PRACTICE ISSUES - COMPILATION AND REVIEW UPDATE

by

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Program Description

The objective of this course is to inform the reader of the various changes made to the compilation and review standards by the AICPA’s Accounting and Review Services Committee (ARSC), and to address practice issues related to compilation and review engagements.

Section I of this course consists of an overview of newly issued SSARS No. 21 including the three types of engagements that can be performed under SSARS No. 21: a preparation of financial statements engagement, a compilation engagement, and a review engagement.

Section II consists of practice issues in compilation and review engagements. Topics include a discussion of an accountant’s responsibility for fraud, internal control and going concern, representation letters for review engagements, personal financial statements, tax-basis financial statements, legends on financial statements, accountant’s liability in compilation and review engagements, saving time in engagements, and more. The focus of the course is to identify, recognize and recall the rules pertaining to various pronouncements, including those related to recent developments.

Field of Study
Auditing

Recommended CPE Credits
20.00 CPE Credits

Instructional Delivery Method
Self-Study

Program Level
Overview

Program Prerequisites
General understanding of U.S. GAAP

Advanced Preparation
Program Expiration Date

This course, including the final exam, must be completed within one year of the date of purchase or enrollment.

Instructions

In order to receive credit for this course, all students should review the learning objectives and outcomes, read and understand all program materials, answer all review questions, and complete and pass the final exam.

The passing score for the final exam for this course is 70% or better answered correctly. In the event that you score less than 70% correct you must retake the final exam.
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Chapter 1: Overview of SSARS No. 21

Learning Objectives

After studying this chapter, you will be able to:

1. Identify some of the changes made to SSARS No. 21 that are carried over from auditing standards
2. Recognize engagement types that are and are not part of SSARS No. 21
3. Recall whether the new preparation of financial statements standard is an attest or nonattest service
4. Recall what must happen for an accountant to perform a preparation of financial statements engagement
5. Recall whether a preparation engagement under AR-C 70 is subject to peer review
6. Identify whether a report is required in a preparation of financial statements engagement under AR-C 70
7. Recognize what the reporting requirements are, if any, when a "no assurance" legend is omitted from prepared financial statements under the AR-C 70 standards
8. Identify where to disclose GAAP departures in a preparation of financial statements engagement
9. Recognize whether an accountant and his or her client must sign an engagement letter for a preparation of financial statements engagement under AR-C 70
10. Recall the objective of a compilation engagement under AR-C 80 of SSARS No. 21
11. Identify some procedures that must be performed in a compilation engagement under AR-C 80 of SSARS No. 21
12. Recognize some of the documentation requirements in a compilation engagement
13. Identify how an accountant should report on a disclaimer of supplementary information in a compilation engagement
14. Identify requirements to be satisfied to perform a review engagement under AR-C 90
15. Identify evidence an accountant should obtain to demonstrate that financial statements reconcile with accounting records
16. Recognize an appropriate title that can be used for a review report under SSARS No. 21
17. Identify the order in which certain report paragraphs should be placed in the SSARS No. 21 review report
18. Recall some of the items that should be documented in a review engagement
19. Recognize the effective dates of SSARS No. 21 including early implementation options

I. SSARS No. 21- The New Compilation and Review Standards. SSARS No. 21: Statements on Standards for Accounting and Review Services: Clarification and Recodification
A. Issued

October 23, 2014

B. Effective Date

SSARS No. 21 is effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2015. Early implementation is permitted.

C. Objective

The objective of SSARS 21 is to reissue most of the compilation and review standards under the Accounting and Review Services Committee's (ARSC's) Clarity Project.

D. Background

In October 2014, the AICPA's Accounting and Review Services Committee (ARSC) issued SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification.*

The issuance of SSARS No. 21 represents the culmination of the ARSC’s Clarity Project under which it clarifies and revises the existing standards for reviews and compilations, and introduces a new engagement to prepare financial statements.

In 2011, the Auditing Standards Board (ASB) reissued most of the existing auditing standards under its own Clarity Project with the issuance of SAS Nos. 122-124, which were subsequently supplemented with SAS Nos. 125-130. In issuing those clarified auditing standards, with an effective date of 2012, the ASB had as its primary goal, to make improvements to existing auditing standards. The ASB achieved that goal by establishing certain standard drafting conventions to more clearly state the auditor's objectives, and make the standards easier to read, understand and apply.

In May 2010, the ARSC approved and initiated its own Clarity Project to revise all existing compilation and review standards in the *Codification of Statements on Standards for Accounting and Review Services* (AR sections of the AICPA’s *Professional Standards*). That project resulted in the issuance of SSARS No. 21.

In issuing SSARS No. 21, the ARSC follows a similar approach taken by the ASB to simplify existing compilation and review standards. The ARSC’s approach incorporated into SSARS No. 21 some, but not all, of the conventions that were used within the reissued auditing standards such as:

- Establishing objectives for each clarified AR-C section
- Including a definitions section, where relevant, in each new AR-C section
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using a prefix and presenting them in a separate section that follows the requirements section, and
- Enhancing the readability of the SSARS by using formatting techniques, such as bulleted lists.
The ARSC did not include in SSARS No. 21 specific application guidance for governmental entities and smaller, less complex entities, both of which are included in the new auditing standards.

SSARS No. 21 supersedes SSARS No. 19 (AR sections 60, 80 and 90) and all other existing compilation and review (AR) sections in AICPA Professional Standards except for AR section 120, *Compilation of Pro Forma Financial Information*. In 2015, the ARSC exposed for comment proposed requirements and guidance related to compilation of prospective financial information, which includes guidance that will supersede AR section 120. Currently, the compilation of prospective financial statements rules are found in SSAE No. 10, *Attestation Standards: Revision and Recodification*.

SSARS No. 21 consists of *four AR sections* as follows:

- AR-C Section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*
- AR-C Section 70, *Preparation of Financial Statements*
- AR-C Section 80, *Compilation Engagements*
- AR-C Section 90, *Review of Financial Statements*

These four sections replace the existing AR sections with an "AR-C" to differentiate the new sections from the existing sections. Sometime after the effective date of SSARS No. 21, the "C" will be dropped from the new sections.

In March 2015, the AICPA issued an implementation guide for SSARS No. 21 entitled *Preparation, Compilation, and Review Engagements*. The Guide is considered an interpretation publication issued in accordance with AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*. As an interpretive publication, the guide provides recommendations on the use of the SSARSs. If an accountant does not apply the guidance within the Guide, the accountant should be prepared to explain how he or she complied with the provisions within the Guide. Throughout this course, the author references the AICPA Guide as the “Guide,” or the “AICPA Guide.”

Following is a mapping of previous AR sections to the new AR-C sections found in SSARS No. 21:
<table>
<thead>
<tr>
<th>Existing Standards (SSARS No. 19)</th>
<th>New AR-C Section (SSARS No. 21)</th>
<th>Description of Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>AR Section 60, Framework for Performing and Reporting on Compilation and Review Engagements</td>
<td>AR-C Section 60, General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services</td>
<td>The new AR-C 60 includes the general principles for engagements performed under the SSARSs and replaces existing AR 60.</td>
</tr>
<tr>
<td>AR Section 80, Compilation of Financial Statements</td>
<td>AR-C Section 80, Compilation Engagements</td>
<td>New AR-C 80 replaces existing AR 80 with respect to compilation engagements.</td>
</tr>
<tr>
<td>AR Section 90, Review of Financial Statements</td>
<td>AR-C Section 90, Review of Financial Statements</td>
<td>New AR-C 90 replaces existing AR 90 with respect to review engagements.</td>
</tr>
</tbody>
</table>

In addition to the new standards replacing existing AR Sections 60, 80 and 90, all other existing AR sections are replaced by SSARS No. 21 except for AR Section 120, Compilation of Pro Forma Financial Information, as follows:
### Other AR Sections Superseded by SSARS No. 21

<table>
<thead>
<tr>
<th>Existing AR Section</th>
<th>Existing Title</th>
<th>Superseded by SSARS No. 21</th>
<th>Not Superseded by SSARS No. 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>AR Section 200</td>
<td>Reporting on Comparative Financial Statements</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(SSARS No. 2, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR Section 300</td>
<td>Compilation Reports on Financial Statements Included in Certain Prescribed Forms</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(SSARS No. 3, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR Section 400</td>
<td>Communications Between Predecessor and Successor Accountants</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(SSARS No. 4, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR Section 600</td>
<td>Reporting on Personal Financial Statements Included in Written Personal Financial Plans</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(SSARS No. 6, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR Section 110</td>
<td>Compilation of Specified Elements, Accounts, or Items of a Financial Statement</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(SSARS No. 13, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR Section 120</td>
<td>Compilation of Pro Forma Financial Information</td>
<td></td>
<td>X Pending</td>
</tr>
<tr>
<td>(SSARS No. 14, as amended)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Key changes made by SSARS No. 21:**

SSARS No. 21 makes several important changes to existing compilation and review standards which are summarized below:

a. **Introduces new general principles for performing engagements under the SSARSs in newly issued AR-C Section 60**

AR-C 60 does the following:

- Establishes the preconditions that must be met to perform an engagement under the SSARSs
- Inserts into AR-C 60 some of the definitions found in auditing standards that are based on SQCS No. 8, *A Firm’s System of Quality Control*
- Clarifies that the financial statements on which an accountant performs a SSARS engagement belong to the client, not the accountant
- Expands the guidance on selection of the applicable financial reporting framework and overall guidance as requirements that must be met in order to prepare financial statements
- Expands the discussion and requirement for an accountant to exercise professional judgment
- Inserts new language on engagement-level quality control and the responsibilities of an engagement partner, and
- Inserts new guidance on acceptance and continuance of client relationships and engagements.
b. Introduces new rules and guidance for engagements to prepare financial statements in newly issued AR-C Section 70

AR-C 70 does the following:

- States that a preparation of financial statements engagement applies when the accountant is engaged to prepare financial statements but is not engaged to perform an audit, review or a compilation on those financial statements
- Establishes criteria that must be met for an accountant to accept and continue client relations in a preparation of financial statements engagement
- Permits the issuance of prepared financial statements without a report provided a legend is placed on each page of the financial statements stating "no assurance is being provided on the financial statements"
- Defines a preparation of financial statements as a nonattest service
- Requires an accountant to obtain an engagement letter signed by both the accountant and the client’s management
- Does not require the accountant to consider whether he or she is independent in a preparation of financial statements engagement
- Permits prepared financial statements to be issued with or without disclosures, and
- Inserts into AR-C 70 the new special purpose framework definition (including a new definition of "tax basis") that is presently found in auditing standards.

c. Makes changes to existing compilation engagement requirements in new AR-C Section 80

AR-C 80 does the following:

- Retains most, but not all, of the existing requirements for compilations
- Establishes criteria that must be met for an accountant to accept and continue client relations in a compilation engagement
- States that a compilation engagement applies only when an accountant is engaged to perform a compilation engagement
- Eliminates the existing requirement that an accountant is forced to perform a compilation engagement if he or she has submitted financial statements (e.g., prepared and presented them)
- States that a compilation engagement always requires a report
- Eliminates the existing management-use only compilation engagement
- Shortens and simplifies the compilation report versus the review or audit report, so that the new standard compilation report contains one paragraph, no heading, and no addressee
- Retains the requirement that an accountant modify the accountant’s compilation report whenever the accountant’s independence is impaired
- Requires the accountant to obtain an engagement letter signed by both the accountant and the client’s management
- Includes a new sample engagement letter for a compilation engagement
- Retains the rules that a compilation engagement may be applied to financial statements with or without disclosures
- Expands the scope of compilation engagements under AR-C 80 to include a compilation of prospective financial information, including budgets, forecasts, or projections, and
• Inserts into AR-C 80, the new special purpose framework definition (including a new definition of "tax basis") that is presently in auditing standards.

d. **Makes changes to existing review engagement requirements in new AR-C Section 90**

AR-C 90 does the following:

• Establishes criteria that must be met for an accountant to accept and continue client relations in a review engagement
• Inserts into the new AR-C 90, the special purpose framework definition (including a new definition of "tax basis") that is presently found in auditing standards
• Requires the accountant to obtain an engagement letter signed by both the accountant and the client’s management
• Includes a new sample engagement letter for a review engagement
• Slightly modifies the list of items that must be documented in a review engagement
• Inserts into AR-C 90 the requirement that an accountant should perform a review engagement with professional skepticism
• Includes a requirement that the accountant should communicate with management or those charged with governance matters concerning the review engagement that are of *significant importance*
• Clarifies that an accountant may perform audit procedures during a review engagement and the engagement is not elevated to an audit engagement
• Expands slightly the list of examples of inquiries that an accountant may make of management in a review engagement
• Expands slightly the examples of analytical procedures and provides additional language that clarifies that the accountant must develop expectations in performing analytical procedures
• Includes a new requirement that an accountant should obtain evidence that the financial statements agree or reconcile with the accounting records
• Replaces the concept of "illegal acts" with "noncompliance with laws and regulations," consistent with a change made to auditing standards
• Adds a new management representation letter, and a new requirement for management to attach to the representation letter a summary of uncorrected misstatements that are immaterial
• Introduces a new and expanded review report that includes headings and expanded language, consistent with some of the changes made to the audit report
• Provides better guidance regarding when an accountant should date the review report
• Introduces a new "other-matter" paragraph in a review report, consistent with this addition found in an audit report
• Clarifies the reporting options with respect to supplementary information in a review engagement, including the option to compile, review or disclaim supplementary information, and
• Includes expanded requirements and guidance in dealing with other accountants who have audited or reviewed financial statements of significant components.

