewed, or compiled by the accountant.

Written Communication. Certain rules apply when the prospective financial statements are accompanied by a written communication (for example, a transmittal letter). The accountant is associated with the presentation and should communicate, in writing, that (a) the prospective results may not be achieved, and (b) the prospective financial statements are for internal use only. Alternatively, the accountant can issue an assembly report on the presentation.

Assembly Report. Although accountants are not required to report on assembly services, the client may request such a report. The accountant may also be required to report on assembly services if he is in some way associated with the presentation. In this course, the terms *assembly engagement* and *assembly services* are used when discussing assembly engagements in which a report will be issued. The AICPA guide allows flexibility in reporting on assembly services, but it provides guidance on what would preferably be included in such a report.

Third-party Use Engagements. If prospective financial statements are to be used by third parties, the accountant should compile, examine, or apply agreed-upon procedures to the presentation unless the guidance in the next paragraph applies. If the prospective presentation is considered a partial presentation, the accountant also may perform a plain paper service, attach a transmittal letter, or assemble and report on the presentation, as discussed above. There are certain limitations on third party use of partial presentations.

Special Disclaimer on Budgets. When a prospective financial presentation is intended for third parties, the AICPA guide states that the accountant should either compile, apply agreed-upon procedures to, or examine the presentation. However, the AICPA guide provides a special exception for certain interim presentations intended for third party use. If a prospective financial presentation (a) is labeled as a "budget" and does not extend beyond the current fiscal year end, and (b) is presented with interim historical financial statements, the accountant is not required to apply any procedures to it. However, the accountant should issue a report indicating that he or she—

- a. Did not examine or compile the budget.
- b. Disclaims an opinion or any other form of assurance on the budget.

Compilation Engagements. Compilation engagements [not to be confused with a SSARS No. 1 (AR 100) compilation] are generally recognized as the lowest level of service an accountant can perform on a prospective financial presentation intended for third party use. A compilation engagement involves the following: (a) assembling the prospective financial presentation to the extent necessary, (b) reading the prospective presentation for conformity with the AICPA presentation guidelines and for consideration of whether they appear to be obviously inappropriate, and (c) issuing a compilation report. A compilation report disclaims an opinion or any assurance on the prospective financial presentation and its assumptions.

Agreed-upon Procedures Engagements. An agreed-upon procedures engagement is generally an engagement that involves (a) applying to prospective financial presentations procedures that have been agreed upon by specified parties, e.g., a specific bank and the client, and (b) issuing a report that enumerates the procedures performed, states the accountant's findings, and restricts use of the report to the parties that have established the procedures. The accountant's engagement to apply agreed-upon procedures can be very limited or quite extensive. For example, the accountant could agree to assemble the presentation, read it for compliance as to format with the AICPA presentation guidelines, and test it for mathematical accuracy. The AICPA guide provides, however, that merely reading the presentation is an insufficient procedure.

Examination Engagements. Generally, an examination engagement involves (a) evaluating the preparation, the support underlying the assumptions, and the presentation of the prospective financial statements for conformity with AICPA presentation guidelines, and (b) issuing an examination report. The examination report expresses a positive opinion on whether the assumptions provide a reasonable basis for the prospective financial statements and whether the prospective presentations conform with the AICPA presentation guidelines. Requests by clients of nonpublic companies to examine prospective presentations are extremely rare. The discussion of positive opinions, i.e., the highest assurance level, is beyond the scope of this course.

Circular 230 Engagements. Treasury Department Circular 230 establishes regulations for providing opinions used in the promotion of tax shelter offerings and applies to CPAs, lawyers, and other professionals who practice before the IRS. Circular 230 applies to a CPA whose report on prospective financial statements appears in an offering document.

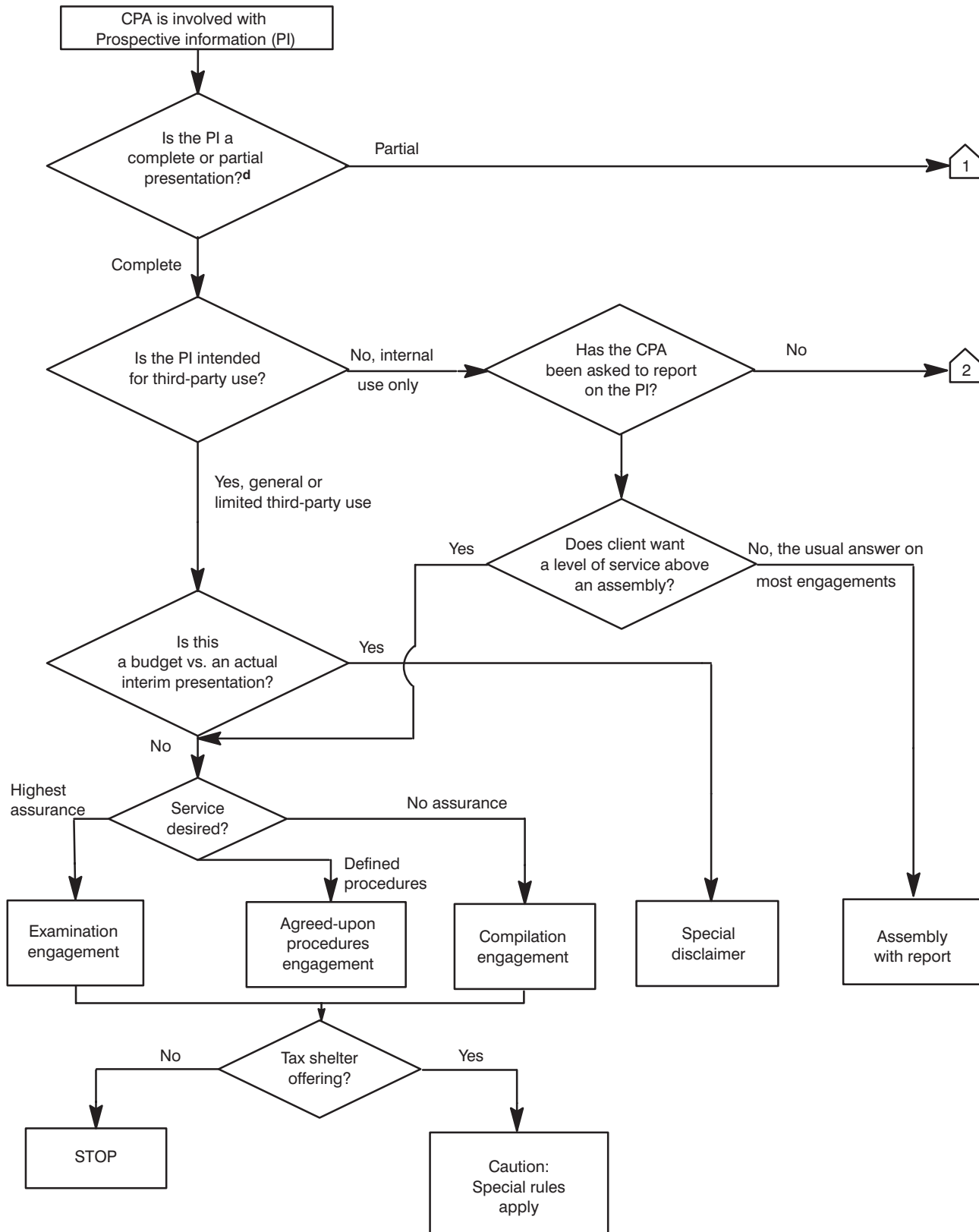
Which Engagement Is Appropriate for Your Client?

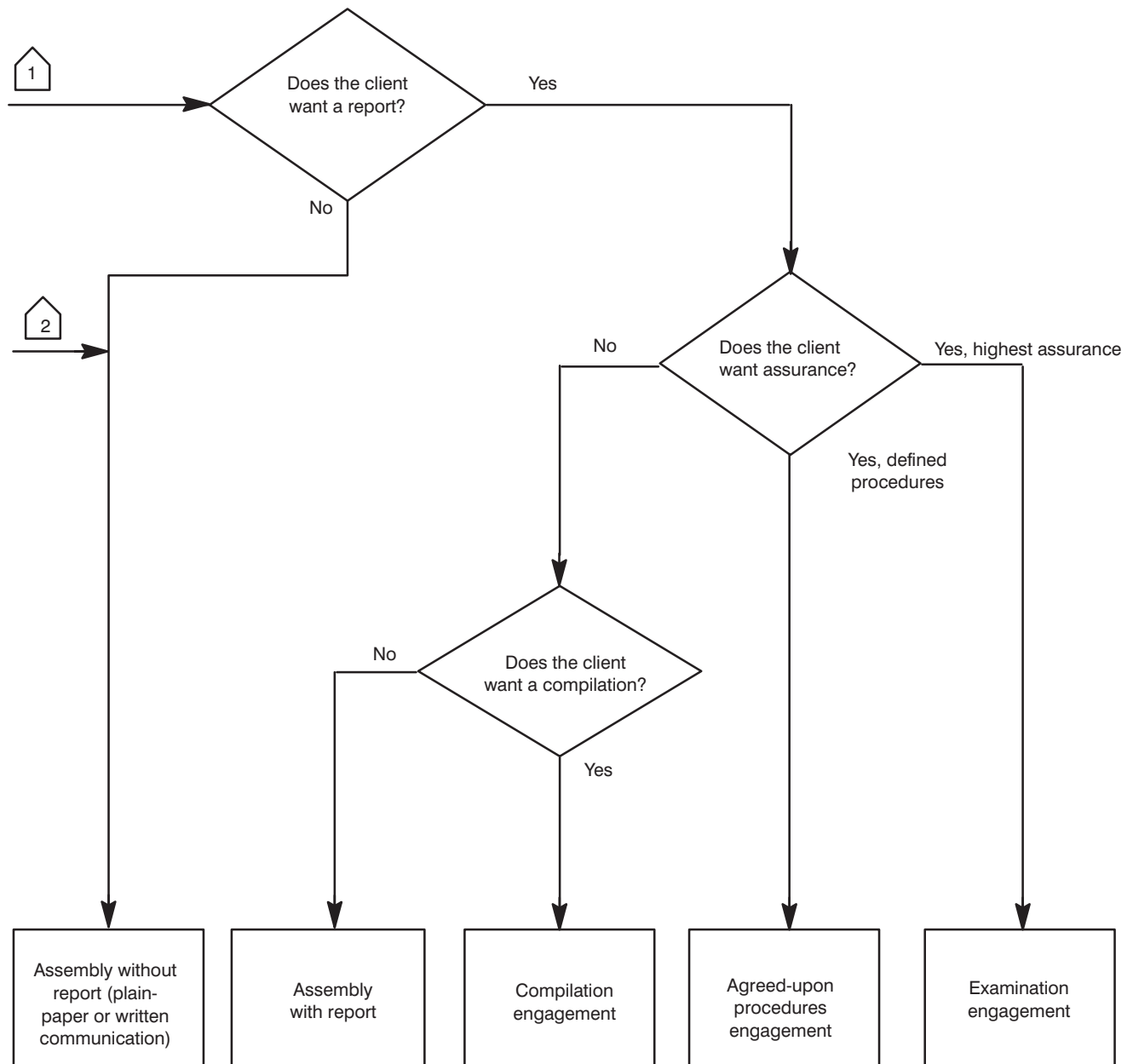
Who Is Likely to Use the Presentation? The most important consideration in selecting the type of service is whether the presentation is intended for third-party use. The answer to this question determines what authoritative literature applies and, in turn, what performance and reporting standards apply to the engagement. If the prospective presentation *is intended for third-party use*, the presentation should be compiled, examined, or subjected to agreed-upon procedures. If the prospective presentation is not intended for third-party use, less restrictive standards apply. In that instance, it is believed that the accountants will most often provide assembly services.

Is It a Complete or Partial Presentation? The accountant should also consider whether a complete or a partial presentation is appropriate for the client. Complete presentations are appropriate for general distribution while partial presentations are not. However, partial presentations are useful in situations such as tax planning or determining whether to buy or lease a particular asset. Because the performance and reporting requirements are less extensive, the accountant should consider the intended use of the presentation to determine if a partial presentation would be appropriate.

The AICPA guide permits an accountant to provide plain paper services in connection with partial presentations of prospective financial information. That is, it does not require specific procedures to be performed or a report to be issued when an accountant assembles or submits a partial presentation. Accountants may compile, examine, or apply agreed-upon procedures to a partial presentation but are not required to unless specifically engaged to provide those services. In that case, they should follow the procedural and reporting requirements set forth in SSAE No. 10 (AT 301), as amended. It is recommended that accountants compile, at a minimum, partial presentations reasonably expected to be used by third parties.

Flowchart to Selecting the Engagement. The flowchart in Exhibit 1-2 shows how the intended use of prospective presentations affects the services accountants can provide. The guidance in this flowchart is believed to apply, regardless of the format of the presentation (complete or partial presentation) or the type of presentation (forecast or projection).

Exhibit 1-2**Determining the Level of Service^{a, b, c}**

**Notes:**

- ^a The authors encourage use of the flowchart for *in-house training* and request that the participants be told it was taken from *PPC's Guide to Compilation and Review Engagements*. Permission must be obtained from Thomson Reuters for any other publication of this illustration.
- ^b Practitioners must be independent to perform examination and agreed-upon procedures engagements, and must disclose any lack of independence in reports for compilation engagements. (Any lack of independence should preferably be disclosed in internal use assembly reports.)
- ^c If the presentation of prospective information is accompanied by the accountants' written communication, a caveat about achievability and a use restriction should be included in the written communication or in the presentation.
- ^d A presentation of prospective information is complete if it presents certain minimum items.

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SELF-STUDY QUIZ

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

4. Jane, a CPA, performs a prospective financial services engagement for her client. During the engagement, her services are limited to entering assumptions, client data, and hypothetical data into a computer spreadsheet application. What type of engagement is this?
 - a. A compilation.
 - b. An assembly.
 - c. An assembly report.
 - d. A Circular 230 engagement.
5. An accountant engaged to perform an examination engagement must issue an examination report. What else must an accountant in this situation do?
 - a. Apply prospective financial presentations procedures that were agreed upon by specified parties.
 - b. Issue a report enumerating procedures performed, stating the accountant's findings, and restricting use of the report to the parties that established the procedures performed.
 - c. Evaluate the preparation, support underlying the assumptions, and presentation of prospective financial statements for conformity with AICPA presentation guidelines.
 - d. Read the prospective presentation for conformity with AICPA presentation guidelines, as well as for consideration whether they appear to be obviously inappropriate.
6. Kim is engaged to perform a prospective financial information engagement. Her client wants a complete presentation format and the information is intended for general third-party use. The engagement is not a budget, and the client wants to define the procedures Kim performs. Using the decision-making process depicted in the flowchart at Exhibit 1-2, what level of service is appropriate for Kim's client?
 - a. Compilation engagement.
 - b. Examination engagement.
 - c. Assembly with report.
 - d. Agreed-upon procedures engagement.

SELF-STUDY ANSWERS

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

4. Jane, a CPA, performs a prospective financial services engagement for her client. During the engagement, her services are limited to entering assumptions, client data, and hypothetical data into a computer spreadsheet application. What type of engagement is this? **(Page 197)**
 - a. A compilation. [This answer is incorrect. The type of services listed in the scenario above do not describe a compilation. A compilation would include the following: (1) assembling the prospective financial presentation to the extent necessary, (2) reading the prospective presentation for conformity with the AICPA presentation guidelines and for consideration of whether they appear to be obviously inappropriate, and (3) issuing a compilation report.]
 - b. An assembly. [This answer is correct. This type of assembly engagement would be an internal use engagement. This is believed to be the most common type of internal use engagements. An assembly is the performance of mathematical or other clerical functions related to the presentation of prospective financial information.]**
 - c. An assembly report. [This answer is incorrect. Jane is not required to report on the services listed in the scenario above, so this would not be an assembly report engagement.]
 - d. A Circular 230 engagement. [This answer is incorrect. This is a special type of engagement performed by CPAs whose reports on prospective financial statements appear in an offering document. Treasury Department Circular 230 establishes regulations for providing opinions used in the promotion of tax shelter offerings, and it applies to CPAs, lawyers, and other professionals who practice before the IRS. This type of engagement does not include the services Jane performed in the scenario above.]
5. An accountant engaged to perform an examination engagement must issue an examination report. What else must an accountant in this situation do? **(Page 199)**
 - a. Apply prospective financial presentations procedures that were agreed upon by specified parties. [This answer is incorrect. An accountant would do this as part of an agreed-upon procedures engagement.]
 - b. Issue a report enumerating procedures performed, stating the accountant's findings, and restricting use of the report to the parties that established the procedures performed. [This answer is incorrect. This would be done by an accountant engaged to perform an agreed-upon procedures engagement.]
 - c. Evaluate the preparation, support underlying the assumptions, and presentation of prospective financial statements for conformity with AICPA presentation guidelines. [This answer is correct. An accountant engaged to perform an examination would perform these tasks. The examination report issued by the accountant expresses a positive opinion on whether the assumptions provide a reasonable basis for the prospective financial statements and whether the prospective presentations conform with the AICPA presentation guidelines.]**
 - d. Read the prospective presentation for conformity with AICPA presentation guidelines, as well as for consideration whether they appear to be obviously inappropriate. [This answer is incorrect. This describes one of the responsibilities of an accountant performing a compilation engagement. Another responsibility of an accountant for this type of engagement is to issue a compilation report.]

6. Kim is engaged to perform a prospective financial information engagement. Her client wants a complete presentation format and the information is intended for general third-party use. The engagement is not a budget, and the client wants to define the procedures Kim performs. Using the decision-making process depicted in the flowchart at Exhibit 1-2, what level of service is appropriate for Kim's client? **(Page 200)**
- a. Compilation engagement. [This answer is incorrect. In this scenario, Kim would perform a compilation engagement if her client wanted no assurance and didn't want to define the procedures.]
 - b. Examination engagement. [This answer is incorrect. Kim would perform an examination engagement in this scenario if, instead of defining her procedures, the client wanted the highest level of assurance. However, it is not typical for a client to request this high level of assurance in most prospective financial information engagements.]
 - c. Assembly with report. [This answer is incorrect. This type of report would be appropriate for an internal use only engagement, not for an engagement in which the prospective financial information is intended for third-party use. If Kim were performing the engagement for internal use only and her client wanted a report but did not want a level of service above an assembly, she would perform an assembly with report.]
 - d. **Agreed-upon procedures engagement. [This answer is correct. If Kim's client wants to define the procedures that Kim performs, it will be an agreed-upon procedures engagement. An agreed-upon procedures engagement can be appropriate for both a complete or a partial presentation format.]**

Definitions and Their Impact on Your Engagement

The term *prospective financial information* is a broad concept that includes all future-oriented financial information with which an accountant might be associated. The AICPA guide narrowed that concept by discussing (a) two basic formats of prospective presentations, and (b) two basic types of prospective presentations. As discussed earlier, it is also important to consider the intended use of the prospective information.

Presentation Formats—Complete or Partial. All prospective financial presentations can be categorized in one of the following two ways:

- a. *Complete presentations* consist of at least the minimum items presented as follows (to the extent that they exist for a particular entity). A complete presentation can take any form. It may be a complete set of prospective financial statements, i.e., balance sheet, statement of income and retained earnings, and statement of cash flows, or it may be a summarized presentation that contains only the minimum items.

- (1) Minimum Financial Statement Elements.

- (a) Sales or gross revenues.
- (b) Gross profit or cost of sales.
- (c) Unusual or infrequently occurring items.
- (d) Provision for income taxes.
- (e) Income from continuing operations.
- (f) Discontinued operations or extraordinary items.
- (g) Net income.
- (h) Basic and diluted earnings per share (not required for nonpublic companies).
- (i) Significant changes in financial position.

- (2) Required Disclosures.

- (a) A description of what the responsible party intends the presentation to present, a statement that the assumptions are based on the responsible party's judgment at the time the information was prepared, and a caveat that results may not be achieved.
- (b) Summary of significant assumptions.
- (c) Summary of significant accounting policies.

- b. *Partial presentations* omit one or more of the minimum items in a.(1). Partial presentations ordinarily are not appropriate for general use; thus, they should be restricted for use by the specified parties who are negotiating directly with the responsible party. An example of a partial presentation would be a sales forecast.

All presentations (complete or partial) should include the required disclosures listed in a.(2). However, item a.(2)(c) can be omitted if the report is modified appropriately. Omitting the required *disclosures* does not result in a partial presentation but is a presentation deficiency that requires either withdrawal or a report modification.

Types of Prospective Information—Forecasts or Projections. Prospective financial information can be classified as a financial forecast or financial projection. The standard carves out a third type of prospective information—a financial analysis. In a financial analysis, the accountant, not management, assumes responsibility for the estimates

(numbers and assumptions). The accountant's involvement with a financial analysis is different from an accountant's involvement with a forecast or projection. In the typical engagement, the client looks to the accountant to lead the way in recommending (or identifying) assumptions and numbers. However, at the end of the engagement, the client embraces these assumptions and numbers as being based on *his* (the client's) set of financial facts. In a financial analysis, the accountant also leads the way in preparing the presentation; however, the assumptions and numbers are based on the accountant's set of facts (usually a data base created for a particular industry like restaurants, hospitals, or hotels), and the client does not take responsibility for the assumptions. Since financial analysis engagements are normally performed by only a few large CPA firms having their own industry data base, they are not discussed in this course.

Financial Forecast. The AICPA guide, paragraph 3.04, defines *financial forecast* as follows:

Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single-point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumption to actually fall. If a forecast contains a range, the range is not selected in a biased or misleading manner (for example, a range in which one end is significantly less expected than the other).

As used in the definition, *entity* means any unit, existing or to be formed, for which financial statements could be prepared in accordance with GAAP or an OCBOA. For example, an entity can be an individual, a proprietorship, a partnership, a corporation, a trust, an estate, an association, or a governmental unit.

Responsible party in the definition refers to the person or persons who are responsible for the assumptions underlying the prospective financial information. The responsible party usually is the client or management, but it can be persons outside the entity who currently do not have the authority to direct operations (for example, a person considering acquiring the entity).

Financial Projection. The AICPA guide, paragraph 3.05, defines *financial projection* as follows:

Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question that begins for instance, "What would happen if . . . ?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range.

The term *hypothetical assumption* is defined in the AICPA guide, paragraph 3.08, as "an assumption used in a financial projection or in a partial presentation of projected information to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the presentation."

Forecast versus Projection. The difference between a forecast and a projection is that in a forecast, all the assumptions are expected to occur, whereas in a projection at least one assumption is not necessarily expected to occur and may be improbable. In other words, a forecast presents management's expectations; a projection presents management's expectations based on a what if situation. Note, however, that the other assumptions in a projection are expected to occur if the hypothetical assumption occurs.

General Use, Limited Use, and Internal Use. The AICPA guide refers to three different uses of prospective financial information: general use, limited use, and internal use only. *General use* refers to use of the prospective financial information by persons who are unable to *negotiate directly* with the responsible party (i.e., they are unable to question the responsible party about the presentation or negotiate the terms and structure of a transaction with the responsible party). For example, this may occur in public offerings of an entity's securities where

potential investors are unable to ask about the prospective financial statements included in the offering document. Because a financial forecast presents the responsible party's best estimate of the entity's expected financial position, results of operations, and cash flows, it is the only type of prospective presentation that is considered appropriate for general use.

Limited use presentations are those used only by the responsible party alone or by persons *negotiating directly* with the responsible party. This means that third parties are able to ask questions of and negotiate the terms and structure of a transaction with the responsible party. Note that the users should be able to *negotiate* as well as ask questions. Also, if even just one user is a passive user who cannot question and negotiate with the responsible party, the use is not a limited use. Examples of limited use situations include use of prospective financial information in a document submitted to a regulatory agency or in a document used to negotiate a bank loan. All forms of prospective financial presentations, including financial forecasts, projections, and partial presentations, are appropriate in limited use situations.

Finally, sole use of prospective financial information by the responsible party and others within the entity is considered *internal use*. When determining whether the presentation is intended solely for internal use, the accountant should consider whether the responsible party's interests are consistent with that of the other users. For example, if the users are employees of the entity, the presentation would be considered internal use. However, if the responsible party is a nonowner manager and the user is an absentee owner, their interests might be incompatible. The accountant may rely on management's representations about the intended use of the presentation unless information comes to his attention that causes him to believe the presentation is likely to be distributed to third parties. All types of prospective financial information are appropriate for internal use only.

Other Terms Used to Describe Prospective Information. Before leaving the discussion about types of prospective information, it is helpful to briefly define other terms used to describe prospective information because these terms are often used incorrectly.

- a. *Feasibility Study.* This is an analysis of a proposed investment or course of action. A feasibility study may involve the preparation of a financial projection or a financial forecast. A financial forecast may, in turn, be based on the results of a feasibility study used in the formulation of management's plans. Feasibility studies are frequently seen in filings by hospitals in connection with proposed bond issues for capital improvements.
- b. *Budgets.* Budgets, plans, goals, and similar presentations also involve elements of predicting the future. However, they may have elements of targets, motivational goals, or hurdles that distinguish them from a forecast, although in some situations, they may be identical. If budgets, plans, or goals do not fit the definition of a forecast, they are projections, i.e., a description of what the results would be if the goals or motivational hurdles are attained. An expired budget, e.g., a year-to-date budget, is not a prospective presentation because it is no longer forward-looking. If it accompanies a year-to-date historical financial statement, it should be treated as historical, supplementary information.
- c. *Pro Forma Presentations.* This is a historical financial statement that has been recast to show the effect of a transaction that had not been consummated during the period covered by the statement. Although such future or hypothetical transactions may appear prospective in nature, pro forma presentations are essentially historical financial statements. Accordingly, the guidance in this course on prospective financial information should not be applied to pro formas. Pro formas that recast prior statements to reflect proposed business changes, e.g., new financing or new ownership, are frequently used in conjunction with projections or forecasts to support the proposed business change.

Note Disclosure Requirements

Another confusing element of the AICPA literature is determining what type of note disclosures should accompany prospective information. Basically, there are three types of note disclosure information.

- a. *Significant Assumptions.* The basic determinants or building blocks underlying the prospective presentation.

- b. *Sensitive Assumptions*. Those significant assumptions for which a small variation would have a large impact or those having a high probability of a variation that may materially affect prospective results.
- c. *Significant Accounting Policies*. The basic accounting policies the entity follows in its historical financial statements.

Exhibit 1-3 explains the disclosure requirements for each type of engagement. Similar note disclosures are required when accountants report on partial presentations. However, only those assumptions and accounting policies related to the presentation need be disclosed.

Exhibit 1-3

Note Disclosure Requirements

Type of Engagement	Significant Assumptions	Identification of Sensitive Assumption	Accounting Policies
Assembly without a report or written communication (plain paper)	No, but recommended	No, but recommended	No, but recommended
Assembly with a written communication	No, but recommended	No, but recommended	No, but recommended
Assembly with a report	Yes	Yes ^a	Yes ^a
Special disclaimer on budgets	No	No	No
Compilation	Yes	Yes	Yes ^a
Agreed-upon procedures	Yes	Yes ^a	Yes ^a
Examination	Yes	Yes ^a	Yes ^a

Note:

- ^a The client can elect to omit these disclosures; however, the report must be modified for the omission. (In an examination engagement, an adverse opinion would be given if the disclosures were omitted.)

* * *

Applicability of SSARS to Prospective Information

SSARS do not apply to prospective financial information. SSARS No. 1, AR 100.04, states that financial forecasts, projections, and similar items are not financial statements for purposes of applying SSARS.

Do Peer Reviews Apply to Engagements on Prospective Information?

All firms that are members of the AICPA must subject their accounting and auditing practices to a peer review. The QC standards and the peer review standards include prospective financial statement engagements under the AICPA standard in their scopes. As a result, firms that perform compilation, agreed-upon procedures, examinations, and special budget services under the AICPA standard must develop and maintain quality control policies and procedures over such engagements. (Although internal use presentations may not technically be covered by the AICPA standard, firms are encouraged to include such engagements in their QC systems.)

Firms that will undergo a peer review must develop a QC system that ensures that their engagements comply with professional standards. A good method for developing a QC system is to use standard engagement checklists that interface with the firm's QC system. The additional steps needed to meet the documentation requirements of a peer review should create no appreciable increase in the time needed to perform a typical engagement.

Applicability of Statements on Standards for Valuation Services to Prospective Engagements

When the practitioner is engaged to provide a service on prospective financial statements and, as part of that engagement, considers factors to estimate the value of a business, Statement on Standards for Valuation Services No.1 (SSVS No. 1), *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, does not apply. VS 100.05 states, "This statement is not applicable to a [practitioner] who participates in estimating the value of a subject interest as part of performing an attest engagement. . ." The practitioner would be required to follow the requirements of SSAE No. 10 (AT 301).

Conversely, CPA valuation consultants commonly prepare prospective financial information as a part of providing valuation services. An interpretation to SSVS No. 1 (paragraph 74) states that if, in the course of performing a valuation under the Statement, a valuation analyst prepares prospective financial information (for example, as part of a discounted cash flow or discounted earnings analysis within the income approach), he or she is *not* required to examine or compile such information in accordance with the SSAEs. It is believed that the interpretation is stating that the practitioner, not the client, takes responsibility for the presentation of prospective financial information in these circumstances, and therefore does not fall under the requirements of AT 301. In the event the CPA valuation consultant wishes to, or is engaged to, perform a compilation, examination, or agreed-upon procedures on the prospective presentation or issues such a report as part of the valuation engagement, he or she is not prohibited from providing such services. However, if the practitioner assembles and submits prospective financial statements (which, by definition is the client's responsibility, not the practitioner's) for third party use, AT 301 requires the practitioner to either compile, examine, or apply agreed upon procedures to the information.

Summary of Recommendations

If prospective financial information is a by-product of a tax planning, budgeting, or other type of consulting engagement, try to avoid specific presentation and reporting rules by meeting all of the conditions of a plain paper engagement. If reporting is required simply because the prospective information is submitted with historical financial statements, recommend an assembly service to the client unless the information is to be submitted to third parties. If reporting is required because the presentation is a complete presentation intended for limited third party use, consider whether a partial presentation may be appropriate to meet the needs of the limited users since there is no requirement to report on a partial presentation. When a complete prospective presentation is to be submitted to third parties, recommend a compilation service. Avoid examination engagements when possible, since they are very expensive and have a higher degree of risk. Finally, the term *forecast* should be used for general purpose (complete) prospective presentations in which all of the assumptions are likely to occur. The term *projection* is reserved for complete presentations that contain a hypothetical assumption that is not necessarily expected to occur and may even be improbable. The terms *forecast* and *projection* should not be used for partial presentations; instead, use *forecasted* or *projected* in describing the presentation.

Engagement Understanding

Required Understanding with the Client. SQCS No. 7, *A Firm's System of Quality Control*, indicates that a firm should establish policies and procedures requiring that the identity and role of the engagement partner be communicated to management and those charged with governance.

For compilation, examination, and agreed-upon procedure forecast and projection engagements, the AICPA guide states that accountants should—

- document, preferably through the use of a written communication to the client, their understanding with the client, and
- describe in that understanding the (a) objectives of the engagement, (b) client's (responsible party's) responsibilities, (c) accountant's responsibilities, and (d) limitations of the engagement.

Thus, accountants should obtain an understanding with their client that covers each of the elements described in the second bullet and to document the understanding in the workpapers. Accountants are encouraged to document the understanding through the use of a written communication with the client. Finally, the AICPA guide states that accountants should decline to accept or perform the engagement if they have been unable to reach an understanding with the client.

Documenting the Understanding. The AICPA guide states that accountants should obtain an understanding with the client about the level of service to be performed. It also requires that the understanding be documented in the workpapers. The easiest way for accountants to meet those requirements is believed to be the use of an engagement letter.

Third-party Use Engagements. It is believed that engagement letters should be obtained on all prospective engagements when third-party use is reasonably expected. In today's litigious environment, a well-worded engagement letter can help prevent misunderstanding by clearly outlining the services to be rendered, the fee, and other terms and conditions of the engagement.

Internal Use Only Engagements. It is also believed important for accountants to obtain engagement letters for internal use engagements. Although such engagements often are less formal, it is helpful to obtain the client's written acknowledgement that third-party use of the prospective information is not intended. Some accountants believe that an engagement letter is not necessary for those engagements since the accountants' assembly report or other written communication states that the presentation is restricted to internal use. Also, many firms choose to include a "restricted to internal use" legend on plain paper presentations. However, many accountants use engagement letters for all internal use engagements because they believe it is simply good business.

Are Engagement Letters Required? The AICPA guide does not require accountants to use engagement letters to document their understanding with the client. It does, however, state that the understanding should be documented, preferably through a written communication with the client. The most common form of written communication used by accountants to document the engagement understanding is the engagement letter. Other forms of documentation may be used, however. For example, accountants might document the understanding in a memo.

SELF-STUDY QUIZ

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

7. Define *prospective financial information*.
 - a. Prospective financial statements that present, to the best of the knowledge of the responsible party, the expected financial position, operation results, and cash flows for an entity.
 - b. A financial analysis in which the accountant assumes responsibility for the estimates instead of management.
 - c. Budgets, goals, plans, and other similar presentations involving elements of predicting the future.
 - d. A broad concept including all future-oriented financial information that an accountant might be associated with.
8. What type of note disclosure is the basic building block underlying a presentation of prospective financial information?
 - a. Significant assumptions.
 - b. Sensitive assumptions.
 - c. Significant accounting policies.
9. What terminology should be used for a partial presentation in a prospective financial information engagement?
 - a. Forecast.
 - b. Projection.
 - c. Forecasted or projected.
10. Compilation, examination, and agreed-upon procedures engagements on prospective financial information include a requirement that the accountant document the understanding with the client. All of the following should be described in that understanding, **except**:
 - a. Engagement objectives.
 - b. Personnel assigned.
 - c. Client's responsibilities.
 - d. Engagement limitations.

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. Define *prospective financial information*. (Page 206)

- a. Prospective financial statements that present, to the best of the knowledge of the responsible party, the expected financial position, operation results, and cash flows for an entity. [This answer is incorrect. Based on the AICPA guide, this is the first sentence of the definition of a *financial forecast*. The first sentence of the guide's definition of a *financial projection* is similar, but it includes the mention of "one or more hypothetical assumptions."]
- b. A financial analysis in which the accountant assumes responsibility for the estimates instead of management. [This answer is incorrect. This definition applies to a *financial analysis*, which is a third type of prospective financial information (in addition to forecast or projection).]
- c. Budgets, goals, plans, and other similar presentations involving elements of predicting the future. [This answer is incorrect. These types of engagements are generally referred to as *budgets*. In addition to the predictive elements, they may include elements of targets, motivational goals, or hurdles that distinguish them from a forecast. If budgets, plans, or goals do not fit the definition of a forecast, they are projections.]
- d. **A broad concept including all future-oriented financial information that an accountant might be associated with. [This answer is correct. The AICPA narrows this concept by discussing (1) two basic formats of prospective presentation (complete or partial) and (2) two basic types of prospective information (forecasts or projections).]**

8. What type of note disclosure is the basic building block underlying a presentation of prospective financial information? (Page 208)

- a. **Significant assumptions. [This answer is correct. Significant assumptions are required for the following types of engagements: (1) assembly with a report, (2) compilation, (3) agreed-upon procedures, and (4) examination.]**
- b. Sensitive assumptions. [This answer is incorrect. Sensitive assumptions are significant assumptions for which a small variation would have a large impact or those having a high probability of a variation that may materially affect prospective results.]
- c. Significant accounting policies. [This answer is incorrect. These are the basic accounting policies that the entity follows in its historical financial statements.]

9. What terminology should be used for a partial presentation in a prospective financial information engagement? (Page 210)

- a. Forecast. [This answer is incorrect. This term would be used for general purpose (complete) prospective presentations in which all of the assumptions are likely to occur.]
- b. Projection. [This answer is incorrect. This term would be used for complete presentations that contain a hypothetical assumption that is not necessarily expected to occur and may even be improbable.]
- c. **Forecasted or projected. [This answer is correct. The terms forecast and projection should not be used for partial presentations; instead, use *forecasted* or *projected* in describing the presentation.]**

10. Compilation, examination, and agreed-upon procedures engagements on prospective financial information include a requirement that the accountant document the understanding with the client. All of the following should be described in that understanding, **except: (Page 210)**
- a. Engagement objectives. [This answer is incorrect. Based on the guidance in the AICPA guide, accountants should include this in the documented understanding.]
 - b. Personnel assigned. [This answer is correct. The understanding is not required to include details such as what personnel in the accountant's firm are assigned to the engagement.]**
 - c. Client's responsibilities. [This answer is incorrect. The responsibilities of both the client (or the responsible party, if not the client) and the accountant should be documented with the understanding.]
 - d. Engagement limitations. [This answer is incorrect. According to the AICPA guide, any limitations of the engagements should be documented in this understanding. The guide encourages accountants to make the documentation using a written communication with the client.]