In drafting the new compilation and review standards, the ARSC did not follow international standards and, instead, used the auditing standards format as a guide.
According to the ARSC, some of the AU-C standards were drafted using the corresponding International Standard on Auditing (ISA) as guidance. In contrast, the ARSC noted it was more appropriate to converge with the corresponding limited assurance engagement guidance in the American auditing literature rather than use international standards found in ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*. Although the ARSC has considered International Standard on Related Services (ISRS) 4410, *Engagements to Compile Financial Statements*, and has adopted some of its requirements, AR-C 80 (compilation engagements) is not identical to ISRS 4410. One particular area of difference is in the area of independence.

Because SSARS No. 21 replaces most existing compilation and review standards, there will be a period of time during which practitioners will have little guidance in certain areas that have been superseded by SSARS No. 21. One of those areas involves reporting on prospective financial information.

The remainder of this course is segregated into the following sections:

- AR-C Section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*
- AR-C Section 70, *Preparation of Financial Statements*
- AR-C Section 80, *Compilation Engagements*
- AR-C Section 90, *Review of Financial Statements*

### Carryover of certain elements found in auditing standards

In issuing SSARS No. 21, the ARSC carried over certain elements found in auditing standards to the SSARSs. Now, those elements are consistent across all engagements.

Following is a summary of those elements:

<table>
<thead>
<tr>
<th>Auditing Standards</th>
<th>Preparation of Financial Statements</th>
<th>Compilation Engagements</th>
<th>Review Engagements</th>
</tr>
</thead>
<tbody>
<tr>
<td>New definition of special purpose framework including &quot;tax basis&quot; financial statements</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Introduction of &quot;other matter&quot; paragraph in report</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Engagement letter must be signed by accountant and management</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Replacement of term &quot;illegal acts&quot; with &quot;noncompliance with laws and regulations&quot;</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>
AR-C Section 60- *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*

A. Introduction

AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*, was issued as part of SSARS No. 21, and supersedes existing AR-60, *Framework for Performing and Reporting on Compilation and Review Engagements*.

The existing AR-60 was issued in 2009 as part of SSARS No. 19.

AR-C 60 does the following:

1. It provides the general principles for engagements performed in accordance with the SSARSs involving:
   - Preparation of Financial Statements (AR-C 70)
   - Compilation Engagements (AR-C 80), and
   - Review Engagements (AR-C 90).

2. It establishes the meaning of certain terms used within the SSARSs related to the professional requirements that must be satisfied in performing a review, compilation, or a preparation of financial statements engagement.

3. It assists accountants in understanding their professional responsibilities when performing an engagement in accordance with SSARSs.

4. It states that the SSARSs, as codified in the AR-C sections, are to be adapted as necessary in the circumstances when applied to reviews, compilations, or engagements to prepare other historical or prospective financial information.

*Note:* AR-C 60 also states that the SSARSs do not address the responsibilities of the accountant that may exist in legislation, regulation, or otherwise, and that may differ from those established in the SSARSs. In such circumstances, use of the SSARSs does not eliminate the accountant's responsibility to comply with all relevant legal, regulatory, or professional obligations.

B. Key Changes Made by AR-C 60

An accountant who performs an engagement under the SSARSs must follow the general principles found in newly issued AR-C 60, in addition to the requirements related to each particular type of engagements.

Thus, in considering the types of engagements covered by SSARS No. 21, an accountant must adhere to the following standards:
<table>
<thead>
<tr>
<th>Type of Engagement</th>
<th>New Section</th>
<th>General Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparation of Financial Statements</td>
<td>AR-C 70</td>
<td>Must follow requirements in AR-C-60, General Principles</td>
</tr>
<tr>
<td>Compilation Engagement</td>
<td>AR-C 80</td>
<td></td>
</tr>
<tr>
<td>Review Engagement</td>
<td>AR-C 90</td>
<td></td>
</tr>
</tbody>
</table>

Although many of the provisions found in AR 60 have been carried over to the newly issued AR-C 60, other elements have been eliminated altogether. Moreover, the new AR-C 60 adds some new provisions.

Following is a summary of some of the key changes that AR-C 60 makes to the existing AR 60:

1. Inserts into AR-C 60 some of the definitions found in auditing standards that are based on SQCS No. 8, *A Firm's System of Quality Control*
2. Clarifies that the financial statements on which an accountant performs a SSARS engagement belong to the client, not the accountant
3. Expands the guidance on selection of the applicable financial reporting framework and overall guidance as requirements that must be met in order to prepare financial statements
4. Expands the discussion and requirement for an accountant to exercise professional judgment
5. Eliminates discussion of the concept of materiality from the general principles
6. Inserts new language on engagement-level quality control and the responsibilities of an engagement partner, and
7. Inserts new guidance on acceptance and continuance of client relationships and engagements.

**C. Requirements for Performing SSARS Engagements**

AR-C 60 provides the general principles that an accountant must satisfy before performing an engagement covered by the SSARSs. Many of the requirements found in the new AR-C 60 are carried over from similar (but not identical) requirements found in auditing standards, more specifically AU-C Section 200, *General Principles and Responsibilities*.

1. There are *three engagements* that SSARS No. 21 authorizes an accountant to perform:
   - Preparation of financial statements
   - Compilation of financial statements
   - Review of financial statements

2. The following sections are addressed within the AR-C requirements that pertain to an accountant who performs any one of the three SSARS engagements noted above:
a. Financial Statement Requirements
b. Ethical Requirements
c. Professional Judgment
d. Conduct of Performing the Engagement in Accordance With SSARSs
e. Engagement Level Quality Control
f. Acceptance and Continuance of Client Relationships and Engagements

Acceptance and Continuance of Client Relationships and Engagements

Regardless of whether an accountant performs a preparation of financial statements, compilation or review engagement, the accountant is required to satisfy certain preconditions of the engagement found in the following:

- Paragraphs .24 and .25 of AR-C 60, and
- Specific preconditions found in the applicable section of the engagement type (AR-C 70, AR-C 80 or AR-C 90)

Preconditions and conditions for all engagements found in AR-C 60:

1. Paragraph .24 of AR-C 60 states that the accountant should not accept an engagement to be performed in accordance with SSARSs if:

   a. The accountant has reason to believe that relevant ethical requirements (including independence) will not be satisfied

   b. The accountant’s preliminary understanding of the engagement circumstances indicates that information needed to perform the engagement is not likely to be available or reliable, or

   c. The accountant has cause to doubt management’s integrity such that it is likely to affect the performance of the engagement.

   Note: The AICPA Guide notes that one example of when an accountant may determine that information is not likely to be “available” or “reliable” is when financial statements or accounting records necessary to perform the engagement are suspected to be substantially inaccurate or incomplete.

2. Paragraph .25 of AR-C 60 states that as a condition for accepting a SSARS engagement, the accountant should do all of the following:

   a. Determine whether preliminary knowledge of the engagement circumstances indicates that ethical requirements (including independence) regarding professional competence will be satisfied

   b. Determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable
1) Factors that are relevant to the accountant’s determination that the financial reporting framework selected by management is acceptable include the following:

- Consideration of the nature of the entity
- The intended purpose of the financial statements
- The users of the financial statements
  Example: Are they prepared to meet the common financial information needs of a wide range of users), and
- Whether law or regulation prescribes the applicable financial reporting framework.

Note: The AICPA Guide states that financial statements prepared in accordance with a special purpose framework may not be suitable for general purposes because the users may not fully understand that particular financial reporting framework.

2) The following general purpose frameworks selected by management are presumed to be “acceptable” unless evidence suggests otherwise:

- Accounting principles generally accepted in the United States of America (U.S. GAAP), and

Note: In addition to the previously noted factors, the AICPA Guide offers additional guidance in determining whether a financial reporting framework is “acceptable” which is whether the financial reporting framework exhibits the characteristics of suitable criteria.

Suitable criteria exhibit all of the following four characteristics:

- Relevance: Criteria are relevant to the subject matter
- Objectivity: Criteria are free from bias
- Measurability: Criteria permit reasonably consistent measurements, qualitative or quantitative, of subject matter
- Completeness: Criteria are complete when subject matter prepared in accordance with them does not omit relevant factors that could reasonably be expected to affect decisions of the intended users made on the basis of that subject matter.

Note: The AICPA Guide notes that the relative importance of each of the four characteristics to a certain engagement should be considered and is a matter of professional judgment. For example, even though a financial reporting framework may not result in financial statements that meet the objectivity criterion (they are not free from bias), that framework may still be acceptable given the circumstances.

c. Obtain the agreement of management (through an engagement letter) that it acknowledges and understands its responsibility:

1) For the selection of the financial reporting framework to be applied in the preparation of financial statements
2) For the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error

3) For preventing and detecting fraud

4) For ensuring that the entity complies with laws and regulations applicable to its activities

5) For the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments provided by management for the preparation of financial statements

6) To provide the accountant with:

   1. Access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters

   2. Additional information that the accountant may request from management for the purpose of the engagement, and

   3. Unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.

3. In addition to satisfying the preconditions found in paragraphs .24 and .25 of AR-C 60, the accountant must satisfy certain engagement-specific conditions found in AR-C 70 (preparation engagements), AR-C 80 (compilation engagements), and AR-C 90 (review engagements), as follows:

   • **Engagement to prepare financial statements**: Preconditions found in paragraphs 9 and 10 of AR-C 70, *Preparation of Financial Statements*.

   • **Compilation engagement**: Preconditions found in paragraphs 8 and 9 of AR-C 80, *Compilation Engagements*.

   • **Review engagement**: Preconditions found in paragraphs 8 and 9 of AR-C 90, *Review of Financial Statements*. 
Review Questions

1. Which of the following represents a change made by SSARS No. 21 to the compilation and review standards:
   a. AR-C section 60 represents a new section dealing with general principles that does not supersede any previous section
   b. AR-C section 70 is a new section that does not supersede any previous section
   c. AR-C section 80 is a new section that does not supersede any previous section
   d. AR-C section 90 is a new section that does not supersede any previous section

2. One key change made by SSARS No. 21 which represents a carryover of an element found in auditing standards is which of the following:
   a. The "other matter" paragraph is eliminated from the report consistent with auditing standards
   b. SSARS No. 21 carries over from auditing standards the requirement that analytical procedures be performed in a review engagement
   c. SSARS No. 21 carries over from auditing standards the requirement that an accountant perform inquiries in a review engagement
   d. The term "illegal acts" is changed to "noncompliance with laws and regulations"

3. Before an accountant accepts any engagement under SSARS No. 21, which of the following is a precondition or condition that, if not satisfied, would result in the accountant not accepting the engagement:
   a. Accountant has concern about the integrity of third parties who might rely on the financial statements
   b. Accountant is concerned about the ethics of the bank to whom financial statements will be sent
   c. Bankers have a history of not responding to receivable and cash confirmations
   d. Accountant doubts management's integrity
AR-C Section 70- Preparation of Financial Statements

A. Effective Date

The effective for the preparation of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

B. Introduction

Although SSARS No. 21 rewrites existing compilation and review standards, clearly the most significant change made by this SSARS is the introduction of a preparation of financial statements engagement within newly issued AR-C 70.

Even though the preparation of financial statements is nothing new, per se, codifying a preparation of financial statements engagement separate from a compilation, review or audit engagement, is novel.

AR-C 70 is a new section within the SSARSs and does the following:

- Introduces a preparation of financial statements engagement as a new engagement that may be performed separate from a compilation, review or audit engagement
- Codifies the preparation of financial statements as a nonattest service, and
- Provides guidance for the preparation of financial engagements that permits an accountant to issue prepared financial statements to a client or third party without a report.

In addition, although not part of AR-C 70, the AICPA’s peer review committee has voted to exempt the preparation of financial statements engagement from being subject to peer review in certain cases.

C. Scope of AR-C 70

AR-C 70 inserts the preparation of financial statements as a separate engagement within the hierarchy of engagements that may be performed under the SSARSs as follows:

- Review Engagement
- Compilation Engagement
- Preparation of Financial Statements (NEW per AR-C 70)

AR-C 70 applies:

when an accountant in public practice is engaged to prepare financial statements and is not engaged to perform an audit, review or compilation engagement on those financial statements.
AR-C 70 may also be applied to the preparation of other historical or prospective financial information, such as the following:

- Specified elements, accounts, or items of a financial statement, such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information
- Pro forma financial information, and
- Prospective financial information, including budgets, forecasts, or projections.

**Observation:** Prior to the issuance of SSARS No. 21, the guidance for reporting on prospective financial information was found in SSAE No. 10 (AT section 301), Financial Forecasts and Projections. SSAE No. 10 permits an accountant to perform a compilation, examination, or agreed-upon procedures engagement on prospective information.