SIGNIFICANT ASSUMPTIONS AND KEY FACTORS

Regardless of the level of service or presentation format, it is helpful to have a basic understanding of the factors and assumptions underlying a prospective presentation. In addition, during a compilation engagement, the accountant should inquire as to how the factors and assumptions were formulated, consider whether they are obviously inappropriate, and consider whether there are any obvious omissions.

The AICPA guide discusses characteristics that information underlying prospective financial information should possess. Although management is responsible for the presentation of the prospective information, the accountant can be involved with key factors and assumptions in the following ways:

- a. Helping clients identify what the key factors are for their business.
- b. Helping clients develop assumptions relevant to their key factors.
- c. Considering and evaluating key factors and assumptions as part of an engagement such as an agreed-upon procedures or a compilation engagement.
- d. Helping the client prepare disclosure of significant assumptions.

Even if the accountant helps identify and develop key factors and assumptions, the prospective financial information is still management's responsibility. Since management can plan and direct the entity's activities, it is in a position to adopt the assumptions as reasonable expectations of future results.

Key Factors

Key factors are defined as the significant matters on which an entity's future results are expected to depend. They serve as a foundation for prospective information and are the basis for the assumptions. Key factors are basic to the entity's operations and affect, among other things, the entity's sales, production, service, and financing activities. Since key factors are the basis for developing assumptions, it is important that all significant key factors be identified as the first step in preparing or evaluating a prospective financial presentation.

Key factors vary from industry to industry and between entities within an industry. For example, the specific determinants of sales for a clothing retailer differ from those for a heavy equipment manufacturer. Key factors for a large supermarket chain may not be the same as those for the local family-owned supermarket. Whereas union wage rates, gasoline costs, and longhaul trucking costs are crucial cost factors to the large chain, these factors may not be as important to the local supermarket.

Key factors may be classified as those *external* to the entity and those *internal* to the entity. External factors could include general economic conditions, interest rates, inflation rates, tax laws, government regulations, and actions of competitors. For example, external key factors for a retail apparel shop include seasonal buying habits of consumers, fashion fads, competition, and economic conditions. Internal factors relate to management's strategies and plans as well as the entity's existing resources and commitments. Internal key factors for a retail apparel shop include types of merchandise to carry, retail markup, promotional markdown, advertising costs, planned store hours, employee wage rates, and policy on credit sales, layaways, and credit for sales returns.

Significant Assumptions

Assumptions provide the basis of prospective financial information and are the single most important determinant of that information. Assumptions are predictions of future conditions for each key factor. For example, if a company's costs and sales prices tend to keep pace with inflation, then the inflation rate is a key factor, and an estimate that inflation will be 5% next year is a significant assumption for the company.

Some assumptions have a more significant effect on prospective results than do others. Such *sensitive assumptions* are defined in the AICPA guide as those having a high probability of a variation that would materially affect prospective results. In developing or evaluating assumptions, particular attention should be given to those for

which either a small variation would have a significant effect on the prospective results or to those assumptions with a high probability of a sizable variation. Industries differ in their sensitivity to particular variations. For example, the housing industry is acutely affected by a change in interest rates. Exhibit 1-3 discusses the types of engagements (levels of service) in which significant and sensitive assumptions should be disclosed. However, even when assumptions should be disclosed, some assumptions that have an enormous potential impact on prospective financial information are implied. For example, it is usually implicitly assumed that conditions of peace or the existing form of government will continue, thus it would not be necessary to disclose this particular assumption.

Subjective Assumptions

Lesson 2 discusses the accountant's responsibility for assumptions that cannot be estimated.

Assumptions for a Financial Forecast

Assumptions for a forecast should have the following qualities:

- a. The assumptions should be based on the best information available at the time they are developed.
- b. The assumptions should be consistent with management's plans, including its anticipated strategies and planned responses to expected future conditions. The accountant can discern indications of management's plans from discussions with management and review of its budgets, statements of policies or objectives, and minutes of directors and committee meetings.
- c. The assumptions should be appropriate. Appropriate assumptions are reasonable, consistent with one another, appropriately related to past or present conditions, and suitably supported.

Assessing Whether Information Is the Best Available. In assessing whether assumptions are based on the best available information, the following factors are considered:

- a. Is the information reliable?
 - (1) What is the source of the data (management, an outside party, an expert)?
 - (2) Is there corroborating evidence? (If different sources of data are available, do they provide consistent results?)
 - (3) Is the data consistent with past patterns, trends, and results adjusted for anticipated changes?
 - (4) How was the data obtained (interview, observation, mathematical analysis)?
- b. Is the information cost-justified? Will spending more time or money improve the quality of the prospective information sufficiently to justify the additional cost or delay?
- c. Is the information sufficiently detailed? For example, separate sales estimates can be made for each product line, or an average sales price can be applied to an overall unit sales total. The appropriateness of each approach depends on the uniformity of sales and prices across product lines.

Assessing Whether Assumptions Are Appropriate. Many assumptions are related to one another or may have multiple effects on the forecast results. Thus, to be appropriate, the assumptions should be internally consistent. The following factors should be taken into account:

- a. The conditions assumed with respect to future sales are also considered when estimating the costs of those sales.
- b. The sufficiency of plant capacity, labor, and other resources to support the estimated sales is taken into account.

- c. The capital expenditures are recognized as appropriate.
- d. The applicable taxes are provided for.
- e. The need for financing is considered.

Past or current trends can be a good starting point for estimating future conditions. However, consideration should be given to the possibility that past or current conditions may change and that past trends may not continue into the future. If necessary, adjustments should be made to historical amounts and trends to give recognition to anticipated changes, or the assumptions will not be appropriate. Knowledge of the industry and an understanding of its key factors and how they affect the industry provides a basis for anticipating change.

To be appropriate, assumptions should be suitably supported. Support for assumptions might be found in the following materials:

- a. General economic analyses.
- b. Market surveys.
- c. Trends and patterns developed from the entity's own operating history.
- d. Internal data and analyses.

Assumptions for a Projection

Some of the requirements listed previously for assumptions underlying a forecast are not applicable to *certain hypothetical assumptions* used in a projection. However, those requirements do apply to the other assumptions in a projection. The criteria of "best available information" does not apply to the hypothetical assumptions. Also, the hypothetical assumptions need not be suitably supported and need not be reasonable, but they should be appropriate, given the purpose for which the projection is prepared. For example, a hypothetical assumption may represent the best or worst possible scenario, which may not be a reasonable assumption but may be appropriate for showing how an entity could react to extreme conditions. The hypothetical assumption may not be consistent with management's plans and expectations, but the other assumptions should reflect expected actions, given the occurrence of the hypothetical assumption. For example, if management's policy is not to lay off workers during slow periods, layoffs should not be assumed as a reaction to a hypothetical assumption of a temporary reduction of production levels.

SELF-STUDY QUIZ

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

11. Which statement best describes key factors?
 - a. Key factors are predictions of future conditions.
 - b. Responsibility for key factors is held by the accountant.
 - c. Most key factors will be the same from industry to industry.
 - d. Key factors can be classified as either internal or external.
12. An assumption for a forecast should have which of these qualities?
 - a. It should be based on information that will not change.
 - b. It should be consistent with plans made by management.
 - c. It can incorporate any possibility, whether reasonable or not.
13. What determination will help an accountant to know if an assumption for a forecast is based on reliable information?
 - a. If the data is consistent with past patterns.
 - b. If the information is cost-justified.
 - c. If the information has sufficient detail.
 - d. If the assumptions have multiple effects on forecast results.

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.)**

11. Which statement best describes key factors? (Page 216)

- a. Key factors are predictions of future conditions. [This answer is incorrect. This is true of significant assumptions, not key factors. Key factors are significant matters on which an entity's future results are expected to depend, and they are the basis for the assumptions.]
- b. Responsibility for key factors is held by the accountant. [This answer is incorrect. The accountant can help identify and develop the key factors, but prospective financial information is ultimately the responsibility of management.]
- c. Most key factors will be the same from industry to industry. [This answer is incorrect. Key factors actual vary from industry to industry, and they can also vary between entities in the same industry.]
- d. **Key factors can be classified as either internal or external. [This answer is correct. External key factors could be interest or inflation rates, while internal key factors could be management strategies and the entity's existing resources.]**

12. An assumption for a forecast should have which of these qualities? (Page 217)

- a. It should be based on information that will not change. [This answer is incorrect. The assumptions must be based on the best information available at the time they are developed.]
- b. **It should be consistent with plans made by management. [This answer is correct. This includes management's anticipated strategies and planned responses to expected future conditions. The accountant can discern indications of management's plans from discussions with management and review of its budgets, statements of policies or objectives, and minutes of directors and committee meetings.]**
- c. It can incorporate any possibility, whether reasonable or not. [This answer is incorrect. The assumptions should be appropriate, which means they must be reasonable, consistent with one another, appropriately related to past or present conditions, and suitably supported.]

13. What determination will help an accountant to know if an assumption for a forecast is based on reliable information? (Page 217)

- a. **If the data is consistent with past patterns. [This answer is correct. Four ways to determine if information is reliable include (1) identifying the source of the data, (2) finding any corroborating evidence, (3) noting if the data is consistent with past patterns, trends, and results adjusted for anticipated changes, and (4) finding out how the data was obtained.]**
- b. If the information is cost-justified. [This answer is incorrect. This is a consideration for determining if assumptions are based on the best information available, but it is not part of discerning if the information is reliable.]
- c. If the information has sufficient detail. [This answer is incorrect. Information should be sufficiently detailed to ensure that it is the best information available for the assumption to be based on; however, this is a different determination than assessing whether the information is reliable.]
- d. If the assumptions have multiple effects on forecast results. [This answer is incorrect. Many assumptions are related to one another or may have multiple effects on the forecast results; however, this is not part of the determination of whether the information is reliable. Instead, it is part of the determination of whether assumptions are appropriate.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (CARTG093)**

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 piece of current AICPA literature establishes the reporting and procedural standards for three types of engagements that involve prospective financial statements reasonably expected to be used by third parties (agreed-upon procedures, examination, and compilation)?
 - a. SSAE No. 10, *Attestation Standards: Revision and Recodification*.
 - b. SSAE No. 14, *SSAE Hierarchy*.
 - c. *Guide for Prospective Financial Information* (the AICPA guide).
 - d. Do not select this answer choice.

2. When following the guidance about forecasts and projections found in the SSAEs, Mike, a CPA, encounters a requirement that uses the word *must*. Due to the specific circumstances of Mike's engagement, he believes alternative procedures would better fulfill the requirement. Based on the guidance found in SSAE No. 13, how should Mike proceed?
 - a. Mike is required to fulfill the requirement as written in the SSAEs, because it is an unconditional requirement.
 - b. If he can justify his actions, Mike can use the alternative procedures, because this requirement is only presumptively mandatory.
 - c. Mike is free to use any method he chooses in this scenario, because the requirement is part of explanatory material and, thus, not a requirement.
 - d. Do not select this answer choice.

3. List the six common practice problems related to prospective financial information included in SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements*.

i. Periods covered by an accountant's report. ii. Prospective financial statements available for internal use only. iii. Forecasts including a projected sale of an entity's real estate investment. iv. Examples of forecast disclosures by responsible parties for effects of events and circumstances that are expected to occur after the forecast period. v. Support for tax assumptions.	vi. Consideration of whether a responsible party has a basis to present a forecast that is reasonably objective. vii. Information that accompanies a financial forecast for an accountant-submitted document. viii. Financial projections that are included in general use documents. ix. Sales prices that are assumed in a projection of a sale of an entity's real estate investment. x. Partial presentations.
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 - a. i., ii., iii., iv., v., and vi.
 - b. i., iii., v., vii., viii., and ix.
 - c. ii., iii., iv., vi., vii., and x.
 - d. iii., v., vii., viii., ix., and x.

4. Which of the following levels of service related to prospective financial engagements is most commonly for internal use, as opposed to third party use?
 - a. Compilation.
 - b. Examination.
 - c. Assembly with a report.
 - d. Agreed-upon procedures.
5. If an accountant is providing *plain paper services*, which of the following is a condition that must be met?
 - a. A transmittal letter or accountant's report accompanies the prospective financial information.
 - b. A special budget exemption is included with the prospective financial information.
 - c. The presentation of the prospective financial information does not refer to the accountant.
 - d. The prospective financial information is shown with historical financial statements that the accountant compiled, reviewed, or audited.
6. Anna is engaged to perform services on prospective financial information. The following information applies to Anna's engagement:
 - i. Anna will prepare a partial presentation.
 - ii. She will include a report.
 - iii. Her client does not want assurance or a compilation.

Using the decision-making process depicted in the flowchart at Exhibit 1-2, what level of service is appropriate for Anna's engagement?

- a. Examination engagement.
 - b. Assembly with report.
 - c. Special disclaimer.
 - d. Agreed upon procedures engagement.
7. Match the following terms related to prospective financial information with the appropriate definition.

1. Partial presentation 2. Pro forma presentations 3. Entity 4. Responsible party 5. Hypothetical assumption	i. Any unit (existing or to be formed) for which financial statements can be prepared in accordance with an OCBOA or GAAP. ii. An assumption that can be used in a financial projection or a partial presentation of projected information to present a condition/course of action not necessarily expected to occur, but consistent with the presentation's purpose. iii. Sole use of prospective financial information by the responsible party and other people within the entity. iv. Use of prospective financial information by people unable to negotiate directly with the responsible party. v. A historical financial statement recast to show the affect of a transaction that was not consummated during the period covered by the statement.
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- 6. General use
 - vi. Use of prospective financial information by only the responsible party or by people who can negotiate directly with the responsible party.
 - 7. Limited use
 - vii. A presentation of prospective financial information that omits one or more of the minimum financial statement elements required for a complete presentation.
 - 8. Internal use
 - viii. The person(s) responsible for assumptions underlying the prospective financial information.
- a. 1., i.; 2., ii.; 3., iii.; 4., iv.; 5., v.; 6., vi.; 7., vii.; 8., viii.
 - b. 1., v.; 2., vii.; 3., viii.; 4., ii.; 5., i.; 6., vi.; 7., iii.; 8., iv.
 - c. 1., viii.; 2., i.; 3., v.; 4., ii.; 5., vii.; 6., iii.; 7., iv.; 8., vi.
 - d. 1., vii.; 2., v.; 3., i.; 4., viii.; 5., ii.; 6., iv.; 7., vi.; 8., iii.
8. What note disclosures are required for an examination engagement of prospective financial information?
- a. Significant assumptions only.
 - b. Accounting policies only.
 - c. Significant assumptions and identification of sensitive assumptions.
 - d. Significant assumptions, identification of sensitive assumptions, and accounting policies.
9. Which of the following standards applies to engagements on prospective information?
- a. Statements on Standards for Accounting and Review Services (SSARS).
 - b. QC and peer review standards.
 - c. Statements on Standards for Valuation Services (SSVS).
 - d. Do not select this answer choice.
10. According to the AICPA guide, are engagement letters required for an engagement on prospective financial information?
- a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
11. When performing a potential financial information engagement, the accountant can be involved with the key factors and assumptions in all of the following ways, **except**:
- a. Helping the client identify key factors for their business.
 - b. Helping the client develop assumptions that are relevant to their key factors.
 - c. Evaluating key factors and assumptions as part of an agreed-upon procedures or compilation engagement.
 - d. Taking responsibility for the key factors and assumptions.

12. What is a *sensitive assumption*?
- a. A significant assumption with a high probability of variation.
 - b. An external key factor that may affect more than one industry.
 - c. A subjective assumption with no reasonably objective basis.
 - d. Do not select this answer choice.
13. The assumptions for a projection will include certain hypothetical assumptions. Which of the requirements for assumptions in a forecast engagement also apply to hypothetical assumptions in a projection engagement?
- a. The best available information requirement.
 - b. The requirement to be suitably supported.
 - c. The requirement to be reasonable.
 - d. The requirement to be appropriate.

Lesson 2: Format and Presentation and Specific Types of Prospective Financial Presentation Engagements

INTRODUCTION

This lesson covers the format and presentation guidelines that apply to forecasts, projections, and similar engagements. It also gives more details on certain prospective financial engagements covered by the overview in Lesson 1, such as plain paper engagements, assembly engagements, compilation engagements, and agreed-upon procedures. A brief discussion of modifications needed for partial presentations, a special disclaimer that is appropriate for budgets, and other miscellaneous items (such as Circular 230 engagements) are also included.

Learning Objectives:

Completion of this lesson will enable you to:

- Prepare prospective financial presentations that follow the correct format and presentation guidelines.
- Assess issues related to plain paper engagements, assembly engagements, and budgets.
- Summarize the fundamentals of performing a compilation engagement on prospective financial information.
- Describe agreed-upon procedures, partial presentations, and other miscellaneous matters related to forecasts, projections, and similar engagements.

GUIDELINES FOR FORMAT AND PRESENTATION

The AICPA guide addresses recommended formats and required disclosures for prospective financial information. In drawing a parallel to historical financial statement literature, these presentation guidelines might be viewed as GAAP for prospective financial presentations. While the format and presentation guidelines discussed in the AICPA guide were written to apply to the levels of service (compilation, agreed-upon procedures, and examinations) covered by the AICPA standard, the application of these guidelines to assembly and plain paper engagements is encouraged. Lesson 1 describes the note disclosures required by the various types of prospective engagements. The ensuing discussion relates primarily to matters of form and presentation.

Title for a Financial Forecast

The title should describe the nature of the presentation and should include the word “forecast” or “forecasted.” For example, a balance sheet should be referred to as a “Forecasted Balance Sheet.” If the forecasted financial statements are presented on an OCBOA, the statement title should be changed appropriately, as illustrated:

Forecasted, GAAP Basis	Forecasted, Tax Basis
FORECASTED BALANCE SHEET	STATEMENT OF FORECASTED ASSETS, LIABILITIES, AND EQUITY— INCOME TAX BASIS
STATEMENT OF FORECASTED INCOME	STATEMENT OF FORECASTED REVENUES AND EXPENSES— INCOME TAX BASIS

Title for a Financial Projection

The title of a *projection* should not imply that the presentation is a forecast. Thus, it should *not* include the word “forecast.” The title should describe or refer to the significant hypothetical assumption on which the projection is based. For example, a projection might be titled: “Projected Results of Operations If a New Plant Is Constructed,” or “Projected Results of Operations Assuming Operation at Full Capacity.” Alternatively, the title can reference the

particular hypothetical assumption, e.g., “Projected Statement of Operations under the Hypothetical Assumption in Note A.” As discussed in the preceding paragraph, the statement titles should be appropriate for the basis of accounting used.