With the issuance of SSARS No. 21, the ARSC moved the compilation of prospective information from SSAE No. 10 to SSARS No. 21. Moreover, in new AR-C 70, a preparation of prospective information engagement is permitted.

The result is that an accountant who wishes to either prepare or compile prospective financial information follows the guidance found in SSARS No. 21, not SSAE No. 10. The ARSC is issuing separate guidance for a preparation or compilation engagement on prospective financial information.

In order for a preparation of financial statements engagement to be subject to AR-C 70, the following elements must exist:

a. The accountant must be in public practice.

b. The accountant must be engaged (hired) by the client to perform a preparation of financial statements engagement, and

c. There must not be a corresponding compilation, review or audit engagement on the prepared financial statements for the same period.

**Definition of special purpose framework**

SSARS No. 21 carries over the definition of a special purpose framework found in auditing standards, AU-C 800, Special Considerations-Audits of Financial Statements Prepared in Accordance with Special purpose frameworks.

Under AU-C 800, the term OCBOA is replaced with the term special purpose framework.

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1 The Accounting and Review Services Committee has exposed for public comment separate proposed Statements on Standards for Accounting and Review Services that would provide requirements and guidance to accountants with respect to engagements on prospective financial information.

2 AR-C 70 states that SSARS No. 21 “may also be applied” to “other historical and prospective financial information” suggesting that there is no requirement to apply SSARS No. 21 to other historical and prospective financial information (e.g., information other than financial statements).

3 New ethics standards change the term “public accounting” to “public practice.”
Further, the definition of income tax basis is changed slightly from the previous one found in SSARS No. 19. The SSARS No. 19 definition was “a basis of accounting that the entity uses or expects to use to file its income tax return for the period covered by the financial statements.” The new definition removes the “expects to use” from the definition. As a practical matter, eliminating the “expects to use” from the definition should have no significant effect on the application of SSARS No. 21.

Lastly, the term “income tax basis” has been replaced with the term “tax basis.”

D. Brief Summary of a Preparation of Financial Statements Engagement

Before the author addresses the details of AR-C 70 for an engagement to prepare financial statements, let's look at a summary of what a preparation of financial statements engagement is:

a. An accountant performs a preparation of financial statements engagement if he or she is 1) in public practice, 2) is engaged to prepare financial statements (e.g., there is an engagement letter to hire the accountant to perform the preparation engagement), and 3) is not hired to perform a compilation, review or audit engagement on those same financial statements.

b. A preparation of financial statements engagement is a nonattest service.

c. An engagement letter that is signed by both management and the accountant is required.

d. The accountant is not required to be independent nor determine whether he or she is independent.

e. There is generally no report issued with a preparation of financial statements engagement, subject to a disclaimer report exception.

f. The prepared financial statements may be issued to the client or third party without restrictions

g. The prepared financial statements may omit notes/disclosures

h. The prepared financial statements may have GAAP/other framework departures

i. The preparation of financial statements engagement is exempt from peer review in certain cases

j. There is no separate reporting or disclosure reference to supplementary information in a preparation of financial statements engagement

The following chart compares the key elements of a preparation engagement with a compilation engagement.
## Comparison of Preparation Versus Compilation Engagement

<table>
<thead>
<tr>
<th></th>
<th>Compilation Engagement (AR-C 80)</th>
<th>Preparation of Financial Statements (AR-C 70)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>When does the standard apply?</strong></td>
<td>When an accountant is engaged to perform a compilation</td>
<td>When an accountant is engaged to prepare financial statements and not engaged to perform a compilation, review or audit on those same financial statements</td>
</tr>
<tr>
<td><strong>Must the accountant be in public accounting?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Is an engagement letter required?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Is the accountant required to determine if he or she is independent of the client?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>If the accountant is not independent, is that fact required to be disclosed?</strong></td>
<td>Yes</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Does the engagement require a report?</strong></td>
<td>Yes</td>
<td>No&lt;sup&gt;4&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>May the financial statements go to users outside of management?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>May the financial statements omit notes?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>May the financial statements have a departure from the applicable financial reporting framework?</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Is there any special reporting or reference to supplementary information?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: *Developments in Review, Compilation and Financial Statement Preparation Engagements* (AICPA) and AICPA Guide, as modified by the Author.

### A preparation engagement and peer review

An important issue that practitioners want answered is whether a preparation of financial statements engagement, by itself, is subject to peer review.

<sup>4</sup> In certain cases, a disclaimer report may be required if each page of the prepared financial statements does not include a “no assurance is provided” legend.
In August 2014, the AICPA Peer Review Board issued an exposure draft entitled, *PROPOSED CHANGES TO THE AICPA STANDARDS FOR PERFORMING AND REPORTING ON PEER REVIEWS- Preparation of Financial Statements Performed under SSARS and the Impact on the Scope of Peer Review*.

At its January 2015 meeting, the AICPA Peer Review Board voted and approved the exposure draft as a final document with modifications as follows:

a. A CPA firm whose only level of service performed is a preparation of financial statements engagement, is not required to enroll in a peer review program nor to have a peer review performed.

b. If a CPA firm is already enrolled in a peer review program because the firm performs other types of engagements (e.g., compilation, review or audit engagements), any preparation of financial statement engagements would be subject to selection as part of a peer review.

That means that if a firm only performs preparation of financial statement engagements, no peer review would be required.

If, instead, a firm performs compilation, review or audit engagements, and also performs a preparation of financial statements engagement, the firm is already subject to peer review, and the preparation engagement is an engagement that could be selected by a peer reviewer for review.

**E. General Rules in Applying a Preparation of Financial Statements Engagement Under AR-C 70**

Following are the rules that apply to a preparation of financial statements engagement covered by AR-C 70:

1. In addition to complying with the rules in AR-C 70, an accountant is required to comply with the general principles found in AR-C section 60, *General Principles form Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

2. An accountant must satisfy the *preconditions* found in paragraphs .24 and .25 of AR-C 60 general principles. [Discussed previously in AR-C 60].

3. A preparation of financial statements engagement is subject to the AR-C 70 rules if *three elements are satisfied*:
   - The accountant is in *public practice*
   - The accountant *is engaged (hired)* to perform a preparation of financial statements engagement, and
   - The accountant *is not engaged (hired)* to perform a compilation, review or audit engagement on the same financial statements for the same period of time.

4. The preparation of financial statements is a *nonattest service*. 
5. The accountant is not required to determine whether the accountant is independent to perform a preparation of financial statements engagement under AR-C 70.

**Note:** Although an accountant is not required to be independent to perform a preparation of financial statements engagement, the accountant must be careful when he or she prepares financial statements (a nonattest service) for an interim period and then performs a compilation, review or audit engagement at annual year end.

The Nonattest Services subtopic of the "Independence Rule" (found in the AICPA Professional Standards, ET sec. 1.295) addresses the accountant’s considerations with respect to independence when performing nonattest services for attest clients. For example, the accountant may prepare monthly or other interim financial statements and also be engaged to perform an audit, review, or compilation engagement with respect to the annual financial statements. The performance of the preparation services may impair independence unless the three safeguards described in the nonattest services subtopic are met.

Those safeguards, which are discussed further on in the review section of this course, include three safeguard requirements found in ET 1.295:

a. The client must agree to assume all management responsibilities for the preparation of financial statements service

b. The accountant must not assume responsibilities for the preparation of financial statements service, and

c. There must be language in the engagement letter that confirms that the client, not the accountant, assumes management responsibility for the nonattest service performed (e.g., preparation of financial statements).

6. In preparation of financial statements engagement, the accountant is not required to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements or otherwise report on the financial statements.

7. The accountant should obtain an agreement of management (engagement letter) signed by both the accountant and management.

8. The accountant should obtain an understanding of:

- The applicable financial reporting framework, and

- The significant accounting policies intended to be used in the preparation of the financial statements.

**Note:** AR-C 70 states that the requirement for the accountant to obtain an understanding of the financial reporting framework adopted by management and the significant accounting policies adopted by management does not prevent the accountant from accepting an engagement to prepare
financial statements for an entity in an industry in which the accountant has no previous experience. The accountant may obtain the required understanding from various sources. For example, such sources may include consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals who are knowledgeable about the industry.

F. Specific Rules for Preparing Financial Statements per AR-C 70

AR-C 70 provides specific rules that must be followed if an accountant performs a preparation of financial statements engagement:

1. The accountant should prepare the financial statements using the records, documents, explanations, and other information provided by management.

2. The accountant does not include a report with the prepared financial statements subject to the disclaimer report exception noted below.

3. Because a report is not included with the prepared financial statements, the accountant should ensure that a legend is included on each page of the financial statements indicating, at a minimum, that "no assurance is provided" on the financial statements.

Note: AR-C 70 states that the "no assurance is provided" statement (legend) on each page of the financial statements, including related notes, is intended to avoid misunderstanding on the part of users with respect to the accountant’s involvement with the financial statements.

Because the financial statements are the responsibility of management, the "no assurance" statement (legend) is made at management’s discretion, and the accountant or the accountant’s firm name is not required to be included within that legend.

SSARS No. 21 offers two examples of a legend that should be included on each page of the financial statements as follows:

"No assurance is provided on these financial statements." or

"These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them."

Other legends would also be acceptable, as long as they convey that no assurance is provided on the financial statements would also be acceptable. The AICPA Guide offers the following additional options for legends that are acceptable:

“No assurance is provided by ABC CPAs on these financial statements.”

“ABC CPAs did not perform an audit, review, or compilation engagement on these financial statements, and no assurance is provided on them.”
ABC CPAs adhered to Statement on Standards for Accounting and Review Services (SSARS) No. 21 issued by the American Institute of Certified Public Accountants in the preparation of these financial statements. No assurance is provided on these financial statements.

Observation: As the reader can see, there are several options in selecting a legend format ranging from the “no assurance is provided…” version, to an elaborate version that includes the identity of the CPA firm. The key is that the legend specifically should state that no assurance is provided on the financial statements. The accountant is not precluded from including the accountant’s firm name in the legend although to do so, explicitly links the accountant to the financial statements. The author suggests that the simplest version "no assurance is provided on these financial statements" is the best and most practical choice because it conveys a clearer and concise message.

4. If the accountant is unable to include a "no assurance is provided" legend on each page of the financial statements, the accountant should issue either:

- A disclaimer report that makes clear that no assurance is provided on the financial statements, or,
- A compilation report in accordance with AR-C section 80, Compilation Engagements.

An example of a disclaimer report that the accountant may issue in a preparation of financial statements engagement follows:

To Management and Board of Directors
XYZ Company

The accompanying financial statements of XYZ Company as of and for the year ended December 31, 20XX, were not subjected to an audit, review, or compilation engagement by me (us) and, accordingly, I (we) do not express an opinion, a conclusion, nor provide any assurance on them.

Signature of accounting firm or accountant
Accountant's city and state

Observation: The financial statements belong to the client, not the accountant. Therefore, there could be rare instances in which the client does not want a legend such as "no assurance is provided" on the financial statement pages of prepared financial statements. In such a case, the accountant cannot force the client to add the legend because the financial statements do not belong to the accountant. Therefore, the accountant can issue a disclaimer report to notify the user that no assurance is provided with respect to the financial statements.

5. When preparing financial statements in accordance with a special purpose framework (such as tax basis), the accountant should include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements.
Example:

XYZ Company
Balance Sheet - Tax Basis
December 31, 20X1

Note: SSARS No. 21 states that a description of the special purpose framework is usually placed either:

- Next to the title of the financial statements (example: balance sheet - tax basis), or
- Under the title of the financial statements.

6. If, during the preparation of financial statements, the accountant assists management with significant judgments regarding amounts or disclosures to be reflected in the financial statements, the accountant should discuss those judgments with management so that management understands the significant judgments reflected in the financial statements and accepts responsibility for those judgments.

Examples of situations in which an accountant may provide assistance to management include:

- Advising management on alternative accounting policies that are significant to the financial statements, or
- Helping management with significant judgments regarding material accounting estimates.

The accountant may wish to document significant consultations or significant judgments regarding amounts or disclosures to be reflected in the financial statements.

7. If the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, used in the preparation of the financial statement are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information.

Observation: AR-C 70 carries over from the compilation standards (AR-C 80) the language related to "incomplete, inaccurate, or otherwise unsatisfactory" documents or information. If an accountant discovers incomplete, inaccurate or otherwise unsatisfactory information during the engagement, the accountant must bring that information to the attention of management and request that management correct the information. What this means is that in performing a preparation of financial statements engagement, an accountant has the same responsibility as an accountant who performs a compilation engagement. That is, if there is a material item that comes to the accountant's attention, he or she must address it and request that management correct it. The fact that an accountant is performing a preparation engagement is not a defense against not researching a potentially material misstatement.

8. When, after discussions with management, the accountant prepares financial statements that contain a known departure(s) from the applicable financial reporting framework (including inadequate disclosure), the accountant should disclose the material misstatement(s) in the financial statements.
The disclosure of a material misstatement or misstatements may be made on the face of the financial statements or in a note to the financial statements and may look like this:

"The financial statements do not include a statement of cash flows which is required under generally accepted accounting principles in the United States."

or

"The financial statements do not include a statement of cash flows."