Identification of the Period Presented—Forecasts and Projections

In identifying the forecasted or projected period being presented in the prospective financial statements, the phrase “Year Ending December 31, 20X5” is used instead of “Year Ended...,” which is used for historical financial statements. The word “Ended” implies an expired period while the word “Ending” has a prospective connotation. See the following illustration.

Historical	Forecasted
XYZ CORPORATION STATEMENT OF INCOME AND RETAINED EARNINGS Year Ended December 31, 20X6	XYZ CORPORATION STATEMENT OF FORECASTED INCOME AND RETAINED EARNINGS Year Ending December 31, 20X7

Title for Prospective and Historical Information Presented Together

Prospective and historical financial statements may be presented together in parallel columns as long as the title appropriately describes each type of statement and the columns are clearly labeled, as illustrated:

- a. XYZ CORPORATION
BALANCE SHEETS
December 31, 20X7 (Forecasted) and 20X6 (Historical)
- b. XYZ CORPORATION
STATEMENTS OF INCOME AND RETAINED EARNINGS
Year Ending December 31, 20X7 (Forecasted) and
Year Ended December 31, 20X6 (Historical)

This format may sometimes be cumbersome for a projection because the title for a projection should refer to the hypothetical assumption. To reduce the length of the title, reference can be made in the title to a note that explains the hypothetical assumption.

Format for a Forecast or Projection

The presentation guidelines described below are appropriate for either a forecast or a projection unless otherwise noted. The AICPA guide contains presentation guidelines for prospective financial presentations for both third party and internal use engagements.

Preferred Format. The AICPA guide states that the preferable presentation of a forecast or projection is in the format of the historical financial statements, unless potential users specify another format. The reason is that the prospective presentation can more easily be compared with the historical results of prior periods and with the actual results of the prospective period if the forecast or projection is in the format historically used by the entity and expected to be used in the future. These types of presentations are discussed in the following paragraphs.

Complete Presentation. The AICPA guide establishes boundaries around the information needed for a complete prospective financial presentation. The presentation may consist of a complete set of basic financial statements, or it may consist only of specified minimum elements (a summarized presentation). As long as the presentation falls within these boundaries, it can be considered a complete prospective financial presentation.

The presentation may be in a summarized or condensed form if one or more of the details usually included in historical statements is omitted. For example, the total of current assets could be presented without the detail components of the total. The level of condensation or summarization may vary based on a number of factors. A complete prospective financial presentation is required to include at least the minimum items listed in the “Presentation Formats—Complete or Partial” paragraph in Lesson 1.

Only those items that would be applicable in the historical financial statements for the prospective period need be presented in the prospective financial statements. For instance, a nonpublic entity need not present the earnings per share data included in the list of minimum required items. Also, a partnership or S corporation would not present a provision for income taxes since income taxes are not applicable to those entities. The captions of the required items should be adapted to fit the circumstances. For example, instead of the caption "sales" or "gross revenue," an entity in the business of renting property might use the caption "rental income," and a law firm might use the caption "fee income." An entity using the tax basis of accounting might use the caption "net income—tax basis" in place of "net income."

Since it is acceptable to present a forecast or projection in either a complete or summarized format, the decision about how much detail to present will be based on factors such as the needs of the user or the ability to develop detailed estimates. For example, if a forecast is presented alongside historical financial statements, the user might want the forecast to be in the same amount of detail for comparison purposes. The practitioner should not automatically assume that preparing a minimum presentation will save significant time. Although some time may be saved, normally the same amount of information will have to be developed to generate the minimum items.

Partial Presentation. A partial presentation is one that omits one or more of the minimum financial statement elements. However, if the omitted item can be derived from the information presented, the presentation is not a partial presentation. The AICPA guide defines a partial presentation as a limited use presentation that is not appropriate for users who do not have the opportunity to negotiate directly with management. The AICPA guide provides presentation and disclosure guidelines by describing how the guidance relating to complete presentations should be modified for partial presentations.

Examples of partial presentations might include the following:

- a. A sales forecast.
- b. A statement of projected operating income when net income and significant changes in financial position are not presented.
- c. A tax return projection that does not show significant changes in financial position.
- d. A statement of projected cost of sales or operating expenses.

Significant Changes in Financial Position

The minimum presentation guidelines listed in the "Presentation Formats—Complete or Partial" paragraph in Lesson 1 include significant changes in financial position. Accountants should not interpret this to mean that a formal statement of changes in financial position should be presented. In fact, any number of presentation formats may be used to satisfy the requirement, so long as all significant changes in financial position are presented separately or are derivable from other statements or notes in the prospective presentation. For example, when significant changes in financial position are adequately described and quantified in the summary of significant assumptions, it is believed that they need not be repeated in a tabular presentation.

Additionally, SFAS No. 95, *Statement of Cash Flows* (FASB ASC 230-10), does not affect the requirement to present significant changes in financial position. Companies presenting a complete set of prospective financial statements (rather than a summarized presentation) are believed to generally present a statement of cash flows in conformity with SFAS No. 95 (SFAS ASC 230). But, neither a balance sheet nor a statement of cash flows is actually required. Further, none of the captions or disclosures required by SFAS No. 95 (FASB ASC 230-10-45 and 230-10-50) are required. What is required is that the presentation disclose significant changes in balance sheet accounts. For example, a financial forecast that includes only the minimum financial statement elements in items a.(1)(a) through a.(1)(i) listed in Lesson 1 (i.e., a summarized presentation) contains only information related to results of operations. That is, it contains only the information normally disclosed in an income statement. What is missing are the disclosures commonly included in a balance sheet. Therefore, the requirement to disclose significant changes in financial position can be satisfied by disclosing significant changes in balance sheet accounts expected to occur because of such things as management's plans to pay dividends, obtain financing, or refinance debt during the forecast period.

Presentation of Amounts

A financial forecast or projection may be expressed in specific monetary amounts or as a range of amounts. However, since presentation of single amounts may imply more certainty and exactness than can exist in a prospective presentation, the tentative nature of a forecast or projection can be conveyed by supplementing it with an explanation of the sensitivity of the information to variations such as the following:

Although the forecast presents management's expectation that sales will be \$10 million, management believes that there is a 20% chance that sales may be as low as \$8 million or as high as \$13 million.

This explanation can be presented in the summary of significant assumptions.

If the prospective financial statements are presented in terms of a range, the presentation should not imply that (a) either end of the range is the best or worst possible outcome, or (b) the ends of the range were calculated based on a scientifically determined interval. The rationale for these rules is that in such presentations, the extremes represent the highest and lowest expected results that typically are not the best or worst possible results. In addition, the AICPA guide states that the range should not be selected in a biased or misleading manner. That is, one end of the range should not be significantly less probable than the other.

Introduction to Summary of Significant Assumptions

An introduction to the summary of assumptions should be included according to the AICPA guide to describe the nature of the assumptions and to indicate that the assumptions disclosed are not all-inclusive and that the forecast or projection is based on circumstances and conditions existing at the time it was prepared. It also describes what management intends the statements to present and includes a caveat that the prospective results may not be realized. The introduction also discloses the date of preparation of the prospective financial presentation. If the presentation is a projection, the introduction should explain any special purpose and limitations of the usefulness of the projection.

Date of Preparation of Prospective Information

The date of preparation of the forecast or projection should be disclosed in the presentation so that users can determine how current the information is. This requirement is unique to a prospective financial presentation; it has no counterpart in historical financial statements. The literature does not give any guidance on determining the preparation date. By analogy to auditing and SSARS literature, it is believed that the date of the forecast or projection would be the date on which management completed its review and approval of the statements. The preparation date is usually disclosed in the introduction to the "Summary of Significant Assumptions." The preparation date may differ from the accountant's report date since the date of completion of the accountant's procedures is used as the *report* date.

Summary of Significant Assumptions

The AICPA guide states that a summary of significant assumptions should be presented in a forecast or projection. (Exhibit 1-3 presents note disclosure requirements for various types of prospective financial information engagements.) However, the AICPA guide recognizes that it is not practical to disclose all underlying assumptions and that the disclosure need not be in such detail as to affect the entity's competitive position. Nevertheless, it states that all the following disclosures should be made:

- a. Disclosure of the assumptions deemed to be significant to the statement.
- b. Preferably, disclosure of the basis or rationale for the assumptions to aid the user in understanding and evaluating the presentation.
- c. Identification of which assumptions are particularly sensitive, i.e., those assumptions for which there is a reasonable possibility of variation that would significantly affect the prospective results.

- d. For a projection, identification of the hypothetical assumptions on which the projection is based. In addition, if the hypothetical assumptions are improbable, the disclosure should indicate that fact.
- e. Disclosure of assumptions related to anticipated conditions that are expected to be significantly different from current conditions (specifically, if there is a reasonable possibility that an implicit assumption, such as absence of natural disasters, may not continue to prevail, the assumption should be disclosed).
- f. Disclosure of other matters considered important for proper interpretation of the prospective information.

Reference to the Summary of Significant Assumptions

Each page of the presentation should include a statement directing attention to the summary of significant assumptions and accounting policies. If an accountant's report accompanies the presentation, this statement might also refer the reader to the accountant's report (although reference to the accountant's report is not required). Such a statement might read, "See accompanying summary of significant assumptions and accounting policies and accountant's report."

Disclosure of Assumptions in Computer-prepared Presentations

The requirement to disclose significant assumptions need not impede the practitioner's ability to efficiently prepare client forecasts or projections on electronic spreadsheets. The AICPA guide, paragraph 9.05, allows a great deal of flexibility in presenting the assumptions, as indicated by the following quotation:

. . . it may be appropriate to commingle the disclosures of assumptions and accounting policies rather than present them separately. It may also be appropriate to present them in a less formal manner than illustrated, such as computer-printed output (indicating data and relationships) from electronic spreadsheet and general-purpose financial modeling software, as long as the responsible party believes that the disclosures and assumptions can be understood by the users. The appropriateness of any format depends upon individual circumstances.

The standard introductory paragraph could be programmed into the spreadsheet software, followed by the normally abbreviated assumptions used in the spreadsheet. Particularly sensitive assumptions could be identified by an asterisk.

Summary of Significant Accounting Policies

The presentation guidelines include disclosure of the significant accounting policies used in the prospective financial information. If the prospective information is included in a document that contains the historical financial statements, the disclosure can be made by cross-referencing to the accounting policies note in the historical statements.

Accounting Principles

The AICPA guide states that accounting principles and policies used in a forecast or projection usually should be consistent with those expected to be used in the historical financial statements of the period covered by the prospective statements. If an OCBOA is expected to be used for the historical financial statements of the prospective period, that basis of accounting preferably should be used for the financial forecast or projection. In such a situation, there should be disclosure of the basis of accounting used and the fact that it is not GAAP.

Different Basis of Accounting Used in a Prospective Presentation

The prospective financial presentation might be based on a different basis of accounting than is expected to be used in the historical financial statements of the prospective period. The user of the prospective information might prefer or request a different basis. For example, a party providing financing might be particularly interested in the cash available to repay the loan. Thus, he or she might prefer cash basis statements to ones on the accrual basis. If a different basis is used, that should be disclosed, and differences in the forecasted results of operations and changes in financial position due to the use of the different basis should either be reconciled or described in third-party presentations.

Different Accounting Principles Used in a Prospective Presentation

Occasionally, the special purpose for which a projection is intended might dictate use of accounting principles other than those expected to be used in the projected period. For example, an entity might prepare a LIFO basis projection to show the effects of a contemplated change to the LIFO basis. Because the entity would not have decided to change to LIFO at the time the projection is prepared, it would still expect the historical statements to be on a different basis than LIFO. In such a case, the use of the different accounting principles should be disclosed. The AICPA guide recommends, but does not require, that the resulting differences in financial position and results of operations be reconciled. An example of such a disclosure follows:

The projection assumes that inventory will be valued on the last-in, first-out method, whereas the company has historically used the first-in, first-out method. If the latter method were used in this projection, inventory and income before income taxes would be increased by \$XX, provision for income taxes and current liabilities would be increased by \$XX, and net income and shareholders' equity would be increased by \$XX.

Entity Plans to Change Accounting Principles

An entity might plan to change accounting principles in the period covered by the prospective statements. In such a case, the change should be reflected in the prospective financial statements in the same way it will be reflected in the future historical financial statements. For example, assume that a company expects to change from an accelerated method to the straight-line method of computing depreciation. The cumulative effect of the change should be computed and shown in both the prospective and historical income statements of the year of change, and the new method should be used in reporting results in both income statements.

Presentation of Forecast with Supplemental Projection

Financial forecasts may be supplemented by financial projections *for the same period* indicating differences that could occur if assumptions other than those expected should occur. The AICPA guide sets the following requirements for presentation of supplemental projections:

- a. If financial forecasts and projections are presented together, each should be clearly labeled.
- b. If several projections are presented side by side, there should be a clear indication that the projections and supporting assumptions do not encompass a range of the best possible to the worst possible alternatives.
- c. If the presentation is for limited use, projections for periods that go beyond the periods for which forecasts are presented may be presented.

Period to Be Covered by a Forecast or Projection

The ability to estimate future results and the needs of the user are considerations in deciding the period to be covered by a forecast or projection. The AICPA guide states that normally the presentation should cover at least one full year of normal operations to be meaningful to users. It gives the following examples of "normal operations":

- a. At least the first full year following acquisition for an entity contemplating a major acquisition.
- b. At least the first full year of normal operations of a newly formed entity.

In some situations, a time period of longer than one year might be appropriate. For example, a short-term forecast may not be meaningful for industries with a lengthy operating cycle, those where aging of the product is required, or for projects such as a shopping center or housing complex for which long-term results are necessary to evaluate the investment consequences. As a rule of thumb, the AICPA guide encourages the presentation of financial forecasts that do not exceed three to five years, unless a reasonably objective basis for a longer period exists.

Disclosing Information about Periods beyond the Forecast Period

If a forecast does not extend far enough out into the future to demonstrate the long-term results that are important to user understanding, the AICPA guide states that the presentation should include a description of the potential

effects of the long-term results. SOP 92-2 allows responsible parties to present information about operating or other results related to periods beyond the forecast period in a partial presentation that supplements the forecast. The AICPA guide permits that option even when the forecast is intended for general use. (Ordinarily, partial presentations are not appropriate for general use.) That allows responsible parties greater flexibility in disclosing information about the long-term results of their investment decisions to users.

The SOP indicates that the specific plans, events, or circumstances that responsible parties might disclose include—

- scheduled increases in loan payments,
- a planned refinancing,
- existing plans for future expansion of production or operating facilities or for the introduction of new products,
- expiration of a significant patent,
- the expected sale of a major portion of an entity's assets, and
- scheduled or anticipated taxes that have adverse consequences for investors.

The purpose of those disclosures is to provide users with additional information useful in analyzing forecasted results. However, the AICPA guide prohibits responsible parties from presenting such disclosures comparatively on the face of the financial forecast or in related summaries of results (for example, the disclosures should not be presented in a summary of investor benefits), or as a financial projection, since such presentations could be misleading.

Because it is not possible to anticipate all the circumstances that might arise, the AICPA guide does not contain a standard format for such disclosures. However, such disclosures should be based on the responsible party's plans and knowledge about specific events and circumstances that, at the date of the forecast, are expected to have a material effect on results beyond the forecast period. Disclosures may be limited to a narrative discussion of the responsible party's plans, or they may include estimates of expected effects of future transactions or events. In all cases, however, the disclosures should be included in, or incorporated by reference into, the summary of significant assumptions and accounting policies. They should also—

- Include a title that indicates information about periods beyond the forecast period is presented.
- Include an introduction that indicates (a) the information does not constitute a financial forecast and (b) the purpose of the information.
- Disclose significant assumptions.
- Identify those assumptions that are hypothetical.
- Disclose specific plans, events, or circumstances that are expected to have a material effect on results beyond the forecast period.
- State that (a) the information is presented for analysis purposes only, (b) there is no assurance that the events and circumstances described will occur, and (c) if applicable, the information is less reliable than the information presented in the financial forecast.

The following example illustrates the type of disclosures that may be appropriate.

Note B: Supplemental Information Related to Periods Beyond the Forecast Period

Although management is unable to prepare a financial forecast for periods beyond 20X5, it believes that the following information is necessary for users to make a meaningful analysis of the forecasted results.

Management's forecast for the three years ending December 31, 20X5, anticipates sales of its Model 714 High Tech Analyzers and related equipment in the amounts of \$13,500,000, \$14,000,000, and \$14,500,000, respectively. Such sales represent approximately 50% of the Company's sales for the forecast period and were the major reason for the Company's growth in 20X0 and 20X1. The Company is currently a leader in laser technology, and its Model 714 is now widely used by the industry. However, the Company expects the sales of this product to peak in 20X5 and decline in periods subsequent to the forecast period. The Company is currently developing the Model 714A High Tech Analyzer, which is an improvement on the Model 714 Analyzer, and an X series visual modulator and laser scanner.

This information is less reliable than the information presented in the financial forecast and, accordingly, is presented for analysis purposes only. Further, there can be no assurance that the events and circumstances described in this analysis will occur.

Correcting and Updating a Prospective Financial Presentation

Correction refers to the modification of a forecast or projection after issuance for an error made in preparation. If users are currently relying on a forecast or a projection that needs correction, the client should inform such users that results should no longer be relied upon and the accountant should consider withdrawing his report. Furthermore, if practical, a corrected presentation should be issued that includes an explanation of the correction.

Updating relates to changing a forecast or projection to reflect changed assumptions, actual results, or unanticipated events or circumstances. According to the AICPA guide, it is not usually expected that prospective financial presentations will be updated, and the client may wish to state this in the presentation. However, there may be situations when updating is appropriate, especially if users would expect prospective statements to be updated. Updating requires reanalysis of the assumptions and preparation work. The reasons for updating should be described in a note to the updated presentation.

Sometimes a prompt update cannot be made because a material change cannot be quantified. In that case, persons relying on the original presentation should be notified by management of the circumstances necessitating the update, the fact that the original presentation should not be used for any purpose, and that an updated presentation will be issued upon its completion. Management might decide not to update a presentation that should no longer be used for any purpose. If so, this decision and the reason for it should be communicated by management to those who may be relying on the presentation.