9. When, after discussions with management, the accountant prepares financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should disclose such omission in the financial statements.

The disclosure of the omission of substantially all disclosures required by the applicable financial framework may be made on the face of the financial statements or in a note to the financial statements.

Example of a disclosure that may be presented on the face of the financial statements (at the top or bottom of the financial statement page) or in the note to the financial statements follows:

"Substantially all disclosures required by accounting principles generally accepted in the United States are not included."

or

“Substantially all disclosures required by GAAP omitted.”

Note: The accountant should not prepare financial statements that omit substantially all disclosures required by the applicable financial reporting framework if the accountant becomes aware that the omission of substantially all disclosures was undertaken with the intention of misleading users of such financial statements.

Observation: If the financial statements omit substantially all disclosures, SSARS No. 21 requires that a disclosure of that fact be made either on the face of each financial statement or in an accompanying note. Typically, it will be made on the face of the financial statements because there usually are no notes to financial statements in a preparation of financial statements engagement.

Where should the disclosure that the financial statements omit substantially all disclosures be made on the face of the financial statements?

There are essentially two options:

Option 1: At the top of each page under the financial statement title, or

Option 2: At the bottom of each page of the financial statements
Following are sample presentations of each option:

Option 1: At the top of each page of the financial statements:

XYZ Company
Balance Sheet
December 31, 20X2
Substantially All Disclosures
Required by GAAP Omitted

Option 2: At the bottom of each page of the financial statements:

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th>Balance Sheet</th>
<th>December 31, 20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td>$XX</td>
<td></td>
</tr>
<tr>
<td><strong>LIABILITIES AND EQUITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$XX</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>XX</td>
<td></td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$XX</td>
<td></td>
</tr>
</tbody>
</table>

Substantially all disclosures required by GAAP omitted.

or

Substantially all disclosures required by accounting principles generally accepted in the United States are not included.

10. If the prepared financial statements include supplementary information, there is no separate disclosure or other reporting reference to that supplementary information.

**Combination of no statement of cash flows and substantially all disclosures omitted**

In most instances, accountants who perform a preparation of financial statements engagement will prepare financial statements that omit the statement of cash flows and substantially all disclosures.

The prepared financial statements will typically consist of three pages and no footnotes as follows:

- Balance sheet
- Statement of income
• Schedule of operating expenses

If this is the case, on each of the three pages there would be the following three legends:

1. "No assurance is provided on these financial statements."

2. "The financial statements do not include a statement of cash flows."

3. "Substantially all disclosures required by GAAP omitted."

Note: Technically, the schedule of operating expenses is not a financial statement and the legends that are required to be placed on each page of the financial statements do not have to be placed on the schedule. The author suggests that an accountant treat the schedule of operating expenses and any other supplementary information "as if" it were a financial statement. In doing so, the accountant would include legends on each page of the supplementary information even though it is not required.

Is an accountant permitted to include in a disclaimer report, the disclosure about the GAAP departure and/or omission of disclosures?

No. AR-C 70 requires that a disclosure be presented either on the face of the financial statements or in the notes to financial statements in two instances:

• There is a GAAP (or other framework) departure, or

• Substantially all disclosures are omitted.

AR-C 70 provides that if there is a GAAP (or other financial reporting framework) departure and/or substantially all disclosures are omitted, the accountant must ensure that a disclosure (legend) is made either on the face of the financial statements or in the notes to those financial statements.

A disclaimer report is required if a client refuses to include on each page of the financial statements a legend, "no assurance is provided on these financial statements" or similar language.

There is no authority within AR-C 70 that permits an accountant to include in a disclaimer report, a disclosure of a GAAP (or other framework) departure or omission of substantially all disclosures.

Is an accountant permitted to include disclosures about only a few matters?

SSARS No. 21 carries over from SSARS No. 19 the mechanism by which financial statements include disclosures only about a few matters.

The accountant may prepare financial statements that include disclosures only about a few matters in the notes to the financial statements. Such disclosures may be labeled:

“Selected Information—Substantially All Disclosures Required By GAAP [or another the applicable financial reporting framework] Are Not Included.”

5 Alternatively, the schedule of operating expenses might be omitted with all operating expenses shown in detail on the statement of income.
If the above disclosure is included on each page of the notes pages, there is no requirement to include an additional disclosure stating that substantially all disclosures required by GAAP are not included.

When the financial statements include *more than a few disclosures* (e.g., more than two or three disclosures), the above disclosure is not appropriate. Instead, the omission of one or more notes, when all other disclosures are presented, should be treated as a GAAP departure.

**Should there be any reference to supplementary information in prepared financial statements?**

No. AR-C 70 does not require that there be any special legend or other reporting requirements with respect to any supplementary information that might be included in prepared financial statements.

Paragraph 2 of AR-C 70 states that the preparation of financial statements standards may also be applied to the preparation of other historical or prospective financial information that includes supplementary information, including required supplementary information.

However, the AR-C 70 standard applies to the preparation of financial statements, not supplementary information. Thus, if a preparation engagement is performed on financial statements and supplementary information is also included, such as a schedule of operating expenses, the rules found in AR-C 70 do not have to be applied to that supplementary information. That means there is no requirement that each page of the supplementary information have a "no assurance" legend. That said, the author suggests that an accountant add the "no assurance" language to any schedules of supplementary information, even though not required.

**Legends when there are tax-basis financial statements**

If an accountant prepares financial statements under a special purpose framework, such as tax-basis financial statements, the legends that are required to be placed on each page of the financial statements differ from the legends required for GAAP statements.

a. *No assurance is provided on these financial statements:* Is required for all financial statements, including those prepared on the tax basis.

b. *The statement of cash flows is not included:* No legend is required because a statement of cash flows is not required under the tax-basis of accounting.

c. *Substantially all disclosures are omitted:* The legend must be modified to state that:

"Substantially all disclosures ordinarily included in financial statements prepared on the tax-basis of accounting are not included."

The following chart compares the required legends for U.S. GAAP versus tax-basis financial statements.
Comparison of Legends Required for GAAP Versus Tax-basis financial statements

<table>
<thead>
<tr>
<th>Legend</th>
<th>GAAP Financial Statements</th>
<th>Tax Basis Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard &quot;no assurance disclaimer&quot;</td>
<td>&quot;No assurance is provided on these financial statements.&quot;</td>
<td>&quot;No assurance is provided on these financial statements.&quot;</td>
</tr>
<tr>
<td>No statement of cash flows presented (GAAP departure)</td>
<td>&quot;The financial statements do not include a statement of cash flows&quot;</td>
<td>NA</td>
</tr>
<tr>
<td>Substantially all disclosures omitted</td>
<td>&quot;Substantially all disclosures required by accounting principles generally accepted in the United States are not included.&quot;</td>
<td>&quot;Substantially all disclosures ordinarily included(^7) in financial statements prepared in accordance with the tax-basis of accounting are not included.&quot;</td>
</tr>
</tbody>
</table>

G. Documentation in a Preparation Engagement

The accountant should prepare documentation in connection with each preparation engagement in sufficient detail to provide a clear understanding of the work performed which, at a minimum, includes the following:

a. The engagement letter or other suitable form of written documentation with management

b. A copy of the financial statements that the accountant prepared

c. If applicable, documentation regarding significant consultations or significant judgments regarding amounts or disclosures to be reflected in the financial statements, and

d. If applicable, if the accountant departs from a relevant presumptively mandatory requirement, documentation of the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of that requirement.

Observation: Typically, the only two items that an accountant will have to document in a preparation of financial statements engagement will be an engagement letter, and a copy of the prepared financial statements, identified as items (a) and (b), respectively, above. It will be unusual for items (c) and (d) to apply as they are both non-recurring events.

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\(^6\) A statement of cash flows is required only for GAAP financial statements. Thus, the omission of a statement of cash flows in tax-basis financial statements is not a departure.

\(^7\) With respect to tax-basis financial statements, the term "ordinarily included" replaces the term "required" because there are no specific disclosures codified for tax-basis financial statements.
H. Engagement Letter- Preparation of Financial Statements Engagement

As a condition for accepting an engagement to prepare financial statements, in addition to the precondition requirements in paragraphs .24 and .25 of AR-C 60, the accountant should obtain the agreement with management. That agreement must be in writing and must be signed by both the accountant and management.

AR-C 70 provides the following guidance for an accountant to obtain agreement on the engagement terms:

1. The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate.
   a. When the agreement on the terms of engagement is only with those charged with governance, the accountant is required to obtain management’s agreement that it acknowledges and understands its responsibilities.
   b. When a third party has contracted for an engagement to prepare the entity’s financial statements, agreeing to the terms of the engagement with management of the entity is necessary in order to establish that the preconditions for an engagement to prepare financial statements are present.

2. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following:
   a. The objective of the engagement
   b. The responsibilities of management set forth in paragraph .25 of AR-C section 60
   c. The agreement with management that either:
      - Each page of the financial statements will include a statement (legend) indicating that "no assurance" is provided on the financial statements, or
      - The accountant will be required to issue a disclaimer report that makes clear that no assurance is provided on the financial statements.
   d. The responsibilities of the accountant
   e. The limitations of the engagement to prepare financial statements
   f. Identification of the applicable financial reporting framework for the preparation of financial statements
   g. Whether the financial statements are to:
      - contain a known departure(s) from the applicable framework, or
omit substantially all disclosures required by the applicable financial reporting framework

3. The engagement letter or other suitable form of written agreement should be signed by both:
   a. The accountant or the accountant’s firm, and
   b. Management or those charged with governance.

Note: The rules found in previously issued SSARS No. 19 required an accountant to obtain an understanding in writing of the terms and conditions of the engagement. However, SSARS No. 19 did not require that the engagement letter be signed by the accountant and the client. Now, SSARS No. 21 requires that the letter be signed by both the accountant and management or those charged with governance.

In lieu of an engagement letter, a more formal contract is another suitable form of written communication. The understanding with management regarding the services to be performed for engagements to prepare financial statements is required to be in a documented form. Accordingly, a verbal understanding is insufficient. An engagement letter is the most common and usually the most convenient method for documenting the understanding with management regarding the services to be performed for engagements to prepare financial statements.

Exhibit —Illustrative Engagement Letter - Preparation of Financial Statements Engagement

The following is an example of an engagement letter for an accountant to prepare financial statements. This sample letter is extracted from AR-C 70 of SSARS No. 21 and the AICPA Guide, and modified by the author. This engagement letter is not authoritative but is intended as an illustration.

Illustrative Engagement Letter- Preparation of Financial Statements Engagement- U.S. GAAP-Substantially All Disclosures and the Statement of Cash Flows Omitted

<table>
<thead>
<tr>
<th>CPA Firm Letterhead</th>
</tr>
</thead>
</table>
| To the appropriate representative of ABC Company:(1)

You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, and changes in stockholders’ equity for the year then ended. **These financial statements will not include a statement of cash flows and related notes to the financial statements.**(2)

We will also perform the following additional services: preparation of the 20XX federal and state income tax returns, and perform bookkeeping services.(3)

We are pleased to confirm our acceptance and our understanding of this engagement to prepare the financial statements of ABC Company by means of this letter.

Our Responsibilities
The objective of our engagement is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you. We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA’s Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to, and will not, verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion, or provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

Management Responsibilities

The engagement to be performed is conducted on the basis that management acknowledges and understands that our role is the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America. Management has the following overall responsibilities that are fundamental to our undertaking the engagement to prepare your financial statements in accordance with SSARSs:

a. The selection of the financial reporting framework to be applied in the preparation of financial statements

b. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error

c. The prevention and detection of fraud

d. To ensure that the entity complies with the laws and regulations applicable to its activities

e. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement to prepare financial statements

f. To provide us with:
   - Access to all information of which you are aware that is relevant to the preparation and presentation of the financial statements, such as records, documentation, and other matters
   - Additional information that may be requested for the purpose of the preparation of the financial statements, and
   - Unrestricted access to persons within the Company of whom we determine necessary to communicate.

The financial statements will not be accompanied by a report. However, you agree that the financial statements will clearly indicate that no assurance is provided on them.

The financial statements will not include a statement of cash flows and substantially all disclosures required by accounting principles generally accepted in the United States of America. You agree that the financial statements will clearly indicate that the statement of cash flows and substantially all required disclosures are omitted.

[If the accountant expects to issue a disclaimer report, instead of the preceding paragraph, the following may be added]:

As part of our engagement, we will issue a disclaimer [report] that will state that the financial
statements were not subjected to an audit, review or compilation engagement by us and, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them.

Other relevant information

Our fees for these services . . .

[The accountant may include language, such as the following, regarding limitation of, or other arrangements regarding, the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):

“You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney’s fees, resulting from management’s knowing misrepresentations to us.”]

If you request us to perform additional services not contemplated or described in this engagement letter, we will provide you with a separate agreement describing those additional services and fees.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein, and our respective responsibilities.

Sincerely yours,

_______________________ (4)

[Signature of accountant or accountant’s firm]

Acknowledged and agreed on behalf of ABC Company by:

_______________________ (4)

[Signature]

[Name and title]____________________________

[Date]

(1): The addresses and references in the engagement letter should be those that are appropriate in the circumstances of the engagement to prepare financial statements, including the relevant jurisdiction. It is important to refer to the appropriate persons.

(2): In most cases, the preparation of financial statements will omit both a statement of cash flows and substantially all disclosures. In such a situation, an additional sentence may be added stating:

“These financial statements will not include a statement of cash flows and related notes to the financial statements.”

If, instead, a statement of cash flows and substantially all disclosures are included, the first paragraph would read as follows:
"You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, and changes in stockholders’ equity, and cash flows for the year then ended and the related notes to the financial statements."

(3): If additional nonattest services are to be performed, such as preparation of tax returns and/or bookkeeping services, reference to such services can be made in the beginning or the end of the engagement letter. Alternatively, the additional nonattest services could be included in a separate engagement letter.

(4): Engagement letter must be signed by both management and the accountant.

I. Illustrative Financial Statements- AR-C 70

Example 1: Preparation of GAAP Financial Statements – No Statement of Cash Flows and Substantially All Disclosures Omitted

Facts:
- An accountant is engaged to prepare a GAAP balance sheet, income statement and schedule of operating expenses.
- The client does not want a statement of cash flows issued (GAAP departure) and wants to omit substantially all disclosures.

Conclusion:
GAAP statements should be prepared with the following:
- Legend on each page stating there is "no assurance"
- Legend on each page for the GAAP departure (no statement of cash flows)
- Legend on each page noting that substantially all disclosures are omitted.

<table>
<thead>
<tr>
<th>Assets</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Property and equipment, net</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Other assets</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Other assets</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholder's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities:</td>
</tr>
</tbody>
</table>
Accounts payable | $XX | $XX
Accrued expenses | XX | XX
Short-term notes payable | XX | XX
Long-term debt | XX | XX

**Stockholders’ equity:**
- Common stock | XX | XX
- Retained earnings | XX | XX
  
  XX | XX

$XXX | $XXX

*No assurance is provided on these financial statements.*

*The financial statements do not include a statement of cash flows.*

*Substantially all disclosures required by accounting principles generally accepted in the United States are not included.*

| XYZ Company |
|---|---|
| Statements of Income and Retained Earnings |
| Years Ended December 31, 20X2 and 20X1 |

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Gross profit</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Net operating income</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Other income</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Income taxes</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Net income</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>End of year</td>
<td>$XXX</td>
<td>$XXX</td>
</tr>
</tbody>
</table>
No assurance is provided on these financial statements.

The financial statements do not include a statement of cash flows.

Substantially all disclosures required by accounting principles generally accepted in the United States are not included.

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th>Schedules of Operating Expenses</th>
<th>Years Ended December 31, 20X2 and 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>20X2</td>
</tr>
<tr>
<td>Rent</td>
<td></td>
<td>$XX</td>
</tr>
<tr>
<td>Utilities</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Payroll and payroll related expenses</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Office supplies</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Professional fees</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Travel and entertainment</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Sundry other</td>
<td></td>
<td>$XX</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$XX</td>
</tr>
</tbody>
</table>

No assurance is provided on these financial statements.

The financial statements do not include a statement of cash flows.

Substantially all disclosures required by accounting principles generally accepted in the United States are not included.

Observation: Example 1 represents what is likely the most common format for a preparation of financial statements engagement under AR-C 70. In the Example, the accountant prepares a balance sheet, income statement and schedule of operating expenses, but no statement of cash flows and no disclosures.
AR-C 70 states that there is no requirement to place any legends on schedules of supplementary information. The author recommends that an accountant include on schedules of supplementary information (such as a schedule of operating expenses), the same legends that are required for financial statements.

Example 2: Preparation of Tax-Basis Financial Statements – No Statement of Cash Flows is Presented and Substantially All Disclosures Omitted

Facts:
- An accountant is engaged to prepare financial statements for XYZ Company on the tax-basis of accounting.
- The client does not want a statement of cash flows and wants to omit substantially all disclosures.
- A schedule of operating expenses is included.

Conclusion:
Tax-basis financial statements would be prepared with the following:
- Statement (legend) on each page stating there is "no assurance."
- Disclosure (legend) on each page of the financial statements noting that substantially all disclosures "ordinarily included" in tax-basis financial statements are omitted.
- No disclosure (legend) is required for not having a statement of cash flows because such a statement is not required unless GAAP statements are issued.

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th>Balance Sheets- Tax Basis</th>
<th>December 31, 20X2 and 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASSETS</td>
<td></td>
<td>20X2</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$XX</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Property and equipment, net</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Other assets</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND STOCKHOLDERS' EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities:</td>
<td>20X2</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$XX</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>XX</td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>XX</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>XX</td>
</tr>
<tr>
<td>Stockholders’ equity:</td>
<td>XX</td>
</tr>
<tr>
<td>Common stock</td>
<td>XX</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>XX</td>
</tr>
<tr>
<td></td>
<td>$XX</td>
</tr>
</tbody>
</table>
No assurance is provided on these financial statements. Substantially all disclosures ordinarily included in financial statements prepared on the tax-basis of accounting are not included.

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th>Statements of Income and Retained Earnings- <strong>Tax Basis</strong></th>
<th>Years Ended December 31, 20X2 and 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>20X2</td>
</tr>
<tr>
<td>Net sales</td>
<td></td>
<td>$XX</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Gross profit</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Net operating income</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Other income</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Income taxes</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td>XX</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>Beginning of year</td>
<td></td>
<td>xx</td>
</tr>
<tr>
<td>End of year</td>
<td></td>
<td>$XX</td>
</tr>
</tbody>
</table>

No assurance is provided on these financial statements. Substantially all disclosures ordinarily included in financial statements prepared on the tax-basis of accounting are not included.
XYZ Company
Schedules of Operating Expenses - **Tax Basis**
Years Ended December 31, 20X2 and 20X1

<table>
<thead>
<tr>
<th>Item</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td>Utilities</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Insurance</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Payroll and payroll related expenses</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Office supplies</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Professional fees</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Travel and entertainment</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Sundry other</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$XX</strong></td>
<td><strong>$XX</strong></td>
</tr>
</tbody>
</table>

*No assurance is provided on these financial statements. Substantially all disclosures ordinarily included in financial statements prepared on the tax-basis of accounting are not included.*

**Observation:** In Example 2, no statement of cash flows is required for tax-basis financial statements, although such a statement could be included in a set of financial statements. Thus, the fact that there is no statement of cash flows is not a departure from the tax-basis of accounting that requires a legend on the bottom of each page of the financial statements.

Note also the language in the legend “substantially all disclosures ordinarily included…” The term “ordinarily included” is used in lieu of “required” because there is no formal codification of specific disclosures required for tax-basis financial statements.
Review Questions

1. To which of the following engagements do the standards found in AR-C 70 of SSARS No. 21 apply assuming an accountant is engaged to perform the engagement:
   a. Preparation of financial statements by an accountant in industry and there is no other engagement performed on those financial statements
   b. Preparation of financial statements by an accountant in public practice and the accountant is also engaged to perform an audit on those same financial statements
   c. Preparation of financial statements by an accountant in public practice and the accountant is not engaged to perform any other engagement on those same financial statements
   d. Preparation of financial statements by an accountant in industry and the accountant is also performing a review engagement on those same financial statements

2. Which of the following is correct with respect to the rules for a preparation of financial statements engagement under AR-C 70:
   a. The accountant must be independent
   b. A special report must be issued in all cases
   c. An engagement letter must be signed by management but not the accountant
   d. The financial statements may be issued to the client or third party

3. An accountant performs a preparation of financial statements engagement under AR-C 70. The accountant obtains information from management to prepare the financial statements. Which of the following properly identifies the accountant's responsibility with respect to the information obtained from management:
   a. The accountant is required to verify the accuracy of the information
   b. The accountant is required to verify the completeness of the information
   c. The accountant is required to verify the completeness, but not the accuracy of the information
   d. The accountant is not required to verify the accuracy or completeness of the information

4. In a preparation of financial statements engagement, which of the following is an appropriate legend to place on each page of the financial statements:
   a. "See Accountant's Preparation Report"
   b. "No assurance is provided on these financial statements"
   c. "See Notes to Financial Statement"
   d. "See Independent Accountant's Report"

5. Sophia Rapallo is an accountant who is hired to prepare financial statements for her client. The client wants her to prepare her financial statements on the tax basis, which is a special purpose framework. What must the accountant do with respect to the special purpose framework:
   a. She should include a description of the framework in the accountant's report
   b. She should include a description of the framework in the notes to financial statements but not on the face of the financial statements
   c. She should include the description of the framework on the face of the financial statements or in the notes to financial statements
   d. She should do nothing as no modification is required
6. Elaine Liberman is performing a preparation of financial statements engagement under AR-C 70. Elaine discovers a significant error that makes the financial statements inaccurate. How should Elaine handle this profound discovery of a significant error:
   a. Elaine should dig a deep hole in the sand, stick her head in it and act like an ostrich. There is no requirement to verify or correct errors in a preparation engagement
   b. Elaine should bring the error to the attention of the third-party users
   c. Elaine should bring the error to the attention of management and request from management any additional information and/or corrected information
   d. Elaine must modify her preparation report to identify the error, if it is material

7. Joseph Coatman is performing a preparation of financial statements engagement under AR-C 70. The financial statements omit substantially all disclosures. Which of the following is the correct way in which Joseph should deal with the omission of disclosures:
   a. The disclosure of the omission should be made on the face of the financial statements or in a note to the financial statement
   b. The disclosure of the omission must be made in a note to the financial statements
   c. Nothing has to be done by Joseph
   d. Disclosure must be made in the preparation report

8. An accountant is performing a preparation of financial statements engagement under AR-C 70 on a client's financial statements. There is no statement of cash flows and substantially all disclosures are omitted. Which of the following identifies the legends that should be presented on each page of the financial statements:
   a. There should be three legends
   b. There should be two legends
   c. There should be one legend
   d. No legends are required

9. Which of the following is an item that should be documented in a preparation of financial statements engagement under AR-C 70:
   a. A copy of the financial statements
   b. A copy of the accountant's preparation report
   c. Preparation checklist
   d. A management representation letter
AR-C Section 80- Compilation Engagements

A. Introduction

AR-C 80, Compilation Engagements, is part of SSARS No. 21 and encompasses the new compilation standards that replace the existing compilation rules found in AR 80 of SSARS No. 19. Following is a summary of the key changes that new AR-C 80 makes to the existing AR 80 compilation standards:

<table>
<thead>
<tr>
<th>Element</th>
<th>Existing AR 80 (SSARS No. 19)</th>
<th>New AR-C 80 (SSARS No 21)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of a compilation engagement</td>
<td>Assist management in presenting financial information in the form of financial statements</td>
<td>Apply accounting and financial reporting expertise to assist the client in the presentation of financial statements</td>
</tr>
<tr>
<td>Triggers for performing a compilation engagement</td>
<td>Accountant performs a compilation engagement if: • accountant is engaged (hired) to perform a compilation engagement, or • accountant submits financial statements to a client or third party&lt;sup&gt;8&lt;/sup&gt;</td>
<td>Accountant performs a compilation engagement only if: • accountant is engaged (hired) to perform compilation engagement Existing submission trigger is eliminated</td>
</tr>
<tr>
<td>Preparation of financial statements</td>
<td>Preparation is implicitly part of a compilation engagement</td>
<td>Preparation is explicitly separated from a compilation engagement</td>
</tr>
</tbody>
</table>
| Management-use financial statements | Management-use only financial statements without a report may be issued to management only Accountant may restrict who receives financial statements | Management-use only financial statements are eliminated
Compilation engagement always requires a report
Financial statements belong to management. Accountant may restrict who the financial statements are issued to by agreement<sup>9</sup> |

---

<sup>8</sup> Pre SSARS No. 21’s definition of submission is when an accountant prepares financial statements and presents them to a client or a third party.

<sup>9</sup> The accountant can restrict who the financial statements are issued to by agreement with the client in an engagement letter.
<table>
<thead>
<tr>
<th>Element</th>
<th>Existing AR 80 (SSARS No. 19)</th>
<th>New AR-C 80 (SSARS No 21)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Engagement letter</strong></td>
<td>Engagement letter or written contract does not have to be signed</td>
<td>Engagement letter or written contract must be signed by both the accountant and management</td>
</tr>
<tr>
<td><strong>Independence</strong></td>
<td>Lack of independence is disclaimed in report</td>
<td>Lack of independence is disclaimed in report</td>
</tr>
<tr>
<td></td>
<td>Accountant may disclose reason(s) for lack of independence as long as all reasons are disclosed</td>
<td>Accountant may disclose reason(s) for lack of independence as long as all reasons are disclosed</td>
</tr>
<tr>
<td><strong>Report</strong></td>
<td>Standard three paragraphs</td>
<td>Abbreviated one paragraph</td>
</tr>
<tr>
<td></td>
<td>Has title</td>
<td>No title</td>
</tr>
<tr>
<td></td>
<td>Has salutation (addressee)</td>
<td>No salutation (addressee)</td>
</tr>
<tr>
<td></td>
<td>Management may elect to omit substantially all disclosures and statement of cash flows</td>
<td>Management may elect to omit substantially all disclosures and statement of cash flows</td>
</tr>
<tr>
<td></td>
<td>Accountant's city and state are not required</td>
<td>Accountant's city and state must be identified in the report&lt;sup&gt;10&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>Income tax-basis financial statements</strong></td>
<td>OCBOA includes &quot;income tax basis&quot; financial statements</td>
<td>Special purpose framework includes &quot;tax basis&quot; financial statements</td>
</tr>
<tr>
<td><strong>Emphasis-of-matter paragraph</strong></td>
<td>Emphasis-of-matter paragraph permitted in certain cases</td>
<td>Carries over existing emphasis-of-matter paragraph and introduces new &quot;other-matter&quot; paragraph from auditing standards</td>
</tr>
</tbody>
</table>

<sup>10</sup> Accountant's city and state may be listed on the accountant's letterhead.
B. Effective Date

AR-C 80 is effective for compilations of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

C. Scope of AR-C 80- Compilation Engagements

AR-C 80 provides the following scope for engagements that are covered under the compilation rules.