A forecast or projection issued with an explicit statement made by management that it does not intend to update the prospective presentation may read as follows:

The financial forecast was prepared as of May 30, 20X1, to assist the prospective lender in estimating whether the operations of the XYZ Company may be expected to support a \$500,000 loan. Because it is contemplated that the loan decision will be made within 45 days hereafter, management does not intend to revise this forecast to reflect changes in present circumstances or the occurrence of unanticipated events.

SELF-STUDY QUIZ

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

14. What phrasing is appropriate for identifying the forecasted or projected period presented in prospective financial statements?
 - a. Year Ended December 31, 20X6.
 - b. Year Ending December 31, 20X7.
15. Which of the following is required for a complete set of prospective financial statements?
 - a. A formal statement of changes in financial position.
 - b. A statement of cash flows in conformity with SFAS No. 95.
 - c. All captions and disclosures required by SFAS No. 95.
 - d. A presentation disclosing significant changes in balance sheet accounts.
16. Which statement best describes the format and presentation of prospective financial statements?
 - a. A financial forecast must be expressed as a range of amounts.
 - b. The range used in a financial forecast must illustrate the best and worst possible outcome.
 - c. The preparation date of a forecast or projection should be disclosed in the presentation.
 - d. The introduction to the summary of significant assumptions is the same for a forecast or projection.
17. Alan is engaged to perform a financial forecast that includes a supplemental projection. The forecast and the projection will be presented together, and the presentation is for general use. Which of these requirements must Alan follow?
 - a. Both the forecast and the projection must be clearly labeled.
 - b. It must be indicated that the projection does not range from the best to worst possible alternatives.
 - c. Alan must present projections for periods beyond that for which the forecast is presented.
 - d. Alan must manually prepare the presentation instead of using electronic spreadsheets.
18. When can prospective financial statements include information about periods extending beyond the forecast period?
 - a. Such information can always be included.
 - b. It can only be included if the presentation is for limited use.
 - c. It can only be included if the specific format outlined in the AICPA guide is used.
 - d. Such information can never be included.

SELF-STUDY ANSWERS

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

14. What phrasing is appropriate for identifying the forecasted or projected period presented in prospective financial statements? **(Page 226)**
- a. Year Ended December 31, 20X6. [This answer is incorrect. This phrasing would be used for historical financial statements.]
 - b. Year Ending December 31, 20X7. [This answer is correct. Ending has a prospective connotation; thus, this phrasing is appropriate for prospective financial statements.]**
15. Which of the following is required for a complete set of prospective financial statements? **(Page 227)**
- a. A formal statement of changes in financial position. [This answer is incorrect. The minimum presentation guidelines include significant changes in financial position; however, a formal statement of changes in financial position is not required. Any number of presentation formats may be used to satisfy the requirement, so long as all significant changes in financial position are presented separately or are derivable from other statements or notes in the prospective presentation.]
 - b. A statement of cash flows in conformity with SFAS No. 95. [This answer is incorrect. Companies presenting a complete set of prospective financial statements (rather than a summarized presentation) are believed to generally present a statement of cash flows in conformity with SFAS No. 95. But, neither a balance sheet nor a statement of cash flows is actually required.]
 - c. All captions and disclosures required by SFAS No. 95. [This answer is incorrect. None of the captions or disclosures required by SFAS No. 95 are required. What is required is that the presentation discloses significant changes in balance sheet accounts.]
 - d. A presentation disclosing significant changes in balance sheet accounts. [This answer is correct. The requirement to disclose significant changes in financial position can be satisfied by disclosing significant changes in balance sheet accounts expected to occur because of such things as management's plans to pay dividends, obtain financing, or refinance debt during the forecast period.]**
16. Which statement best describes the format and presentation of prospective financial statements? **(Page 228)**
- a. A financial forecast must be expressed as a range of amounts. [This answer is incorrect. It may be expressed in specific monetary amounts or as a range of amounts.]
 - b. The range used in a financial forecast must illustrate the best and worst possible outcome. [This answer is incorrect. The range should not imply that either end of the range is the best or worst possible outcome. It also should not imply that the ends of the range were calculated based on a scientifically determined interval.]
 - c. The preparation date of a forecast or projection should be disclosed in the presentation. [This answer is correct. The date is disclosed so that users can determine how current the information is. This requirement is unique to a prospective financial presentation; it has no counterpart in historical financial statements.]**
 - d. The introduction to the summary of significant assumptions is the same for a forecast or projection. [This answer is incorrect. If the presentation is a projection, the introduction should explain any special purpose and limitations of the usefulness of the projection.]

17. Alan is engaged to perform a financial forecast that includes a supplemental projection. The forecast and the projection will be presented together, and the presentation is for general use. Which of these requirements must Alan follow? **(Page 230)**
- a. **Both the forecast and the projection must be clearly labeled. [This answer is correct. This is true for financial forecasts and projections that are presented together. The financial projection must be for the same period as the financial forecast.]**
 - b. It must be indicated that the projection does not range from the best to worst possible alternatives. [This answer is incorrect. This would be needed if Alan planned to present several projections side-by-side. In this scenario, Alan is only presenting one supplemental projection.]
 - c. Alan must present projections for periods beyond that for which the forecast is presented. [This answer is incorrect. Alan cannot do this for a general use presentation. If the presentation was for limited use, projections for periods that go beyond the periods for which forecasts are presented may be presented.]
 - d. Alan must manually prepare the presentation instead of using electronic spreadsheets. [This answer is incorrect. This is not a requirement for forecasts presented with a supplemental projection. The requirement to disclose significant assumptions also need not impede the practitioner's ability to efficiently prepare client forecasts or projections on electronic spreadsheets.]
18. When can prospective financial statements include information about periods extending beyond the forecast period? **(Page 230)**
- a. **Such information can always be included. [This answer is correct. If a forecast does not extend far enough out into the future to demonstrate the long-term results that are important to use understanding, the AICPA guide states that the presentation should include a description of the potential effects of the long-term results. After the issuance of SOP 92-2, which has been incorporated into the AICPA guide, responsible parties are allowed to present information about operating or other results related to periods beyond the forecast period in a partial presentation that supplements the forecast.]**
 - b. It can only be included if the presentation is for limited use. [This answer is incorrect. Ordinarily, partial presentations are not appropriate for general use, but according to SOP 92-2 and the AICPA guide, if needed for understanding, information about periods beyond the forecast period can be disclosed in a forecast that is for general use.]
 - c. It can only be included if the specific format outlined in the AICPA guide is used. [This answer is incorrect. Because it is not possible to anticipate all the circumstances that might arise, the AICPA guide does not contain a standard format for such disclosures. However, such disclosures should be based on the responsible party's plans and knowledge about specific events and circumstances that, at the date of the forecast, are expected to have a material effect on results beyond the forecast period.]
 - d. Such information can never be included. [This answer is incorrect. Based on the information available in the AICPA guide and SOP 92-2, there are times that including this type of disclosure is appropriate. However, the AICPA guide prohibits responsible parties from presenting such disclosures comparatively on the face of the financial forecast or in related summaries of results, or as a financial projection, since such presentations could be misleading.]

TYPES OF PROSPECTIVE FINANCIAL PRESENTATIONS: PLAIN PAPER ENGAGEMENTS

Definition

In general, a plain paper engagement is a term used to describe a prospective financial presentation that the accountant has prepared (or assisted in preparing) but is not associated with. To be defined as a plain paper engagement, it is believed that all of the following conditions must exist. The prospective financial information—

- a. Is not accompanied by an accountant's report or transmittal letter.
- b. Is typed or printed on plain paper; that is, paper that does not contain the accountant's or his firm's name, watermark, or logo.
- c. Is not presented in the accountant's report cover.
- d. Does not refer to the accountant in the presentation.
- e. Is not shown alongside or bound with historical financial statements accompanied by the accountant's audit, review, or compilation report.

If any of these conditions are not met, it is the opinion of this course that the accountant is associated with the prospective presentation and must at a minimum comply with the requirements for written communications or assemble and report on the presentation.

Authoritative Basis for Plain Paper Engagements

The AICPA guide states that an accountant is not required to report on a prospective presentation intended for internal use. That is, accountants are permitted to provide a plain paper service. Therefore, as long as the accountant meets the five conditions cited previously, he is not required to perform any examination, compilation, or agreed-upon procedures or issue any type of report on the presentation.

Procedure, Presentation, Disclosure, and Reporting Requirements

The only required procedures for a plain paper engagement are (a) that the accountant establish an understanding with their client about the nature of the services to be performed and (b) that the presentation be restricted to internal use only and not be shown to third parties for any purpose. Other than those requirements, it is believed that no other procedure, presentation, disclosure, or reporting requirements apply to plain paper engagements; however, when practical, accountants are encouraged to perform the following steps:

- a. List or obtain a list of the significant assumptions underlying the presentation.
- b. Test the assembly of the presentation by performing or testing the mathematical accuracy of the computations that translate the assumptions into the presentation.
- c. Follow the presentation guidelines recommended by the AICPA guide.

An accountant also may provide plain paper services on a partial presentation.

Transmittal Letters and Other Written Communication

Special rules apply when an accountant includes a written communication with the prospective financial statements. The AICPA guide does not define what constitutes a written communication but does list an accountant's transmittal letter or report as examples. Such a communication should generally indicate both the name of the accounting firm and the prospective financial statements involved, but not the accountant's procedures, conclusions, analysis, or recommendations with respect to the prospective information. Although the most common form

of written communication is the transmittal letter, there are others. For example, if the prospective information is included in an accountant-submitted document that also contains the client's historical financial statements and the accountant's report thereon, the document is considered a written communication in the opinion of this course.

If a written communication accompanies a plain paper presentation, the accountant is associated with the presentation. Consequently, the following caveats should be included in the prospective financial statements or in the accountant's written communication:

- a. The prospective financial results may not be achieved.
- b. The prospective financial statements are for internal use only.

The accountant may include the required information on the statements themselves by adding the following sentences to the bottom of each page of the prospective information:

The actual results may vary from the forecast (projection), and the variations may be material.
This presentation is intended for internal use only and should not be used for any other purpose.

The following is an example of a transmittal letter that includes the required caveats:

Date (date presentation was prepared)

Client's name (or firm)

Client's address

Dear John (the letter may be less formal than a report):

Enclosed is your (or the company's) statement of forecasted income for the year ending 20XX. It is intended for internal use only and should not be used for any other purpose. The actual results may vary from those presented, and the variations may be material.

Sincerely,

Name of CPA handling the account

TYPES OF PROSPECTIVE FINANCIAL PRESENTATIONS: ASSEMBLY ENGAGEMENTS

Assembly services are similar to plain paper services, except that the accountant issues a report to describe his services or discuss the prospective statements in writing. Basically, an assembly is limited to performing, or testing the mathematical accuracy of, the computations that translate assumptions into prospective financial presentations.

An accountant also may provide assembly services in connection with a partial presentation.

Assembly Procedures

The AICPA guide states that the accountant should establish an understanding with the client, preferably in writing, of the assembly services to be performed and to specify in that understanding that the prospective financial statements and accountant's report are not to be distributed to outside users. In addition to these requirements, it is believed that the following minimum procedures should be performed on all assembly engagements:

- a. Perform or test the mathematical accuracy of the computations that translate the assumptions into the prospective presentation.
- b. Complete an internal use checklist.
- c. Report on the assembly. (The AICPA guide prohibits an accountant from reporting unless the prospective presentation includes a summary of significant assumptions.)

These procedures are substantially less than the compilation procedures discussed later in this lesson.

Workpapers for an Assembly Engagement

The authoritative literature does not suggest any specific workpapers for an assembly engagement. However, this course suggests that the workpapers contain the following:

- a. Checklists or work programs that include assembly procedures, presentation considerations, and reporting guidelines.
- b. A copy of the prospective financial information and related computation worksheets.
- c. A list of significant assumptions. (This can be an informal listing.)
- d. An engagement letter that describes the understanding with the client and states that the distribution is limited to internal use.
- e. Final copy of the prospective presentation and accompanying accountant's internal use report.

Assembly Reports

Accountants who issue a report have flexibility in the type of report they give. According to the AICPA guide, the accountant's report preferably would be addressed to the responsible party and include all of the following:

- a. An identification of the prospective financial information.
- b. A statement that the presentation has been assembled from information provided by management and that the accountant has not examined or compiled the information and expresses no assurance on it.
- c. A caveat regarding the achievability of the prospective financial results.
- d. A statement that the presentation is intended for the internal use of management, and thus may not be distributed to third parties.
- e. For a projection, a description of, or reference to, the hypothetical assumptions.
- f. For a projection, a description of the limitations on the usefulness of the presentation.
- g. A report date that should be the completion date of the accountant's procedures.

In addition, each page of the prospective presentation should have a reference such as "Restricted to internal use—see accompanying summary of significant assumptions and accounting policies and accountant's report."

The assembly report should not refer to AICPA standards for an assembly of prospective financial statements because there are no performance standards for the accountant. Additionally, the accountant's report should not include a caveat that the accountants do not have a responsibility to update their report for events and circumstances occurring after the report date. Such a caveat might imply a responsibility for considering events and circumstances before the date of the report, and it is believed that there is no such responsibility in an assembly engagement.

Modifications to the Assembly Report

An assembly report would be modified in the following circumstances:

- a. If the accountant is not independent, the report should disclose the lack of independence.
- b. If accounting policy disclosures are omitted, their omission should be described.
- c. If the summary of significant assumptions does not indicate which of the assumptions are particularly sensitive, their omission should be described.

- d. If the prospective financial information is presented on an OCBOA, the statement titles in the report should be changed to reflect appropriate OCBOA titles, and the basis of accounting should be disclosed in the accountant's report if it is not disclosed in the notes.

The AICPA guide prohibits the accountant from reporting on prospective financial statements that omit the summary of significant assumptions. However, it is not necessary to identify which of the disclosed assumptions are particularly sensitive, provided the report notes this omission.

Assembled Prospective Presentations Shown with Compiled Historical Financial Statements

One condition that must be met for an engagement to be classified as a plain paper engagement is that "the prospective financial information must not be shown alongside or bound with historical financial statements that are audited, reviewed, or compiled by the accountant." If the otherwise plain paper presentation is attached to historical financial statements, the accountant's name becomes associated with the document via the accountant's report on the historical financial statements. When this occurs, this course advises the accountant to follow the special rules in the discussion of plain paper engagements earlier in this lesson for written communications or issue an assembly report "restricted to internal use" on the prospective information, even though a nonrestricted SSARS No. 1 compilation report is issued on the historical financial statements. A SSARS No. 1 compilation report in the document containing both historical and prospective financial statements does not automatically mean that the document is intended for third parties. Instead, the decision about intended use of the document is an engagement decision made between the client and the accountant.

SSARS No. 1 permits accountants to submit management-use-only historical financial statements without issuing a compilation report if certain conditions are met. Instead, accountants are required to make certain communications in an engagement letter to management. If accountants issue an engagement letter in lieu of a compilation report, they would not be associated with the historical presentation and could, therefore, follow the rules for plain paper engagements. (Note, however, that the historical statements would be required to contain a legend restricting the use of the statements to management.)

SPECIAL DISCLAIMER THAT CAN BE USED FOR BUDGETS

Practitioners submitting interim historical financial statements to their clients often include comparisons with amounts budgeted for the year. Either of the following presentations are found in practice:

- a. Prospective amounts for the year are allocated to interim periods so that the interim comparative presentation shows the budget for the same period as the historical presentation; e.g., financial statements for five months ended May 31, 20X1, shown in comparison with the budget for the same period.
- b. Prospective amounts for the year are presented with interim historical results; e.g., financial statements for the five months ended May 31, 20X1, shown in comparison with the budget for the year ending December 31, 20X1.

In the first situation, the budget information is for an expired period; i.e., none of it relates to the future. Therefore, it is not considered a prospective presentation under the AICPA *Guide for Prospective Financial Information*. In that case, presenting the budgeted information in a column labeled "budget" and treating it as supplemental historical information is recommended, since it relates to the same period as the historical statements.

In the second situation, although the budget includes information for the future; e.g., for the next seven months in the illustration. The AICPA guide provides a special exemption from its requirements if all of the following conditions are met:

- a. The prospective presentation is labeled as a budget.
- b. The budget does not extend beyond the end of the current fiscal year.
- c. The budget is presented with interim historical financial statements for the current year.

If all of the preceding conditions are met, AT 301.59 and the AICPA *Guide* at Paragraph 10.20 do not require the practitioner to apply any procedures to the budget and do not require the summaries of significant assumptions and accounting policies to be disclosed, provided the omissions are not intended to mislead users and are disclosed in the practitioners' report. AT 301.59 does state that the practitioner should report on the budget and include (a) a statement that the practitioner did not examine or compile the budget and (b) a disclaimer of opinion or any form of assurance on the budget. However, accountants must, at a minimum, compile the historical interim financial statements in accordance with SSARS No. 1 (AR 100).

The following standard paragraphs should be added to the practitioners' report on the historical statements when the budgeted information is a complete presentation:

The accompanying budgeted balance sheet, statements of income, retained earnings, and cash flows of ABC Company as of December 31, 20X1, and for the year then ending, have not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on them.

Management has elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the Company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

Without that exemption, practitioners should include disclosures for the budgeted information or withdraw from the engagement, even though disclosures could be omitted for the historical information. Practitioners should also consider whether the actual results for the expired period indicate the need for changes to the prospective presentation.

SELF-STUDY QUIZ

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

19. Which of the following procedures is required in a plain paper engagement?
 - a. The accountant is required to report on and be associated with the prospective financial presentation.
 - b. The accountant must establish an understanding about the nature of the services to be performed with the client.
 - c. The accountant must obtain a list of all significant assumptions underlying the presentation.
 - d. The accountant must follow all presentation guidelines outlined in and recommended by the AICPA guide.
20. According to the AICPA guide, how should an assembly report be presented?
 - a. The guide includes a strict format that must be adhered to by the accountant.
 - b. The accountant must refer to AICPA standards for an assembly of prospective financial statements.
 - c. A statement about the accountants' responsibility to update the report for future events should not be included.
21. Under which of the following circumstances would an assembly report be modified?
 - a. The accountant is independent from the client.
 - b. Accounting policy disclosures are omitted.
 - c. The summary of significant assumptions indicates which are particularly sensitive.
 - d. The prospective financial information is presented using GAAP.
22. Whammy Inc. is a fiscal year-end company. Greyson, a CPA, will present Whammy's interim historical financial statements for the period ended on July 31, 2008 to the company in comparison with the company's budget. What type of budgetary information qualifies Greyson's presentation for the special budget exemption in the AICPA guide?
 - a. The company's budget for the same period, ending on July 31, 2008.
 - b. The company's budget for the year, ending on December 31, 2008.
 - c. The company's future budget, ending on July 31, 2009.

SELF-STUDY ANSWERS

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

19. Which of the following procedures is required in a plain paper engagement? **(Page 236)**

- a. The accountant is required to report on and be associated with the prospective financial presentation. [This answer is incorrect. The AICPA guide states that an accountant is not required to report on a prospective presentation intended for internal use. That is, accountants are permitted to provide a plain paper service. In general, a plain paper engagement is a term used to describe a prospective financial presentation that the accountant has prepared (or assisted in preparing) but is not associated with.]
- b. **The accountant must establish an understanding about the nature of the services to be performed with the client. [This answer is correct. There are only two required procedures for a plain paper engagement, and this is one of them. The second required procedure is that the presentation must be restricted to internal use only and not be shown to third parties for any purpose.]**
- c. The accountant must obtain a list of all significant assumptions underlying the presentation. [This answer is incorrect. If practical, it is recommended that the accountant perform this procedure, but the procedure is not required.]
- d. The accountant must follow all presentation guidelines outlined in and recommended by the AICPA guide. [This answer is incorrect. This is recommended, if practical, but it is not required for an accountant performing a plain paper engagement. Another recommended step the accountant could perform is to test the assembly of the presentation.]

20. According to the AICPA guide, how should an assembly report be presented? **(Page 238)**

- a. The guide includes a strict format that must be adhered to by the accountant. [This answer is incorrect. The guide lists things that would preferably be included in the assembly report, but there is no strict format that the accountant must adhere to. Accountants who issue an assembly report have flexibility in the type of report they give.]
- b. The accountant must refer to AICPA standards for an assembly of prospective financial statements. [This answer is incorrect. Because there are no performance standards for the accountant, the standards should not be referred to in the assembly report.]
- c. **A statement about the accountants' responsibility to update the report for future events should not be included. [This answer is correct. Including a caveat that the accountants do not have a responsibility to update their report for events and circumstances occurring after the report date might imply a responsibility for considering events and circumstances before the date of the report, and it is believed that there is no such responsibility in an assembly engagement.]**

21. Under which of the following circumstances would an assembly report be modified? **(Page 238)**

- a. The accountant is independent from the client. [This answer is incorrect. The assembly report would be modified if the accountant is *not* independent. In this case, the accountant would need to disclose the lack of independence.]
- b. **Accounting policy disclosures are omitted. [This answer is correct. In these circumstances, the accountant should modify the assembly report to describe the omission of the accounting policy disclosures.]**
- c. The summary of significant assumptions indicates which are particularly sensitive. [This answer is incorrect. The assembly report should be modified if the summary of significant assumptions does *not* indicate which of the assumptions are particularly sensitive. In that case, their omission should be described.]
- d. The prospective financial information is presented using GAAP. [This answer is incorrect. The assembly report should be modified if the prospective financial information is presented using an OCBOA. If an OCBOA is used, the statement titles in the report should be changed to reflect appropriate OCBOA titles, and the basis of accounting should be disclosed in the accountant's report if it is not disclosed in the notes.]

22. Whammy Inc. is a fiscal year-end company. Greyson, a CPA, will present Whammy's interim historical financial statements for period ended on July 31, 2008 to the company in comparison with the company's budget. What type of budgetary information qualifies Greyson's presentation for the special budget exemption in the AICPA guide? **(Page 239)**
- a. The company's budget for the same period, ending on July 31, 2008. [This answer is incorrect. In this presentation, none of the budget information relates to the future. Therefore, it is not considered a prospective presentation under the AICPA *Guide for Prospective Financial Information*. Greyson should treat it as supplemental historical information.]
 - b. The company's budget for the year, ending on December 31, 2008. [This answer is correct. The budget includes information for the future. Since it is labeled as a budget, the budget doesn't extend past the end of the current fiscal year, and the budget is presented with interim historical financial statements for the current year, Greyson will qualify for the exemption. He will not be required to apply any procedures to the budget and summaries of significant assumptions and accounting policies are not required to be disclosed.]**
 - c. The company's future budget, ending on July 31, 2009. [This answer is incorrect. Because this presentation extends beyond the end of Whammy's fiscal year (December 31, 2008), Greyson would not qualify for the special budget exemption with this presentation.]

TYPES OF PROSPECTIVE FINANCIAL PRESENTATIONS: COMPILATION ENGAGEMENTS

Definition

The lowest level of service that an accountant can perform on prospective financial presentations intended for third parties is a compilation. However, the compilation procedures are not SSARS No. 1 (AR 100) procedures, as the prospective standard establishes unique compilation procedures for prospective information. This section discusses the primary procedures and reporting requirements of a compilation engagement.

AT 301.12 defines a compilation service as involving the following broad procedures:

- a. Assembling, to the extent necessary, the prospective financial information based on the responsible party's assumptions.
- b. Performing the required compilation procedures, including reading the prospective financial statements with their summaries of significant assumptions and accounting policies, and considering whether the prospective financial statements appear to be (1) presented in conformity with AICPA guidelines and (2) not obviously inappropriate.
- c. Issuing a compilation report.

The compilation procedures are not performed for the purpose of providing any assurance on the presentation or the underlying assumptions. They are performed to decide if there are any obvious matters that should be followed up on or that might cause the accountant to withdraw from the engagement.

Partial Presentations. An accountant also may be engaged to compile a partial presentation of forecasted or projected results. Such presentations generally are appropriate only for internal or limited third party use.

Disclosures about Periods beyond the Forecast Period. When reading a financial forecast for conformity with AICPA presentation guidelines, the AICPA guide states that accountants also should consider whether disclosures about periods beyond the forecast period are needed and, if so, whether they are made. The accountants' consideration is based on information they obtain during the course of the compilation engagement about the responsible party's existing plans and knowledge of future events and circumstances. The AICPA guide clarifies that accountants are not (a) required to design specific procedures to identify conditions and events that might occur beyond the forecast period and (b) responsible for predicting future events, circumstances, or the responsible party's plans. Further, the accountant's report does not provide assurance that all such matters might occur for any time following the period reported on have been disclosed.

Summary of Significant Assumptions

The AICPA guide prohibits the accountant from compiling any prospective financial statement that excludes the summary of significant assumptions (including identification of sensitive assumptions). Also, the accountant cannot compile a financial *projection* that excludes—

- a. an identification of the hypothetical assumptions, or
- b. a description of the limitations on the usefulness of the presentation.

Performance Standards

The AICPA guide obligates the accountant to adhere to the following performance standards.

Training and Proficiency. The accountant—

- a. should be familiar with the guidelines for the preparation and presentation of a financial forecast and

- b. should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable the accountant to compile a financial forecast that is in an appropriate form for an entity operating in that industry.

Planning. To compile the prospective financial statements of an *existing entity*, the accountant should obtain a general knowledge of—

- a. the nature of the entity's business transactions, and
- b. the key factors upon which its future financial results appear to depend.

Also, the accountant should understand the accounting principles and practices of the entity to determine if such principles are comparable to those used within the industry in which the entity operates.

To compile the prospective financial statements of a proposed entity, the accountant should obtain knowledge of the proposed operations and the key factors upon which its future results appear to depend and that have affected the performance of entities in the same industry.

Detailed Procedures. When performing a compilation of prospective financial statements, the accountant should apply certain procedures, such as those listed in the AICPA guide.

Workpapers for Compilation Engagements

Paragraph 12.12 of the AICPA guide states that, in a compilation of prospective financial statements, the practitioner should ordinarily prepare workpapers indicating that —

- the work was adequately planned and supervised, and
- the required compilation procedures were performed as a basis for the compilation report.

SSAE No. 10 (AT 301) contains the following additional documentation requirements for compilations of prospective financial information:

- The engagement understanding, including the nature of the engagement, the responsible party's responsibilities, the practitioner's responsibilities, and limitations of the engagement. (AT 301.69, paragraph 5.a.)
- Signed representations. (AT 301.69, paragraph 5.i.)

A checklist that is signed off indicating the steps were completed can serve to document the items mentioned in paragraph 12.12 of the AICPA guide. Supplementing the checklist with documentation of the engagement understanding and the signed representations might technically meet the AICPA documentation requirements.

The additional documentation requirements described for attestation engagements in SSAE No. 11 are believed useful for describing an ideal for documentation of compilation engagements on prospective financial information. Accordingly, practitioners should consider documenting the following in a compilation engagement on prospective financial information:

- The nature, timing, and extent of procedures applied.
- The results of the procedures applied.
- The information obtained.
- The engagement team member who performed the work.
- The engagement team member who reviewed the work.

At a minimum, it is recommended that content of compilation workpapers consist of the following:

- a. An engagement acceptance form.
- b. An engagement letter.
- c. Documentation of knowledge about the client, industry, and key factors.
- d. A checklist that covers procedure and reporting requirements.
- e. A copy of the prospective presentation and related computation worksheets.
- f. A list of significant assumptions and accounting policies.
- g. A presentation and disclosure checklist.
- h. A written representation letter.
- i. A technical reviewer checklist.
- j. Documentation of any unusual matters encountered and additional information about assumptions or representations considered necessary, or reasons for withdrawal. (This documentation should include the justification for any departure from a presumptively mandatory requirement and a description of how the practitioner achieved the requirement's objectives.)
- k. Copies of accountants' report, prospective financial statements compiled, any drafts reviewed with the client, and related worksheets.

Engagement Letter. The AICPA guide states that accountants should establish an understanding with their client regarding the services to be performed in each forecast and projection engagement. Furthermore, the AICPA guide states that accountants should document that understanding in the workpapers, preferably in the engagement letter. Therefore, as with compilations of historical financial statements, the use of engagement letters for engagements to compile prospective financial information is encouraged.

In several respects, the engagement letters for a compilation of prospective information illustrated in the AICPA guide differ from the SSARS No. 1 (AR 100) engagement letters for compilations of historical statements. The unique features of engagement letters for compilations of prospective information are as follows:

- a. A definition of the type of prospective financial information being compiled: a forecast or a projection.
- b. A statement concerning management's responsibility for representations about the prospective financial information and its responsibility to supply a representation letter. Also included is a statement that the engagement will not be completed and a report will not be issued if management does not furnish appropriate assumptions.
- c. A statement that actual results may vary from prospective results.
- d. A statement that the accountant has no responsibility to update his report.
- e. A statement of conditions should management reproduce or publish the prospective information and the accountant's report.

Knowledge about the Client, Industry, and Key Factors. For SSARS engagements, it is recommended that the accountant complete a worksheet documenting his understanding of the client's industry and business. Key factors on which future financial results depend can be included. The authoritative literature does not require documentation of this knowledge, but it is recommended that the form be completed on engagements to compile prospective financial statements. Examples can be found in *PPC's Guide to Compilation and Review*.

Compilation Checklists. A compilation checklist that covers procedural and reporting considerations, and a presentation checklist for compilation engagements can be completed expeditiously and provide both documentation and quality control over the service. Examples can be found in *PPC's Guide to Compilation and Review*.

Copy of Prospective Presentation and Related Worksheets. These would be similar to the trial balance and preparation worksheets now common for a compilation or a review of historical financial statements. The important point to emphasize is that these workpapers should document the work performed, but they can be informal. Also, the use of elaborate or time-consuming workpaper indexes or cross-references on these engagements is not recommended by this course.

List of Significant Assumptions. The list of significant assumptions does not need to be an elaborate workpaper. If a computer spreadsheet is used, the significant assumptions are normally identified on the printout. If the computations were made manually, consider using tickmarks to identify significant assumptions used in the computations.

Representation Letter. A client representation letter is *not* optional for a compilation of prospective financial statements as it is for a SSARS compilation. The AICPA guide illustrates a letter that includes the responsible party's representation of what the prospective financial statements represent, i.e., a forecast or a projection. The representation letter should be supplemented to include any additional matters pertinent to a specific engagement. Examples can be found in *PPC's Guide to Compilation and Review*.

When to Withdraw from a Compilation Engagement

The guide identifies several situations when an accountant should consider withdrawing from a compilation engagement on prospective financial statements. Those situations are summarized as follows:

- a. The summary of significant assumptions (including identification of sensitive assumptions) is omitted. Since the summary of significant assumptions is integral to the understanding of prospective information, an accountant should not be associated with the prospective financial statements if it is omitted.
- b. Assumptions or management representations appear inappropriate. The AICPA guide states that the accountant should withdraw from a compilation engagement if the accountant does not receive revised information that would correct the apparently inappropriate, incomplete, or otherwise misleading assumptions or representations.
- c. Assumptions (other than hypothetical assumptions) are so subjective that they are not susceptible to reasonably consistent estimation or measurement.
- d. The accountant believes that a presentation deficiency or omitted disclosure was undertaken with the intent to mislead.
- e. The hypothetical assumptions in a compiled projection are not identified, or disclosure of any hypothetical assumptions that are improbable is not made.
- f. A compiled projection does not describe the limitations on the usefulness of the presentation.
- g. The presentation is inappropriate for the intended use. A partial presentation and a financial projection should not be used in a general offering of debt or equity. The accountant should not be associated with such information if he believes it will be used for such a purpose.
- h. Management refuses to provide additional or revised information to correct or explain a material inconsistency between other information and prospective financial information.
- i. The forecast or projection covers an inappropriate period.
- j. The forecast or projection is prepared using a biased range.

- k. The accountant believes disclosures about periods beyond the forecast period are obviously inappropriate, incomplete, or otherwise misleading, or are not presented in conformity with the presentation guidelines in the AICPA guide, and the client refuses to revise such disclosures.

Compilation Reports—Basic Ingredients

As prescribed by AT 301.18–.23, the accountant's standard report on a compilation of prospective financial statements should contain the following elements:

- a. An identification of the prospective financial statements presented by the responsible party.
- b. A statement that the accountant has compiled the prospective financial statements in accordance with attestation standards established by the AICPA.
- c. A statement that a compilation is limited in scope and does not enable the accountant to express any form of assurance on the prospective financial statements or the assumptions.
- d. A caveat that the prospective results may not be achieved.
- e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- f. When the presentation is a projection, the report should include (1) a statement describing the special purpose for which the projection was prepared, and (2) a separate paragraph restricting the use of the presentation solely for the specified parties.
- g. When the prospective financial statements contain a range, the report should also include a separate paragraph that states that the client has elected to portray the expected results of one or more assumptions as a range.
- h. The manual or printed signature of the accountant's firm.
- i. The date of the compilation report, which should be the date of the accountant's completion of the compilation procedures. (The compilation procedures are complete when the accountant has read the presentation and considered, after applying all other necessary procedures, whether there are any assumptions or representations that appear obviously inappropriate, incomplete, or misleading, and has followed up if necessary.)
- j. If the accountants are not independent, a statement that they are not.
- k. A description of any deficiencies in the presentation (other than those related to the assumptions).

In addition, each page of the prospective presentation should include the reference: "See accompanying summary of significant assumptions and accounting policies." Although the AICPA guide does not require that the accountant's report be referenced on each page of the presentation, including such a reference is recommended.

Modifications of the Standard Compilation Report

The AICPA guide allows the accountant to compile a financial forecast or projection that contains presentation deficiencies or that omits disclosures other than those relating to significant assumptions, provided that the deficiency or omission is not, to his knowledge, undertaken with the intention to mislead. The standard states that the accountant should disclose the deficiency or omission in his report. Other reasons for a departure from the standard report include the accountant's nonindependence or desire to emphasize a matter.

Omission of Significant Assumptions Not Allowed. The accountant cannot compile a prospective financial statement that excludes significant assumptions. An accountant should withdraw from a compilation engagement if significant assumptions are omitted.

Summary of Significant Accounting Policies Omitted. In a compilation engagement, management might elect to omit the summary of significant accounting policies from the prospective financial statements. In such a case, an additional paragraph should be added to the report disclosing the omission. The AICPA guide, paragraph 14.10, suggests a paragraph, such as the following:

Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast (projection) established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast (projection), they might influence the user's conclusions about the Company's financial position, results of operations, and cash flows for the forecast (projection) period. Accordingly, this forecast (projection) is not designed for those who are not informed about such matters.

Disclosure requirements for prospective information differ from those for historical statements. With the exception of significant accounting policies, disclosures required by GAAP need not be made in prospective presentations.

Presentation Deficiencies. An accountant may compile prospective financial statements that contain presentation deficiencies as long as the deficiency does not relate to inappropriate, incomplete, or otherwise misleading assumptions. The deficiency or omission should be clearly indicated in this report, and the omission should not be undertaken to mislead. Presentation deficiencies include (a) unclear labeling of the statements as "forecasts" or "projections," (b) omission of the presentation description preceding the summary of assumptions that indicates, for example, that the list of assumptions is not all-inclusive and what the responsible party intends to present, and (c) nondisclosure of the preparation date.

Report When the Presentation Contains a Measurement Departure. The literature on prospective financial statements addresses reporting when there is a presentation deficiency; however, the literature does not address reporting when the prospective presentation contains a measurement departure, other than unreasonable assumptions. Examples of such situations might include a failure (perhaps because of the time and cost of making the computations) to capitalize leases, to provide deferred taxes, or to adjust a deferred tax liability for reversals of significant temporary differences. The accountant can consider the following in evaluating prospective financial statements containing measurement departures.

- a. Does the departure appear to have a material effect on the presentation? The standard states that the concept of materiality applies to prospective information, as it does to historical statements. (That is, materiality is a concept that is judged in light of the expected range of reasonableness of the information; users do not expect prospective financial statements to be as precise as historical financial statements.) If the accountant believes that the deficiency is not material, he would not need to concern himself any further.
- b. If the prospective presentation is in the form of summarized financial statements or the minimum required items, is the departure merely a classification matter that does not affect the amount of the items presented? As long as the amount is properly estimated and the misclassification does not impact the summarized information, the accountant would not treat the misclassification as a departure.
- c. If the accountant concludes that the effect of the departure is material and management refuses to correct the problem, the accountant should modify his report.
- d. In some cases, a possible alternative might be to omit the item or items affected by the departure and report on the presentation as a partial presentation. However, the practitioner should consider whether a partial presentation would be appropriate in the circumstances.

Reporting on a Financial Forecast That Includes Disclosures about Periods beyond the Forecast Period

Accountants may be engaged to compile a financial forecast supplemented by a partial presentation of disclosures about plans, events, and circumstances expected to occur in periods beyond the forecast period. Because the partial presentation is included in the notes to the financial forecast, the AICPA guide indicates that it is covered by the accountant's standard compilation report. However, accountants should consider whether (a) the disclosures are consistent with the responsible party's existing plans and knowledge of future events and circumstances, and (b) the disclosures are presented in conformity with the guidelines in the AICPA guide.