1. An engagement is subject to the compilation rules found in AR-C 80 only when the accountant is engaged to perform a compilation engagement (e.g., client hires the accountant to perform a compilation engagement).

   a. The existing rules that a compilation engagement is required if an accountant submits financial statements is eliminated.

   Observation: AR 80 (SSARS No. 19) has provided that an accountant is required to perform a compilation engagement if he or she is either hired to perform a compilation engagement, or if he or she submits financial statements. Under AR 80, an accountant submits financial statements if he or she prepares and presents financial statements to a client or third party. The original definition of "submission" was issued in 1978 as part of SSARS No. 1. Since that time, technology has affected how one determines whether financial statements have been "prepared" and whether they have been "presented." For example, if an accountant makes adjusting entries to a "QuickBooks®" file that automatically updates the financial statements, has the accountant prepared those financial statements? If the accountant prints out financial statements, has he or she prepared them? The challenge with the "submission" definition found in SSARS No. 19 is that it has not kept up with technological changes. It also does not necessarily reflect the needs of the client and end user. For example, an accountant may be forced to perform a compilation engagement solely because he or she has submitted financial statements even though the client has not engaged that accountant to do so. The new definition of a compilation engagement in AR-C 80 states that the only way an accountant performs a compilation engagement is if he or she is actually engaged (hired) to do so.

2. Historical or prospective financial information may be the subject of a compilation and includes the Following:

   - A financial statement(s)
   - Specified elements, accounts, or items of a financial statement, such as schedules of rentals, royalties, profit participation, or provision for income taxes
   - Supplementary information
   - Required supplementary information
   - Pro forma financial information
   - Prospective financial information, including budgets, forecasts, or projections

   Observation: Prior to the issuance of SSARS No. 21, the guidance for prospective financial information was found in SSAE No. 10 (AT section 301), Financial Forecasts and Projections. SSAE No. 10 permits an accountant to perform a compilation, examination, or agreed-upon procedures engagement on prospective information.
With the issuance of SSARS No. 21, the ARSC moved the guidance for a compilation of prospective information from SSAE No. 10 to SSARS No. 21. Moreover, in new AR-C 70, a preparation of prospective information engagement is now permitted.

The result is that an accountant who wishes to either prepare or compile prospective financial information follows the guidance found in SSARS No. 21, not SSAE No. 10. The ARSC is issuing separate guidance for a compilation engagement on prospective financial information.

D. Objective of a Compilation Engagement

AR-C 80 states that the accountant’s objective in a compilation engagement is to do the following:

"apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with this standard (AR-C 80) without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework."

1. A compilation engagement is separate from a preparation of financial statements engagement performed under AR-C 70 (a nonattest engagement).

Note: An accountant can be engaged to perform a compilation engagement and not prepare financial statements. If the accountant is hired to both prepare financial statements and perform a compilation engagement on them, the engagement letter must identify both services separately.

E. Definitions

AR-C 80 includes the various definitions related to compilation engagements some of which are noted below:

**Special purpose framework:** A financial reporting framework other than GAAP that is one of the following bases of accounting:

- **Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

- **Tax basis:** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.

- **Regulatory basis:** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).

- **Contractual basis:** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- **Other basis:** A basis of accounting that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash basis, tax basis, regulatory basis, and other basis of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA).

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

**Those charged with governance:** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

**F. Requirements- Compilation Engagements- AR-C 80**

An accountant who performs a compilation engagement, must comply with the following rules found in AR-C 80:

1. In addition to complying with AR-C 80, an accountant is required to comply with AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

2. **Acceptance and continuance of client in compilation engagement:**

   In order for an accountant to accept a compilation engagement with respect to an entity’s financial statements, the accountant must meet *certain conditions* as follows:

   a. The accountant must satisfy general preconditions found in paragraphs .24 of the general conditions in AR-C 60.

   b. The accountant must satisfy certain general conditions found in paragraphs 25(a) and (b) of AR-C 60 general conditions which are discussed in more detail in the section related to AR-C 60.

   c. The accountant should obtain the agreement of management (included in an engagement letter) that it acknowledges and understands its responsibilities found in paragraph .25(c.) of AR-C 60, *General Principles*, and as to certain specific terms related to compilation engagements found in AR-C 80.

3. A compilation engagement does not require the accountant to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements.
Note: Paragraph 2.35 of the AICPA Guide expands on the notion that an accountant is not required to verify the accuracy or completeness of the information management provides in a compilation engagement. The Guide notes that within a compilation engagement, an accountant may perform procedures that are customarily performed in a review or audit. In doing so, the engagement remains a compilation engagement and the accountant is not required to change the engagement to a review or audit. What the Guide states clearly is that nothing precludes an accountant from performing additional procedures as part of a compilation engagement.

If the accountant does, in fact, perform review or audit procedures as part of a compilation engagement, the accountant should be careful not to use phrases that would suggest that a review or audit engagement is being performed. For example, if the accountant decides to perform confirmation procedures as part of a compilation engagement, the accountant should refrain from using language in the confirmation letter such as “as part of an audit” or similar language that could be misconstrued to suggest an audit is being performed.

Independence - compilation engagement and preparation of financial statements

It is typical for an accountant who performs a compilation engagement to also prepare financial statements. The preparation of financial statements is a nonattest service while the compilation engagement is an attest engagement.

If an accountant performs a compilation engagement and also prepares financial statements, the accountant is performing a nonattest service (preparation) for an attest client. In such a case, the accountant’s independence is impaired unless the accountant applies certain safeguards required by the Nonattest Services subtopic of the Independence Rule found in ET sec. 1.295 of the AICPA Professional Standards.

Those safeguards, which are discussed further in the review engagement section of this course, include three requirements:

1. The client must agree to assume management responsibilities for the nonattest service (preparation of financial statements, in this case)
2. The accountant must not assume management responsibilities for the nonattest service performed (preparation of financial statements, in this case), and
3. There must be language in the engagement letter that confirms that the client, not the accountant, assumes management responsibility for the nonattest service performed (e.g., preparation of financial statements, in this case).

G. Engagement Letter - Compilation

AR-C 80 provides the following guidance for an accountant to obtain agreement on the compilation engagement terms:

1. The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate.
2. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following:

   a. The objectives of the engagement
   b. The responsibilities of management
   c. The responsibilities of the accountant
   d. The limitations of the compilation engagement
   e. Identification of the applicable financial reporting framework for the preparation of the financial statements
   f. The expected form and content of the accountant’s compilation report, and a statement that there may be circumstances in which the report may differ from its expected form and content.

3. The engagement letter or other suitable form of written agreement should be signed by both:

   a. The accountant or the accountant’s firm, and
   b. Management or those charged with governance, as appropriate.

Observation: SSARS No. 19 has required that an engagement agreement be in writing but does not require that the agreement be signed by both parties. SSARS No. 21 now requires that all engagement letters involving SSARS engagements (preparation, compilation and review engagements) must be signed by both the accountant and management and/or those charged with governance.

The roles of management and those charged with governance in agreeing upon the terms of the compilation engagement for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity’s structure, the agreement may be with management, those charged with governance, or both. When the agreement on the terms of engagement is only with those charged with governance, in accordance with paragraph 25(c) of AR-C 60, the accountant is required to obtain management’s agreement that it acknowledges and understands its responsibilities. Thus, in general, management should sign the engagement letter even if the board of directors also signs it.

4. A contract is another suitable form of written communication. The understanding with management regarding the services to be performed for compilation engagements is required to be in a documented form, and, accordingly, a verbal understanding is insufficient.

Following is an illustration of an engagement letter extracted from the exhibits to SSARS No. 21 as modified by the AICPA Guide and the Author.

Illustration 1—An Engagement Letter for an Engagement to Prepare Financial Statements in Accordance With U.S. GAAP and to Perform a Compilation Engagement With Respect to Those Financial Statements

Facts:
The accountant is hired to prepare, as a nonattest service, the financial statements, including related notes.

The accountant is also hired to perform a compilation engagement on the same financial statements for the same period.

U.S. GAAP is the applicable framework.

The accountant expects that his or her independence will not be impaired by performing the preparation of financial statements nonattest service.

To the appropriate representative of management of ABC Company:

You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements, and perform a compilation engagement with respect to those financial statements. We are pleased to confirm our acceptance and our understanding of this compilation engagement by means of this letter.

We will also perform the following additional services: preparation of the 20XX federal and state income tax returns, and perform bookkeeping services. (a)

Our Responsibilities
The objective of our engagement is to:

a. prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you, and

b. apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA’s Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to and will not verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion, nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

Your Responsibilities
The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and to assist you in the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America. You have the following overall

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responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of financial statements
b. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
c. The prevention and detection of fraud
d. To ensure that the entity complies with the laws and regulations applicable to its activities
e. To make all financial records and related information available to us
f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
g. To provide us with:
   • Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
   • Additional information that may be requested management for the purpose of the engagement, and
   • Unrestricted access to persons within the Company of whom we determine necessary to make inquiries.
h. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America.

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services. [AICPA ET 1.295 - Nonattest Services] (b)

You are also responsible for including the following reference on each page of the financial statements including supplementary information: "See Accountant's Compilation Report." (c)

Our Report
As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them. There may be circumstances in which the report differs from the expected form and content.

You agree to include the compilation report in any document containing financial statements that indicates that the entity's accountant has performed a compilation engagement on such financial statements and, prior to inclusion of the report, to ask our permission to do so.

Other relevant information
Our fees for these services . . . .

[The accountant may include language, such as the following, regarding limitation of or other arrangements regarding the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):

   You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney’s fees, resulting from management’s knowing misrepresentations to us.

If you request us to perform additional services not contemplated or described in this engagement letter, we will provide you with a separate agreement describing those additional services and fees.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a compilation engagement with respect to those same financial statements, and our respective responsibilities.
Sincerely yours,

_______________________
[Signature of accountant or accountant’s firm]

Acknowledged and agreed on behalf of ABC Company by:

_______________________
[Signature]
[Name and title]

[Date]

(a): If additional nonattest services are to be performed, such as preparation of tax returns and/or bookkeeping services, reference to such services can be made in the beginning or the end of the engagement. Alternatively, the additional nonattest services could be included in a separate engagement letter.

(b): Because a nonattest service (preparation of financial statements) is performed for an attest engagement (compilation engagement), the accountant is required to include language in the engagement letter in accordance with AICPA Professional Standards, Nonattest Services, ET section 1.295, to remain independent.

c): The legend "See Accountant's Compilation Report" or similar language, is not required. Because the financial statements are the responsibility of management, if an accountant wishes to include the legend on each page of the financial statements (including supplementary information), management should agree to it within the engagement letter.

H. The Accountant’s Knowledge and Understanding of the Entity’s Financial Reporting Framework - Compilation Engagement

In performing a compilation engagement, AR-C 80 requires that an accountant should obtain an understanding of the applicable financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements.

Note: SSARS No. 21 states that although the accountant is required to obtain an understanding of: a) the applicable financial reporting framework intended to be used in the preparation of the financial statements, and b) the significant accounting policies adopted by management, such requirements do not prevent the accountant from accepting a compilation engagement for an entity in an industry in which the accountant has no previous experience. The accountant may obtain such an understanding, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals who are knowledgeable about the framework or the industry.
I. Compilation Procedures

In performing a compilation engagement, AR-C 80 requires an accountant to perform the following procedures:

1. The accountant should read the financial statements in light of the accountant’s understanding of the applicable financial reporting framework and the significant accounting policies adopted by management and consider whether such financial statements appear to be appropriate in form and free from obvious material misstatements.

2. If, during the compilation engagement, the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, provided by management are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information.

Note: In a compilation engagement, an accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have performed such inquiries or procedures and the results of those inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that information provided by management is incorrect, incomplete, or otherwise unsatisfactory.

3. The accountant should propose appropriate revisions to the financial statements in the following circumstances if the accountant becomes aware during the course of the engagement that:

   a. the financial statements do not adequately refer to, or describe the applicable financial reporting framework either through:

      - the financial statement titles, or
      - the notes to the financial statements.

   b. revisions to the financial statements are required for the financial statements to be in accordance with the applicable financial reporting framework, or

   c. the financial statements are otherwise misleading.