If the accountants conclude, on the basis of known facts, that such disclosures are obviously inappropriate, incomplete, or otherwise misleading given their purpose, or that the disclosures are not presented in conformity with the presentation guidelines in the AICPA guide, they should discuss the matter with the responsible party and propose appropriate revision of the disclosures. If the responsible party will not agree to revise the disclosures, accountants should either modify their compilation report on the financial forecast or withdraw from the engagement.

Report When the Compilation Engagement Includes Other Services

While performing a compilation, an accountant may assist management in identifying assumptions, gathering information, or assembling the prospective financial information. In such circumstances, the accountant's report should not characterize the engagement as including preparation of the prospective financial information. The reason is that management is responsible for preparation and presentation of prospective information even if the company receives assistance from the accountant.

Compilation Report When OCBOA Is Not Disclosed

If the prospective information is based on an OCBOA that is not disclosed in the presentation, the accountant should include the disclosure in his report. Such a situation would most likely occur if the summary of significant accounting policies were omitted.

Compilation Report When Accountant Is Not Independent

The AICPA guide allows a nonindependent accountant to render a compilation report on a financial forecast or projection. However, he must disclose the lack of independence by the addition of the statement, "We are not independent with respect to XYZ Company," after the last paragraph of the report. The reason for the accountant's lack of independence should not be described.

Emphasis of a Matter in a Compilation Report

The accountant may emphasize a matter in a separate paragraph of his compilation report. However, he should not emphasize the matter in a way that would imply he is expressing assurance or assuming additional responsibility.

SELF-STUDY QUIZ

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

23. Which statement best describes a compilation engagement on prospective financial information?
- a. The compilation procedures are the same as those in SSARS No. 1.
 - b. The accountant reads the prospective statements for conformity with GAAP.
 - c. Partial presentations are not allowed in a compilation engagement.
 - d. Compilation procedures do not provide assurance on the presentation.
24. How does relevant authoritative literature affect compilations of prospective financial statements?
- a. Workpapers must be prepared to indicate the work was planned and supervised adequately.
 - b. A checklist that is signed off when steps are completed must be used for documentation.
25. What should accountants consider documenting when performing a compilation engagement on prospective financial information?
- a. The nature, timing, and extent of procedures applied.
 - b. That the prospective financial statements have been labeled a "budget."
 - c. A preliminary draft of the report.
26. Engagement letters for a compilation of prospective information differ from those discussed in SSARS No. 1 for compilations of historical statements. Which of the following is a unique feature of an engagement letter for a forecast or projection?
- a. A statement that the compilation is of prospective financial information.
 - b. A statement that the accountant is responsible for the prospective financial information.
 - c. A statement that actual results and prospective results may vary.
 - d. A statement that the accountant will update the report, as needed.
27. Blake is engaged to perform a compilation on MegaCo's forecasted financial statements. During the engagement, Blake discovers that the summary of significant accounting policies was omitted. After investigating, Blake determines that MegaCo's management did not make the omissions in attempt to mislead. What type of compilation report can Blake submit for MegaCo in this engagement?
- a. A standard compilation report as prescribed by AT 301.
 - b. A modified compilation report with a paragraph to address the omission.
 - c. Blake cannot submit a report, so he must withdraw from the engagement.

SELF-STUDY ANSWERS

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

23. Which statement best describes a compilation engagement on prospective financial information? **(Page 244)**
- a. The compilation procedures are the same as those in SSARS No. 1. [This answer is incorrect. The compilation procedures for prospective financial statements are *not* the same as those in SSARS No. 1. The prospective standard establishes unique compilation procedures for prospective information.]
 - b. The accountant reads the prospective statements for conformity with GAAP. [This answer is incorrect. Required compilation procedures for prospective financial information include reading the prospective financial statements with their summaries of significant assumptions and accounting policies, and considering whether the prospective financial statements appear to be (1) presented in conformity with AICPA guidelines (not GAAP) and (2) not obviously inappropriate.]
 - c. Partial presentations are not allowed in a compilation engagement. [This answer is incorrect. An accountant may be engaged to compile a partial presentation of forecasted or projected results. Such presentations generally are appropriate only for internal or limited third party use.]
 - d. **Compilation procedures do not provide assurance on the presentation. [This answer is correct. Compilation procedures are not performed for the purpose of providing any assurance on the presentation or the underlying assumptions. They are performed to decide if there are any obvious matters that should be followed upon or that might cause the accountant to withdraw from the engagement.]**
24. How does relevant authoritative literature affect compilations of prospective financial statements? **(Page 245)**
- a. **Workpapers must be prepared to indicate the work was planned and supervised adequately. [This answer is correct. This must be done according to the AICPA guide. The guide also says that the workpapers must indicate that the required compilation procedures were performed as a basis for the compilation report.]**
 - b. A checklist that is signed off when steps are completed must be used for documentation. [This answer is incorrect. This is a possibility for documenting the items mentioned in the AICPA guide, but not a requirement. If this type of checklist is used, it can be supplemented with documentation of the engagement understanding and the signed representations.]
25. What should accountants consider documenting when performing a compilation engagement on prospective financial information? **(Page 245)**
- a. **The nature, timing, and extent of procedures applied. [This answer is correct. Other information that the accountant should consider documenting includes results of the procedures applied, information obtained, and the engagement team members that performed the work or reviewed the work.]**
 - b. That the prospective financial statements have been labeled a "budget." [This answer is incorrect. This is important when determining if the special exemption for budgets is met. It is not pertinent to a compilation engagement.]
 - c. A preliminary draft of the report. [This answer is incorrect. This is not part of the recommended documentation for a compilation engagement. Prospective financial statements submitted marked as "draft" can be issued without a final report, but only if the accountant plans to issue a final report.]

26. Engagement letters for a compilation of prospective information differ from those discussed in SSARS No. 1 for compilations of historical statements. Which of the following is a unique feature of an engagement letter for a forecast or projection? **(Page 246)**
- a. A statement that the compilation is of prospective financial information. [This answer is incorrect. Instead, the engagement letter should include a definition of the type of prospective financial information being compiled: a forecast or a projection.]
 - b. A statement that the accountant is responsible for the prospective financial information. [This answer is incorrect. The statement should be about *management's* responsibility for representations about the prospective financial information and its responsibility to supply a representation letter. Also included is a statement that the engagement will not be completed and a report will not be issued if management does not furnish appropriate assumptions.]
 - c. **A statement that actual results and prospective results may vary. [This answer is correct. This statement should be included in an engagement letter for a forecast or projection. Another item that should be included, according to the AICPA guide, is a statement of conditions should management reproduce or publish the prospective information and the accountant's report.]**
 - d. A statement that the accountant will update the report, as needed. [This answer is incorrect. The engagement letter for a forecast or projection should include a statement that the accountant has *no* responsibility to update his report.]
27. Blake is engaged to perform a compilation on MegaCo's forecasted financial statements. During the engagement, Blake discovers that the summary of significant accounting policies was omitted. After investigating, Blake determines that MegaCo's management did not make the omissions in attempt to mislead. What type of compilation report can Blake submit for MegaCo in this engagement? **(Page 249)**
- a. A standard compilation report as prescribed by AT 301. [This answer is incorrect. Because MegaCo omitted the summary of significant accounting policies, Blake cannot submit a standard compilation report in this scenario. This presentation deficiency must be addressed according to the AICPA guide.]
 - b. **A modified compilation report with a paragraph to address the omission. [This answer is correct. Under the AICPA guide, Blake is allowed to compile a financial forecast or projection that contains presentation deficiencies or that omits disclosures other than those relating to significant assumptions, provided that the deficiency or mission is not, to Blake's knowledge, undertaken with the intent to mislead. In this scenario, the AICPA guide suggests that Blake modify the standard compilation report with an additional paragraph that discloses the omission.]**
 - c. Blake cannot submit a report, so he must withdraw from the engagement. [This answer is incorrect. If MegaCo had omitted the significant assumptions, Blake could not compile the statements and would have to withdraw from the engagement; however, that is not the case if the summary of significant accounting policies is omitted.]

TYPES OF PROSPECTIVE FINANCIAL PRESENTATIONS: AGREED-UPON PROCEDURES

Since the AICPA guide does *not* permit a review engagement, the accountant may have situations when an agreed-upon procedures engagement is needed. An agreed-upon procedures engagement is one in which an accountant is engaged by a client to perform specific procedures and report findings. The accountant does not perform an examination or provide an opinion. Rather, the accountant reports only procedures and findings. In an engagement to apply agreed-upon procedures to prospective financial statements, the accountant performs whatever procedures the users of the prospective statements specify. It is a flexible form of engagement; the procedures may be as extensive or cursory as the specified parties want, but should include more than a mere reading of the prospective financial statements. The service may be lower than a compilation, between a compilation and an examination, or as high as an examination.

Guidance for applying agreed-upon procedures to prospective financial statements is included in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, as amended, in the following sections:

- AT 301, *Financial Forecasts and Projections*.
- AT 201, *Agreed-Upon Procedures Engagements*.

Those sections of the attestation standards provide guidance on the following:

- a. The nature of an agreed-upon procedures engagement and the applicable attestation standards.
- b. Conditions necessary for performing an agreed-upon procedures engagement.
- c. The nature, timing, and extent of procedures performed in an agreed-upon procedures engagement.
- d. Involvement of internal auditors and others in an agreed-upon procedures engagement.
- e. Responsibilities of the accountant.
- f. Responsibilities of the specified parties.
- g. Reporting in an agreed-upon procedures engagement.

A detailed discussion of engagements to apply agreed-upon procedures to prospective financial statements is beyond the scope of this course.

TYPES OF PROSPECTIVE FINANCIAL PRESENTATIONS: PARTIAL PRESENTATIONS

Definition

A partial presentation omits one or more of the minimum financial statement elements listed in the “Presentation Formats—Complete or Partial” paragraph in Lesson 1 (unless the omitted item is derivable from the information presented). Omission of one or more of the required *disclosures* in that same paragraph, however, results in a deficient presentation that requires either withdrawal or report modification. Omitting an element that does not apply (for example, because the element would not be presented in historical financial statements using the same basis) does not result in a partial presentation.

When Are They Appropriate?

The AICPA guide states that a partial presentation ordinarily is not appropriate for general use. (It may, however, be used to disclose information about periods beyond the forecast period.) It is appropriate for internal use or limited

third party use. The presentation should be restricted for use by specified parties who have the opportunity to ask questions of and negotiate directly with the responsible party. In addition, a partial presentation should not be used if it does not adequately present the information, given the special purpose of the presentation. Partial presentations are commonly used in tax planning, lease or buy analyses, budgeting operations, or to present only key elements of operations (e.g., sales or expenses).

Partials may be based on either forecasted or projected information and may be prepared using either GAAP or an OCBOA. Accountants should follow the guidance in AT 301 if they are compiling, examining, or applying agreed-upon procedures to a partial presentation. A detailed discussion of partial presentations is beyond the scope of this course.

MISCELLANEOUS MATTERS RELATED TO PROSPECTIVE FINANCIAL PRESENTATIONS

Preliminary Drafts

The AICPA guide permits an accountant to submit prospective financial statements that are clearly marked “draft” without issuing a report. However, a draft should not be issued unless the accountant intends to issue a final report. (The only exception to this is a plain paper engagement.) This guidance is consistent with Interpretation No. 17 of SSARS No. 1.

Prospective Information Presented along with Historical Financial Statements

In discussing prospective financial statements that are presented in the same document as compiled, reviewed, or audited historical financial statements, the AICPA guide defines the accountant’s responsibility according to the type of document submitted. There are two types of documents:

- a. Accountant-submitted documents, e.g., a presentation that is typically bound in the CPA’s report cover.
- b. Client-prepared documents, e.g., an annual report similar in appearance to the annual report submitted to stockholders by General Motors or IBM.

Accountant-submitted Documents. If the accountant’s compilation, review, or audit report on the historical financial statements is presented in the same document as prospective financial statements, the accountant should examine, compile, or apply agreed-upon procedures to the prospective information. Of course, if the accountant-submitted document is not designed for third party use, the CPA could follow the special rules discussed in the plain paper engagement section for written communications or report on the prospective information as an assembly engagement.

SSARS No. 1 permits accountants to submit management-use-only historical financial statements without issuing a compilation report if certain conditions are met. Instead, accountants are required to make certain communications in an engagement letter to management. If accountants issue an engagement letter in lieu of a compilation report, they would not be associated with the historical presentation and could, therefore, follow the rules for plain paper engagements. (Note, however, that the historical statements would be required to contain a legend restricting the use of the statements to management.)

The AICPA guide provides an important exception to the rules for accountant-submitted documents discussed above. If the prospective financial information is labeled as a “budget,” does not extend beyond the current fiscal year, and is presented along with interim historical statements for the current year, accountants are not required to apply any procedures to the budget. However, they should report on it and indicate—

- a. that they did not examine or compile the budget, and
- b. that they disclaim an opinion or any other form of assurance on the budget.

This exception was discussed earlier in this lesson.

Client-prepared Documents. According to the AICPA guide, if the accountant's compilation, review, or audit report on historical financial statements is presented with prospective financial statements in a client-prepared document, the accountant has the following options:

- a. Compile, examine, or apply agreed-upon procedures to the prospective financial statements.
- b. Assume no responsibility for the prospective financial statements, if the client indicates in the document that the CPA has no responsibility for the statements.
- c. Assume no responsibility for the prospective financial statements, if another accountant has examined, compiled, or applied agreed-upon procedures to the prospective statements, and his report is included in the document.

Subjective Assumptions with No Reasonably Objective Basis

The accountant should not accept or complete any engagement (plain paper, assembly, compilation, agreed-upon procedures, or examination) that is based on an assumption that is so subjective that there is no reasonably objective basis. Thus, before accepting any engagement, the accountant is obligated to consider whether the responsible party has a reasonably objective basis to present a forecast and whether management has selected reasonable assumptions for a forecast. The AICPA guide provides practical guidance on how to determine whether a responsible party has a reasonably objective basis for presenting a forecast. Basically, however, judgment about whether a reasonably objective basis exists hinges on whether sufficiently objective assumptions can be developed for each key factor. Exhibit 2-1 lists some factors to be considered when determining whether there is a reasonably objective basis. In making this determination, the accountant is not required to obtain or review documentation supporting the assumptions; rather, he should consider whether it would be possible to obtain appropriate documentation to support the assumptions.

Exhibit 2-1

Sufficiently Objective Assumptions—Matters to Consider

Basis	Less Objective	More Objective
Economy	Subject to uncertainty	Relatively stable
Industry	Emerging or unstable; high rate of business failure	Mature or relatively stable
Entity:		
• Operating history	Little or no operating history	Seasoned company; relatively stable operating history
• Customer base	Diverse, changing customer group	Relatively stable customer group
• Financial condition	Weak financial position; poor operating results	Strong financial position; good operating results
Management's experience with:		
• Industry	Inexperienced management	Experienced management
• The business and its products	Inexperienced management; high turnover of key personnel	Experienced management
Products or services:		
• Market	New or uncertain market	Existing or relatively stable market
• Technology	Rapidly changing technology	Relatively stable technology

Basis	Less Objective	More Objective
• Experience	New products or expanding product line	Relatively stable products
Competing assumptions	Wide range of possible outcomes	Relatively narrow range of possible outcomes
Dependency of assumptions on the outcome of the forecasted results ^a	More dependency	Less dependency

Note:

- ^a Assumptions may depend on the achievement of other forecasted results. For example, the sales price of a real estate property in a forecast might be estimated by applying a capitalization rate to forecasted cash flows.

* * *

An example of a forecast that could not be compiled is as follows: A \$10 million genetic engineering limited partnership is being offered, and the presentation in the offering document includes a forecast showing \$20 million in income resulting exclusively from assumptions about the sale of patents yet to be developed. In this situation, there is no reasonably objective basis for the income assumption.

In some situations, the engagement may be changed to enable the accountant to be associated with the presentation. If the presentation is not for general use, i.e., not for general third party distribution, the subjective assumption could be stated as a hypothetical assumption and a projection could be presented. Another possible solution might be to present a partial presentation that excludes the projection or forecast of the subjective assumption.

Other Information

According to the AICPA guide, if the accountant has compiled prospective financial statements that are presented with other information in a client-prepared document, in addition to historical financial statements, he should consider whether such information, or the manner of its presentation, is materially inconsistent with the prospective financial statements. If material inconsistencies are identified, the accountant should obtain additional or revised information. If such information is not revised by management, the accountant should withhold the use of his report or withdraw from the engagement.

If, while reading other information as discussed above, the accountant becomes aware of information that he believes is a material misstatement of fact, he should discuss the matter with management. If the apparent misstatement is not resolved, the accountant should consult with his legal counsel to determine an appropriate course of action.

The discussion of "Other Information" applies to compilation engagements. This discussion should also be applied to assembly and agreed-upon procedures engagements.

Circular 230 Engagements

U.S. Treasury Department Circular 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers Before the Internal Revenue Service*, sets forth requirements for tax opinions for tax shelter offerings.

Practitioners involved with tax opinions should read the requirements of Circular 230. Circular 230 is presented in Appendix C of the AICPA *Guide for Prospective Financial Information*. However, practitioners should also be alert for amendments and revisions to Circular 230 and should monitor developments at www.irs.gov.

A practitioner's services on a forecast included in a tax shelter offering may be deemed to be a *covered opinion*. A *covered opinion* is written advice by a practitioner concerning one or more Federal tax issues arising from

transactions, the principal purpose of which is tax avoidance, or transactions that have a significant purpose of tax avoidance. (Because tax shelter offerings are general-use documents, it would be inappropriate to use a projection in such an offering unless it supplemented a forecast for the same period.)

Circular 230 requires that covered opinions provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits of each significant Federal tax issue covered in the opinion. The opinion must also contain the practitioner's overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment. The reasons for that conclusion must also be provided. Finally, if the practitioner is unable to reach an overall conclusion, the opinion must state this and describe the reasons for the inability to reach a conclusion.

The standard compilation procedures do not include the analytical procedures that would be necessary for practitioners to provide that type of opinion. Thus, practitioners would either have to rely on another professional's opinion or substantially supplement their compilation procedures to provide a Circular 230 opinion.