Note: Financial statements may be misleading if the applicable financial reporting framework includes the premise that the financial statements are prepared on the going concern basis, and undisclosed uncertainties exist regarding the entity’s ability to continue as a going concern.

If the accountant becomes aware that uncertainties exist regarding the entity’s ability to continue as a going concern, the accountant may suggest additional disclosures concerning the entity’s ability to continue as a going concern, in order to avoid the financial statements being misleading.

Disclosure of items, such as an uncertainty, is not required in financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted.
4. The accountant should withdraw from the compilation engagement and inform management of the reasons for withdrawing if:

   a. the accountant is unable to complete the engagement because management has failed to provide records, documents, explanations, or other information, including significant judgments, as requested, or

   b. management does not make appropriate revisions that are proposed by the accountant or does not disclose such departures in the financial statements, and the accountant determines to not disclose such departures in the accountant’s compilation report.

   **Note:** If an accountant withdraws from the engagement, the responsibility to inform management of the reasons for withdrawing provides an opportunity to explain the accountant’s ethical obligations. When making a determination about whether and how to withdraw from an engagement, the accountant may wish to consult with legal counsel.

**J. The New Accountant’s Compilation Report**

SSARS No. 21 makes significant changes to the compilation report as compared with the report previously found in AR 80 of SSARS No. 19.

The following table compares the key elements of the new report with the existing compilation report.
### Comparison of Existing Versus New Compilation Report

<table>
<thead>
<tr>
<th>Description of Element</th>
<th>Existing AR 80 Compilation Report</th>
<th>New AR-C 80 (SSARS 21) Compilation Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paragraphs</td>
<td>Three paragraphs</td>
<td>One paragraph</td>
</tr>
<tr>
<td>Addressee [Salutation to management or board of directors]</td>
<td>Yes</td>
<td>No&lt;sup&gt;11&lt;/sup&gt;</td>
</tr>
<tr>
<td>Report title</td>
<td>Yes &quot;Accountant's Compilation Report&quot; or &quot;Independent Accountant's Compilation Report&quot;</td>
<td>No&lt;sup&gt;12&lt;/sup&gt;</td>
</tr>
<tr>
<td>Identify the entity whose financial statements have been subjected to the compilation engagements</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Include a statement that the accountant performed a compilation engagement</td>
<td>We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended.</td>
<td>We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA.</td>
</tr>
<tr>
<td>Identify the financial statements that have been subjected to the compilation engagement</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>The date or period covered by the financial statements</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Statement that accountant did not audit or review the financial statements and does not express an opinion</td>
<td>We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.</td>
<td>We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.</td>
</tr>
</tbody>
</table>

<sup>11</sup> Although a salutation is not required in the SSARS 21 compilation report, nothing precludes an accountant from adding a salutation.

<sup>12</sup> Although a report title is not required in the SSARS 21 compilation report, nothing precludes an accountant from adding a report title.
<table>
<thead>
<tr>
<th>Description of Element</th>
<th>Existing AR 80 Compilation Report</th>
<th>New AR-C 80 (SSARS 21) Compilation Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement that management is responsible for the financial statements</td>
<td>Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.</td>
<td>Management is responsible for the accompanying financial statements of XYZ Company.</td>
</tr>
<tr>
<td>Accountant's responsibility</td>
<td>Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.</td>
<td>NONE</td>
</tr>
<tr>
<td>Objective (definition) of a compilation engagement</td>
<td>The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.</td>
<td>NONE</td>
</tr>
<tr>
<td>Signature of accountant</td>
<td>The manual or printed signature of the accounting firm or the accountant, as appropriate.</td>
<td>The signature of the accountant or the accountant’s firm, either a manual, printed, or digital format.</td>
</tr>
<tr>
<td>Accountant's city and state where he or she practices</td>
<td>Not required</td>
<td>Include the city and state where the accountant practices.</td>
</tr>
<tr>
<td>Date on accountant's report</td>
<td>The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant's report).</td>
<td>The date of the report, which should be the date that the accountant has completed the procedures required.</td>
</tr>
<tr>
<td>Paragraph headings</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Modification for lack of independence</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Reasons can be identified as long as all reasons for lack of independence are identified.</td>
<td>Reasons can be identified as long as all reasons for lack of independence are identified.</td>
</tr>
</tbody>
</table>
General Rules for the SSARS No. 21 Compilation Report

SSARS No. 21 (AR-C 80) provides the following rules related to the compilation report:

1. The accountant’s compilation report should be in writing and should:
   a. include a statement that management (owners) is (are) responsible for the financial statements
   b. identify the financial statements that have been subjected to the compilation engagement
      
      **Note:** If financial statements include disclosures, in the first paragraph of the report, the financial statements include the "related notes to the financial statements."
   c. identify the entity whose financial statements have been subjected to the compilation engagement
   d. specify the date or period covered by the financial statements
   e. include a statement that the accountant performed the compilation engagement in accordance with SSARSs promulgated by the Accounting and Review Services Committee of the AICPA
   f. include a statement that the accountant did not audit or review the financial statements nor was the accountant required to perform any procedures to verify the accuracy or completeness of the information provided by management and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on the financial statements
   g. include the signature of the accountant or the accountant’s firm, either a manual, printed, or digital format
   h. include the city and state where the accountant practices
      
      **Note:** The city and state where the accountant practices may be indicated on letterhead that contains the issuing office’s city and state.
   i. include the date of the report, which should be the date that the accountant has completed the procedures required by this section

2. There is no longer a requirement to include a title in the compilation report or a greeting (salutation).

3. An accountant *may request* that management include a reference on each page of the financial statements to the accountant's compilation report, such as:

   "See Accountant's Report"
   "See Accountant's Compilation Report"
   "See Independent Accountant's Compilation Report"
Observation: It is generally understood that there is a risk that an accountant's report could become detached from the related financial statements. If that occurs, financial statements with no report and no reference to the level of service, could be received and relied on by a client or third party. SSARS No. 1 and its replacement, SSARS No. 19, have required that the accountant include a legend on each page of the financial statements such as "See Accountant's Compilation Report" or "See Independent Accountant's Compilation Report." Unlike previous SSARS No. 19, the new SSARS No. 21 (AR-C 80) no longer requires that the accountant include a legend on each page of the financial statements such as "See Accountant's Compilation Report." Instead, SSARS No. 21 states that the accountant "may wish to request that management include the legend on each page of the financial statements" related to the accountant's report. SSARS No. 21 also makes a suggestion, but not a requirement, that a legend be placed on each page of supplementary information, as well.

Some commentators believe that the ARSC should have made the legend mandatory in SSARS No. 21, just like it has been required previously. One reason for not requiring the legend is the fact that the financial statements belong to management, not the accountant. Thus, management could choose not to include any legend. Second, current audit standards do not require a legend be placed on financial statements pages although many auditors do, in fact, include a legend such as "See Auditor's Report."

The author believes it is important that an accountant does, in fact, include a legend such as "See Accountant's Compilation Report" or "See Independent Accountant's Compilation Report" on each page of compiled financial statements (including supplementary information), even though such a legend is no longer required.

Because the financial statements are the responsibility of management, the engagement letter should clearly state that management shall place on each page of the financial statements a reference (legend) "See Accountant's Compilation Report" or similar legend.

The author suggests that the engagement letter include language similar to the following:

You are also responsible for including the following reference on each page of the financial statements including supplementary information: "See Accountant's Compilation Report."

Accountant’s Compilation Report on Financial Statements Prepared in Accordance with a Special Purpose Framework

If a compilation report is issued on financial statements prepared under a special purpose framework (such as tax basis), SSARS No. 21 provides special reporting rules:

1. Unless the entity elects to omit substantially all disclosures, the accountant should modify the compilation report when that accountant becomes aware that the financial statements do not include:
   a. a description of the special purpose framework
   b. a summary of significant accounting policies
c. an adequate description about how the special purpose framework differs from GAAP. (The effects of these differences need not be quantified), and

d. informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

**Note:** If an entity elects to omit substantially all disclosures, the four disclosures noted above in 1(a) through 1(d) are not required.

2. If financial statements are prepared in accordance with a *contractual basis of accounting*, the accountant should modify the compilation report if the financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based.

3. The accountant’s compilation report on financial statements prepared in accordance with a special purpose framework should:

   - make reference to management’s responsibility for determining that the applicable financial reporting framework is *acceptable* in the circumstances when *management has a choice of financial reporting frameworks* in the preparation of such financial statements, and

   - describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information when the financial statements are prepared in accordance with a *regulatory basis or contractual basis* of accounting.

   **Note:** When the financial statements are prepared in accordance with a regulatory or contractual basis of accounting, the accountant is required to describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information. This is necessary to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended. The note to the financial statements may also describe any significant interpretations of the contract on which the financial statements are based.

4. The accountant’s compilation report on financial statements prepared in accordance with a special purpose framework should include a *separate paragraph* that:

   - indicates that the financial statements are prepared in accordance with the applicable special purpose framework

   - refers to the note to the financial statements that describes the framework, if applicable, and

   - states that the special purpose framework is a basis of accounting other than GAAP.
Reporting When the Accountant Is Not Independent

When the accountant is not independent with respect to an entity for which a compilation engagement is performed, the accountant should do the following:

1. Indicate the accountant’s lack of independence in a final paragraph of the accountant’s compilation report.

2. If the accountant elects to disclose a description about the reasons the accountant’s independence is impaired, the accountant should include all such reasons in the description.

An example of a disclosure that an accountant may make to indicate the accountant’s lack of independence would be:

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

3. The accountant is not precluded from disclosing a description about the reason(s) that the accountant’s independence is impaired. The following are examples of descriptions the accountant may use:

   I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.

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

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

Reporting on Financial Statements That Omit Substantially All the Disclosures Required by the Applicable Financial Reporting Framework

SSARS No. 21 carries over from SSARS No. 19, rules that apply when compiled financial statements omit substantially all disclosures required by GAAP or the applicable financial reporting framework.

1. The accountant should not issue an accountant’s compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework unless the omission of substantially all disclosures is not, to the accountant’s knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

2. When reporting on financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should include a separate paragraph in the accountant’s compilation report that includes the following elements:
a. A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework (or ordinarily included in the financial statements if the financial statements are prepared in accordance with a special purpose framework)

b. A statement that if the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows (or the equivalent for presentations other than GAAP)

c. A statement that, accordingly, the financial statements are not designed for those who are not informed about such matters:

   Management has elected to omit substantially all of the disclosures (and the statement of cash flows, if applicable) required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

3. When management elects to include disclosures about only a few matters in the notes to the financial statements, such disclosures may be labeled:

   “Selected Information - Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included.”

Note: Typically, the above label is presented at the top of each page of the notes to the financial statements.

SSARS No. 21 carries over a long-standing option of including a “few disclosures” in the notes to financial statements while still including in the compilation report the standard “management has elected to omit substantially all disclosures” paragraph. This paragraph states that “substantially all disclosures” have been omitted and not that “all” disclosures have been omitted. That means the accountant is permitted to include a few disclosures in the notes, while omitting the remainder of the required disclosures. As long as the standard “management has elected to omit substantially all disclosures” paragraph is included in the compilation report along with the “selected information - substantially all disclosures required” label on each page of the notes, this option is permitted under SSARS No. 21. A “few” disclosures generally means two or three disclosures.

4. The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the applicable financial reporting framework, and the nature of the departure and its effects, if known, should be disclosed.
**Reporting Known Departures From the Applicable Financial Reporting Framework**

SSARS No. 21, in general, carries over the guidance found in SSARS No. 19 with respect to reporting on known GAAP (or other framework) departures in the compilation engagement:

1. When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and the financial statements are not revised, or the departure is not disclosed in the notes to the financial statements, the accountant should modify the compilation report to disclose the departure.

2. The effects of the departure on the financial statements should be disclosed if such effects have been determined by management or are readily known to the accountant as the result of the accountant's procedures.

3. If the effects of the departure have not been determined by management or are not readily known to the accountant as a result of the accountant’s procedures, the accountant is not required to determine the effects of a departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.

4. If the accountant believes that modification of the compilation report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the engagement and provide no further services with respect to those financial statements.

5. The accountant should not modify the compilation report to include a statement that the financial statements are not in conformity with the applicable financial reporting framework.

**Notes:** SSARS No. 21 states that an accountant is precluded from including a statement that the financial statements are not in conformity with the applicable financial reporting framework because such a statement would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement.

**Reporting on Supplementary Information – Compilation Engagement**

*Supplementary Information That Accompanies Financial Statements and the Accountant’s Compilation Report*

SSARS No. 21 expands some of the language found in SSARS No. 19 with respect to supplementary information that accompanies a compilation report.

1. Although not required to perform a compilation engagement on supplementary information that accompany financial statements and the accountant’s compilation report, nothing precludes the accountant from performing a compilation engagement on the supplementary information if engaged to do so.

2. If an accountant issues a compilation report on the financial statements, the accountant may report on any supplementary information as follows:
Option 1: Compile the supplementary information, or

Option 2: Disclaim the supplementary information

Note: An accountant who compiles the financial statements is not permitted to review the supplementary information. The accountant is also not permitted to audit the supplementary information in compiled financial statements.