If another professional has provided a Circular 230 opinion, the compiling practitioners should read the opinion to see if it appears to comply with the requirements of Circular 230. The tax opinion needs no further work if the other professional's opinion appears to comply with Circular 230, and there is no reason to believe that the other professional did not comply with the circular.

If the other professional's opinion does not cover all the matters required by Circular 230, the compiling practitioners should request that the client have the other professional expand the opinion to cover the omitted items. Failing that, the practitioners are required by the circular to render their own opinion on the omitted items, which would require an expansion of their compilation procedures. If the practitioners believe that the tax assumptions are obviously inappropriate, incomplete, or otherwise misleading and the practitioners are unable to have the matter corrected, they should withdraw from the compilation engagement.

When compiling practitioners rely on the tax opinion of another professional in a tax shelter forecast, they may find it advisable to state explicitly that their report is not intended to be a tax opinion under Circular 230. Such a reference is not required by either the IRS or the AICPA, but some practitioners believe it clarifies the extent of the practitioners' service to users. (Some practitioners believe, however, that such a statement is not effective in disclaiming responsibility for the tax opinion.) If such a statement is included in a compilation report, it should be made in an emphasis of a matter paragraph, such as the following:

The Company's tax counsel, Jones and Smith, has provided an opinion on the tax assumptions on material tax issues as required by Treasury Department Circular 230. Their report, which appears on pages xx-yy of the offering document, states that, in their opinion, [State tax counsel's opinion here]. The inclusion of that reference to the opinion of counsel shall not be construed, under the provisions of Circular 230, to be the rendering of a "tax shelter opinion" by us as to the material tax issues covered by such opinion.

If practitioners provide a Circular 230 opinion, they may present it as a separate report or include it in the compilation report. Although the AICPA guide prohibits a compilation report from expressing any form of assurance, footnote 8 at Paragraph 14.07 of the AICPA guide states that, "the practitioner may provide [in his compilation report] assurance on tax matters in order to comply with the requirements of regulations governing practice before the Internal Revenue Service contained in 31 CFR pt. 10 (Treasury Department Circular 230)." That exception is permitted because it would be pointless to prohibit practitioners from stating in one report what they could state in two reports on the same document.

SELF-STUDY QUIZ

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

28. What piece of authoritative literature should an accountant turn to for guidance on applying agreed-upon procedures to prospective financial statements?
- a. SSAE No. 10, *Attestation Standards: Revision and Recodification*.
 - b. SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*.
 - c. SOP 92-2, *Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements*.
29. Which of the following statements best describes partial presentations?
- a. They are only appropriate for internal use.
 - b. They are commonly used in tax planning.
 - c. They must be prepared using GAAP.
 - d. They are always a plain paper engagement.
30. Wireless Enterprises (WE) is offering a \$20 million limited partnership. The presentation in the offering document includes a forecast that shows \$50 million in income. The income results exclusively from assumptions about patents for new computer technology that has yet to be developed. WE asks Sam, a CPA, to perform assembly services on the prospective financial information. Should he accept this engagement?
- a. Yes.
 - b. No.

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.)**

28. What piece of authoritative literature should an accountant turn to for guidance on applying agreed-upon procedures to prospective financial statements? **(Page 254)**
- a. **SSAE No. 10, *Attestation Standards: Revision and Recodification*. [This answer is correct. The guidance for applying agreed-upon procedures on prospective financial information is found at AT 201, *Agreed-Upon Procedures Engagements*, AT 301, *Financial Forecasts and Projections*.]**
 - b. SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. [This answer is incorrect. This standard clarifies the meaning of certain terms used in SSAEs and defines the terminology that the ASB will use to describe the degrees of responsibility that the professional requirements impose on practitioners.]
 - c. SOP 92-2, *Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements*. [This answer is incorrect. This SOP does several things, including providing guidance for accountants when considering whether a responsible party has a reasonably objective basis to present a forecast.]
29. Which of the following statements best describes partial presentations? **(Page 254)**
- a. They are only appropriate for internal use. [This answer is incorrect. They are appropriate for both internal and limited third-party use. Under certain limited circumstances, they can be part of a general use presentation, as well.]
 - b. **They are commonly used in tax planning. [This answer is correct. Other common uses of partial presentations are lease or buy analyses, budgeting operations, or to present only key elements of operations (e.g., sales or expenses).]**
 - c. They must be prepared using GAAP [This answer is incorrect. Partial presentations may be based on either forecasted or projected information and may be prepared using either GAAP or an OCBOA.]
 - d. They are always a plain paper engagement. [This answer is incorrect. The AICPA guide permits an accountant to provide plain paper services in connection with partial presentations of prospective financial information. However, partial presentations are not always a plain paper engagement.]
30. Wireless Enterprises (WE) is offering a \$20 million limited partnership. The presentation in the offering document includes a forecast that shows \$50 million in income. The income results exclusively from assumptions about patents for new computer technology that has yet to be developed. WE asks Sam, a CPA, to perform assembly services on the prospective financial information. Should he accept this engagement? **(Page 256)**
- a. Yes. [This answer is incorrect. An accountant should not accept or complete any engagement (plain paper, assembly, compilation, agreed-upon procedures, or examination) that is based on an assumption that is so subjective that there is no reasonably objective basis. Basically, judgment about whether a reasonably objective basis exists hinges on whether sufficiently objective assumptions can be developed for each key factor.]
 - b. **No. [This answer is correct. The prospective financial information used by WE has no reasonably objective basis for the income assumption; therefore, Sam should not accept this engagement. The AICPA guide provides practical guidance on how to determine whether a responsible party has a reasonably objective basis for presenting a forecast.]**

EXAMINATION FOR CPE CREDIT**Lesson 2 (CARTG093)**

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.

14. Which of the following titles would be used for a forecast presented on an other comprehensive basis of accounting (OCBOA)?
- a. FORECASTED BALANCE SHEET.
 - b. STATEMENT OF FORECASTED INCOME.
 - c. STATEMENT OF FORECASTED ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
 - d. PROJECTED RESULTS OF OPERATIONS IF A NEW PLAN IS CONSTRUCTED—INCOME TAX BASIS
15. Which of the following statements best describes the proper format for a forecast or projection, as described in the AICPA guide?
- a. The format of a forecast or projection must be distinctive from, not similar to, the historical financial statements.
 - b. Historical and prospective financial statement information cannot be combined.
 - c. The forecast or projection must be a complete presentation (i.e., not summarized or condensed).
 - d. Only items applicable to historical financial statements in the prospective period must be presented in the prospective financial statements.
16. Which of these presentations would be considered a partial presentation?
- a. A tax return projection in which significant changes in financial position are not included.
 - b. Historical financial statements presented alongside prospective financial statements.
 - c. A presentation in which an omitted item can be derived from the information presented.
 - d. Do not select this answer choice.
17. Lindsey, a CPA, is engaged to prepare a forecast for her client. List all of the following disclosures Lindsey should include in the summary of significant assumptions for this engagement.
- i. Disclosure of assumptions that are significant to the statement.
 - ii. Disclosure of the rationale for or basis of the assumptions.
 - iii. Identification of particularly sensitive assumptions.
 - iv. Identification of hypothetical assumptions.
 - v. Disclosure of assumptions related to anticipated conditions believed to differ significantly from current conditions.
 - vi. Disclosure of other matters considered important for the prospective financial information to be properly interpreted.

- a. ii., iv., and v.
 - b. i., iii., v., and vi.
 - c. i., ii., iii., v., and vi.
 - d. i., ii., iii., iv., v., and vi.
18. According to the AICPA guide, what is the minimum length of time a forecast or projection should cover normal operations to be meaningful to users?
- a. Six months.
 - b. One year.
 - c. Two years.
 - d. Five years.
19. Bob, a CPA, is engaged to perform a plain paper engagement on prospective financial information. He includes a transmittal letter with the prospective financial statements. The transmittal letter includes the name of Bob's accounting firm and the prospective financial statements involved, but it does not indicate Bob's conclusions, procedures, recommendations, or analysis with respect to the prospective information. How does this affect the status of his engagement as a plain paper engagement?
- a. The transmittal letter described above has no effect on the engagement, and Bob does not have to perform any additional procedures.
 - b. This associates Bob with the presentation, so he must include extra caveats in the prospective financial statements or the transmittal letter.
 - c. The existence of a transmittal letter associates Bob with the presentation, so instead of performing a plain paper engagement, he must perform a compilation.
 - d. Do not select this answer choice.
20. How do assembly services differ from plain paper engagements?
- a. The accountant describes the services in a report or discusses the prospective statements in writing.
 - b. The accountant must establish an understanding with the client, preferably in writing.
 - c. The prospective financial statements cannot be distributed to third parties or outside users.
 - d. Do not select this answer choice.
21. The AICPA guide provides a list of preferred items that should be included in an assembly report. Which of the items would only need to be included in the assembly report for a projection?
- a. Identification of prospective financial information.
 - b. A caveat about achievability of prospective financial results.
 - c. A description of limitations on the presentation's usefulness.
 - d. A report date (date the accountant's procedures were completed).

22. If an accountant is associated with an interim budget and historical presentation that meets the qualifications for the special budget exemption, which of the following is necessary?
- a. Performing compilation or examination procedures.
 - b. Performing agreed-upon procedures.
 - c. Compiling the historical interim financial statements.
 - d. A disclaimer of opinion or assurance on the budget.
23. What is the lowest level of service an accountant can perform on a prospective financial presentation, if that presentation is intended for third-party use?
- a. A plain paper engagement.
 - b. An assembly engagement.
 - c. A compilation engagement.
 - d. An examination engagement.
24. How does the AICPA guide suggest accountants deal with disclosures about periods beyond the forecast period in a compilation engagement?
- a. The accountant should consider if disclosures about periods beyond the forecast period are needed and, if so, if they were made.
 - b. The accountant should design procedures to identify events and conditions that might happen after the forecast period.
 - c. The accountant should take responsibility for predicting future events, circumstances, and the plans of the responsible party.
 - d. In the report, the accountant should provide assurance that all such matters have been disclosed that may occur any time following the period.
25. An accountant is prohibited by the AICPA guide from performing a compilation on forecasted financial statements if which of the following is excluded?
- a. Hypothetical assumptions.
 - b. A description of limitations on the presentation's usefulness.
 - c. The summary of significant assumptions.
 - d. Do not select this answer choice.
26. The practitioners in these scenarios have all been hired to perform compilations of their clients' prospective financial statements. In which case, has the accountant correctly dealt with a problem that arose during the engagement based on guidance in the AICPA guide?
- a. Alice discovers inappropriate management representations. Her client sends revised information to correct the problem, but Alice has no choice but to withdraw from the engagement.
 - b. Bryant's client omitted the summary of significant assumptions from the financial statements, but Bryant decides he can understand the information without it and continues the engagement.
 - c. Claire's client wants to use a partial presentation and a financial projection in a general offering of debt or equity and cannot be dissuaded, so Claire withdraws from the engagement.
 - d. Don believes disclosures about periods beyond the forecast period are very obviously inappropriate, but since this is management's responsibility he continues with the engagement.

27. Which of the following statements best describes the compilation report for a forecast or projection?
- a. If an accountant assists management with identification of assumptions, gathering information, or assembling prospective financial information, it must be mentioned in the report.
 - b. If the accountant is not independent from his client, that lack of independence must be described in the compilation report.
 - c. The accountant is not allowed to emphasize a matter in a separate paragraph of a compilation report on prospective financial statements, as it would imply he is expressing assurance.
 - d. Literature on prospective financial statements specifically prohibits reporting when prospective information contains a measurement departure.
28. What is required of an accountant engaged to perform an agreed-upon procedures engagement on prospective financial information?
- a. The accountant reports on procedures and findings only.
 - b. The accountant performs an examination and provides an opinion.
 - c. The accountant specifies what procedures should be applied.
 - d. The accountant is only allowed to read the prospective financial statements.
29. Lucy, a CPA, is engaged by Bankston-Meyers to compile historical financial statements. The historical financial statements will be presented along with projected financial statements as accountant-submitted documents. The projection covers the company's next two fiscal years. The documents are designed for third-party use. How should Lucy proceed?
- a. If Bankston-Meyers indicates in the document that Lucy has no responsibility, she should assume no responsibility for the projected statements.
 - b. If another accountant compiled the projected financial statements and that report is included, Lucy should assume no responsibility for the statements.
 - c. Lucy should compile Bankston-Meyers' projected financial information as part of her compilation engagement.
 - d. Lucy can claim the special budget exemption for Bankston-Meyers' projected financial statements.
30. Which of the following statements best describes a Circular 230 engagement?
- a. Either a forecast or projection can be included in tax shelter offerings that may be deemed a covered opinion under Circular 230.
 - b. Standard compilation procedures include sufficient analytical procedures to allow an accountant to provide an opinion in a Circular 230 engagement.
 - c. A practitioner who provides a Circular 230 opinion as part of a compilation engagement must include the opinion in the compilation report.
 - d. A practitioner can use another professional's Circular 230 opinion in their engagement with no further work if it appears to comply with the circular's requirements.

GLOSSARY

Agreed-upon procedures engagement: An agreed-upon procedures engagement is one in which an accountant is engaged by a client to perform specific procedures and report findings. The accountant does not perform an examination or provide an opinion. Rather, the accountant reports only procedures and findings.

Assembly engagement: Assembly services are similar to plain paper services, except that the accountant issues a report to describe his services or discuss the prospective statements in writing.

Budgets: Budgets, plans, goals, and similar presentations also involve elements of predicting the future. However, they may have elements of targets, motivational goals, or hurdles that distinguish them from a forecast, although in some situations, they may be identical. If budgets, plans, or goals do not fit the definition of a forecast, they are projections.

Circular 230 engagement: Treasury Department Circular 230 establishes regulations for providing opinions used in the promotion of tax shelter offerings and applies to CPAs, lawyers, and other professionals who practice before the IRS. Circular 230 applies to a CPA whose report on prospective financial statements appears in an offering document.

Compilation: The lowest level of service that an accountant can perform on prospective financial presentations intended for third parties is a compilation. However, the compilation procedures are not SSARS No. 1 (AR 100) procedures, as the prospective standard establishes unique compilation procedures for prospective information.

Entity: Any unit, existing or to be formed, for which financial statements could be prepared in accordance with GAAP or an OCBOA.

Examination: Generally, an examination engagement involves (a) evaluating the preparation, the support underlying the assumptions, and the presentation of the prospective financial statements for conformity with AICPA presentation guidelines, and (b) issuing an examination report. The examination report expresses a positive opinion on whether the assumptions provide a reasonable basis for the prospective financial statements and whether the prospective presentations conform with the AICPA presentation guidelines.

Explanatory material: Material that provides additional guidance on professional requirements or identifies other procedures or actions. A practitioner is not required to perform other procedures or actions that are identified through explanatory material. Explanatory material is identified through the words *may*, *might*, and *could*.

Feasibility study: An analysis of a proposed investment or course of action. A feasibility study may involve the preparation of a financial projection or a financial forecast.

Forecast: Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take.

General use: Use of the prospective financial information by persons who are unable to *negotiate directly* with the responsible party (i.e., they are unable to question the responsible party about the presentation or negotiate the terms and structure of a transaction with the responsible party).

Hypothetical assumption: An assumption used in a financial projection or in a partial presentation of projected information to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the presentation.

Internal use: Sole use of prospective financial information by the responsible party and others within the entity.

Key factors: The significant matters on which an entity's future results are expected to depend. They serve as a foundation for prospective information and are the basis for the assumptions.

Limited use: Limited use presentations are those used only by the responsible party alone or by persons negotiating directly with the responsible party. This means that third parties are able to ask questions of and negotiate the terms and structure of a transaction with the responsible party.

Partial presentation: These presentations omit one or more of the minimum items necessary for a complete presentation. Partial presentations ordinarily are not appropriate for general use; thus, they should be restricted for use by the specified parties who are negotiating directly with the responsible party.

Plain paper engagement: In general, a plain paper engagement is a term used to describe a prospective financial presentation that the accountant has prepared (or assisted in preparing) but is not associated with.

Presumptively mandatory requirements: Practitioners are 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 practitioner 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*.

Pro forma presentations: A historical financial statement that has been recast to show the effect of a transaction that had not been consummated during the period covered by the statement. Although such future or hypothetical transactions may appear prospective in nature, pro forma presentations are essentially historical financial statements.

Projection: Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question that begins for instance, "What would happen if . . .?"

Responsible party: The person or persons who are responsible for the assumptions underlying the prospective financial information.

Sensitive assumptions: Those significant assumptions for which a small variation would have a large impact or those having a high probability of a variation that may materially affect prospective results.

Significant accounting policies: The basic accounting policies the entity follows in its historical financial statements.

Significant assumptions: The basic determinants or building blocks underlying the prospective presentation.

Unconditional requirements: Requirements that a practitioner must follow in all cases if the circumstances apply to the requirement. These requirements use the words *must* or *is required*.

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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: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements— Course Acronym: CARTG091
Course 1—Interim Engagements, OCBOAs, and Prescribed Forms

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:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Special Reporting Issues for Proprietorships, Partnerships, and S Corporations (CARTG092)

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
CARTG092 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 **September 30, 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.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

**Companion to PPC's Guide to Compilation and Review
Engagements—Course 2—Special Reporting Issues for Proprietorships,
Partnerships, and S Corporations (CARTG092)**

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: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements— Course Acronym: CARTG092
Course 2—Special Reporting Issues for Proprietorships, Partnerships,
and S Corporations

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:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Forecasts, Projections, and Similar Items (CARTG093)

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
CARTG093 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 \$75. 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 \$214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$319 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 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.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's Guide to Compilation and Review
Engagements—Course 3—Forecasts, Projections, and Similar Items (CARTG093)****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. ○	○	○	○	9. ○	○	○	○	17. ○	○	○	○	25. ○	○	○	○
2. ○	○	○	○	10. ○	○	○	○	18. ○	○	○	○	26. ○	○	○	○
3. ○	○	○	○	11. ○	○	○	○	19. ○	○	○	○	27. ○	○	○	○
4. ○	○	○	○	12. ○	○	○	○	20. ○	○	○	○	28. ○	○	○	○
5. ○	○	○	○	13. ○	○	○	○	21. ○	○	○	○	29. ○	○	○	○
6. ○	○	○	○	14. ○	○	○	○	22. ○	○	○	○	30. ○	○	○	○
7. ○	○	○	○	15. ○	○	○	○	23. ○	○	○	○				
8. ○	○	○	○	16. ○	○	○	○	24. ○	○	○	○				

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: September 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements— Course Acronym: CARTG093
Course 3—Forecasts, Projections, and Similar Items

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** ☐ ☐

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