3. When supplementary information accompanies compiled financial statements and the accountant’s compilation report, the accountant should clearly indicate the degree of responsibility, if any, the accountant is taking with respect to such information in either:

   a. An other-matter paragraph in the accountant’s compilation report on the financial statements, or

   b. A separate report on the supplementary information.

Option 1 - Compile the Supplementary Information:

When the accountant has performed a compilation engagement with respect to both the financial statements and the supplementary information, the accountant should either:

   a. Include an other-matter paragraph in the accountant’s compilation report on the financial statements, or

   b. Issue a separate report on the supplementary information,

Either an other-matter paragraph or a separate report should state the following:

- the information is presented for purposes of additional analysis and is not a required part of the financial statements
- the information is the representation of management
- the accountant performed a compilation engagement in accordance with SSARSs promulgated by the AICPA on information that is the representation of management, and
- the accountant has not audited or reviewed the information and, accordingly, does not express an opinion, a conclusion, or provide any form of assurance on such information.

The following is an example of a separate paragraph in the accountant’s compilation report addressing supplementary information when the accountant has performed a compilation engagement on both the financial statements and the supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the
information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

**Option 2- Disclaim the Supplementary Information:**

When the accountant has performed a compilation engagement with respect to the financial statements but *has not performed a compilation engagement with respect to the supplementary information* (disclaimed the supplementary information), the accountant should either:

a. Include an **other-matter paragraph** in the accountant’s compilation report on the financial statements, or

b. Issue a **separate report** on the supplementary information

Either an other-matter paragraph or separate report should state the following:

- the information is presented for purposes of additional analysis and is not a required part of the financial statements
- the information is the representation of management, and
- the information was not subject to the compilation engagement and, accordingly, the accountant does not express an opinion, a conclusion, nor provide any assurance on such information.

The following is an example of how an accountant may word a separate paragraph in the accountant’s compilation report addressing supplementary information when the accountant has performed a compilation engagement on the financial statements but *has not performed* a compilation on the supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, or provide any assurance on such information.

4. The accountant *may request* that management include a reference to the accountant’s compilation report on each page of the supplementary information.

An example of a reference to the accountant’s compilation report included on each page of the supplementary information is:

"See Accountant’s Report"
"See Accountant’s Compilation Report"
"See Independent Accountant’s Compilation Report"
Observation: SSARS No. 21 makes a significant change to existing SSARS No. 19 by eliminating the requirement that each page of compiled financial statements include a reference (legend) such as "See Accountant's Compilation Report." Although the inclusion of a legend on each page is no longer required, the author recommends that an accountant include a legend on each page of the financial statements, notes and supplementary information. Interestingly, now that there is no required compilation report title, if a legend such as "See Accountant's Compilation Report" is included on each page of the compiled financial statements, query how the user knows where the "compilation report" is located if there is no longer a report title to identify a compilation report?

Required Supplementary Information

1. With respect to required supplementary information, the accountant should include an other-matter paragraph in the accountant’s compilation report on the financial statements. The other-matter paragraph should include language to explain the following circumstances, as applicable:

   a. The required supplementary information is included, and the accountant performed a compilation engagement on the required supplementary information.

   b. The required supplementary information is included, and the accountant did not perform a compilation, review, or audit on the required supplementary information.

   c. The required supplementary information is omitted.

   d. Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines.

   Note: Prescribed guidelines are the authoritative guidelines established by the designated accounting standard-setter for the methods of measurement and presentation of the required supplementary information.

   e. The accountant has identified departures from the prescribed guidelines.

   f. The accountant has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

2. Examples of required supplementary information that may accompany financial statements and the accountant’s compilation report thereon include the following:

   • With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB ASC 972-235-50-3, Real Estate- Common Interest Realty Associations.

   • Management’s discussion and analysis and budgetary comparison statements as required by Governmental Accounting Standards Board Statement No. 34, Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments.
3. If the entity has presented all or some of the required supplementary information and the accountant did not perform a compilation engagement on the required supplementary information, the separate paragraph in the accountant’s compilation report should include the following elements:

a. A statement that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] requires that the [identify the required supplementary information] be presented to supplement the basic financial statements

b. A statement that such information, although not part of the basic financial statements, is required by [identify designated accounting standard-setter], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

c. A statement that the accountant did not perform a compilation, review, or audit on the required supplementary information and, accordingly, does not express an opinion, a conclusion, or provide any assurance on the information

d. If some of the required supplementary information is omitted:

- a statement that management has omitted [description of the missing required supplementary information] that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] required to be presented to supplement the basic financial statements

- a statement that such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard-setter], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

e. If the measurement or presentation of the required supplementary information departs materially from the prescribed guidelines, a statement that material departures from prescribed guidelines exist [describe the material departures from the applicable financial reporting framework], and

f. If the accountant has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, a statement that the accountant has doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by [identify designated accounting standard-setter].

Note: Because the required supplementary information accompanies the basic financial statements, the accountant’s compilation report on the financial statements includes a discussion of the responsibility taken by the accountant on that information. However, if the required supplementary information is omitted by the entity, the accountant does not have a responsibility to present that information.
4. If all the required supplementary information is omitted, the separate paragraph in the accountant's compilation report should include the following elements:

   a. A statement that management has omitted [description of the missing required supplementary information] that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] required to be presented to supplement the basic financial statements

   b. A statement that such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard-setter], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

K. Elimination of Management-Use Only Financial Statements

SSARS No. 21 eliminates the option of issuing management-use only financial statements previously found in SSARS No. 19 which was originally found in SSARS No. 8.

The management-use only financial statement rules permit an accountant to issue compiled financial statements without a compilation report, provided the financial statements are not expected to be issued to a third party (e.g., the financial statements are issued for management-use only).

Now, under SSARS No. 21, the management-use only financial statement option is no longer available.

What is the impact of eliminating management-use only financial statements in SSARS No. 21?

With SSARS No. 21's elimination of the management-use only financial statement option, now, in all instances, a compilation report must be issued in a compilation engagement.

Practitioners and their clients no longer have the option to perform a compilation engagement and issue financial statements for management use only without a report.

So, what do those practitioners use in place of the management-use only engagement option?

One choice is for the practitioner to issue prepared financial statements under AR-C 70, which was discussed in the previous section of this course. In issuing prepared financial statements, those statements are issued without a report except that there is no restriction for use. That is, the prepared financial statements may be issued to third parties.
L. Examples of the Accountant’s Compilation Reports on Financial Statements

Following are sample compilation reports extracted from SSARS No. 21, as modified by the author.

Illustration 1—An Accountant’s Compilation Report on Comparative Financial Statements Prepared in Accordance With U.S. GAAP

Facts:
- Standard compilation report for comparative years
- U.S. GAAP
- Full set of financial statements that includes a statement of cash flows and notes to financial statements

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

Observations:

Notice that the SSARS No. 21 compilation report has no title, and no salutation (addressee). Moreover, the report fails to include a description of a compilation engagement. Because there are disclosures, the first paragraph includes: "the related notes to the financial statements." Further, the new compilation report requires that the accountant's city and state be included on the report or at least on the report page.

Management Has Elected to Omit Substantially All Disclosures and the Statement of Cash Flows

Facts:
- Standard compilation report for comparative years using U.S. GAAP
- Management has elected to omit the statement of cash flows and substantially all disclosures required by U.S. GAAP
- No supplementary information

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

Observation: Because management has elected to omit substantially all disclosures, the first paragraph no longer includes "related notes to financial statements" in the description of the financial statements covered by the report. Moreover, the statement of cash flows is not described in the first paragraph because it has been omitted.
<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
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<tbody>
<tr>
<td><strong>ASSETS</strong></td>
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<td>Cash</td>
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<td>Accounts receivable</td>
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<tr>
<td>Property and equipment, net</td>
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<td>Other assets</td>
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<tr>
<td><strong>LIABILITIES AND STOCKHOLDERS' EQUITY</strong></td>
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<tr>
<td>Liabilities:</td>
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<td>Accounts payable</td>
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<tr>
<td>Accrued expenses</td>
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<td>Short-term notes payable</td>
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<td>Stockholders' equity:</td>
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<td>Common stock</td>
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<td>Retained earnings</td>
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### XYZ Company

**Statements of Income and Retained Earnings**

**Years Ended December 31, 20X2 and 20X1**

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<th>20X2</th>
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<td>Net sales</td>
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<td>Cost of goods sold</td>
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<td>Gross profit</td>
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<td>Operating expenses</td>
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<td>Net operating income</td>
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<td>Other income</td>
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<td>Net income before income taxes</td>
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<td>Income taxes</td>
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<tr>
<td>Net income</td>
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<td>XX</td>
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</tbody>
</table>

**Retained earnings:**

- **Beginning of year**: XX
- **End of year**: $XX

**Note:** SSARS No. 21 no longer requires that a legend be included on each page such as, “See Accountant’s Report,” “See Accountant’s Compilation Report” or "See Independent Accountant's Compilation Report." Therefore, both the balance sheet and statement of income do not include any such legend.
Illustration 3—An Accountant’s Compilation Report on Comparative Financial Statements Prepared in Accordance With U.S. GAAP. Management Has Elected to Omit Substantially All Disclosures and the Statement of Cash Flows. A Schedule of Operating Expenses is Presented as Supplementary Information

Facts:

- Standard compilation report for comparative years using U.S. GAAP
- Management has elected to omit the statement of cash flows and substantially all disclosures required by U.S. GAAP
- Supplementary information in the form of a schedule of operating expenses is included with the financial statements

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Compile supplementary information] (1)
The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information, or

[Disclaim supplementary information] (1)
The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, or provide any assurance on such information.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

(1) Paragraph heading is shown for illustrative purposes and should not be shown with the actual report that is issued. The accountant has to option of compiling or disclaiming supplementary information where the financial statements are compiled.
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<th>ASSETS</th>
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**LIABILITIES AND STOCKHOLDERS' EQUITY**

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<td>Statements of Income and Retained Earnings</td>
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<td>Retained earnings:</td>
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<td>End of year</td>
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<td>Rent</td>
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<td>Utilities</td>
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<td>Insurance</td>
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<td>Payroll and payroll related expenses</td>
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<td>Professional fees</td>
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<td>Repairs and maintenance</td>
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<td>Travel and entertainment</td>
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<td>Sundry other</td>
<td>XX</td>
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<td>$XX</td>
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**Note:** SSARS No. 21 no longer requires that a legend be included on each page such as, “See Accountant’s Report,” “See Accountant’s Compilation Report” or "See Independent Accountant's Compilation Report." Therefore, both the balance sheet and statement of income, as well as the schedule of operating expenses do not include any such legend.
Is an accountant permitted to modify the standard compilation report to include a salutation (addressee) and a report title?

Although there are both compliments and criticisms of the SSARS No. 21 compilation report, those practitioners who do not like the new report generally identify the following reasons for their displeasure:

- The report does not define a compilation engagement.
- There is no salutation (addressee) to the board of directors, members and/or management.
- There is no report title.

The question is whether a practitioner could choose to add a salutation and a report title even though they are not part of the standard SSARS No. 21 compilation report.

The answer is that there is nothing in SSARS No. 21 that precludes an accountant from adding a salutation (addressee) and/or a report title, although not required.

If added, the report would look like the following sample report:

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Accountant’s Compilation Report (1)

To the Board of Directors and Management (1)

XYZ Company

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholder’s equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]
(1) The new compilation report does not require a report title or a salutation (addressee). The above sample report offers these elements as an option because SSARS No. 21 does not preclude their inclusion.

M. Documentation in a Compilation Engagement

AR-C 80 states that an accountant should prepare documentation in connection with each compilation engagement in sufficient detail to provide a clear understanding of the work performed which, at a minimum, includes the following:

a. An engagement letter or other suitable form of written documentation, signed by both the accountant and management

b. A copy of the financial statements, and

c. A copy of the accountant’s report.

N. Change from an Audit or Review Engagement to a Compilation Engagement

There may be instances when, before completion of an audit or review engagement, the accountant is asked to change the engagement to a compilation. The AICPA Guide provides guidance on dealing with such a situation.

1. Before the accountant agrees to the change from an audit or review to a compilation engagement, the accountant should consider certain factors including:

   a. The reason for the client’s request, with particular emphasis on the implications of a restriction on the scope of the audit or review, whether imposed by the client or by other circumstances.

      Note: In considering the implications of a restriction on the scope of an audit or review, the accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory.

   b. The additional audit or review effort required to complete the audit or review engagement.

   c. The estimated additional cost to complete the audit or review engagement.

2. A reasonable basis for a client requesting a change in the engagement to a compilation would include:

   a. A change in circumstances that affects the entity’s requirement for an audit or review, or

   b. A misunderstanding about the nature of an audit, review or compilation engagement.

3. When, during an audit or review engagement, a client restricts the following, the accountant ordinarily would be precluded from issuing a compilation report:
a. The client precludes an accountant from communicating with the entity’s legal counsel, or
b. The client does not provide the accountant with a signed representation letter.
Review Questions

1. In accordance with AR-C 80, when is an accountant required to perform a compilation engagement:
   a. When he or she has submitted financial statements
   b. When he or she is engaged (hired) to perform a compilation engagement
   c. When he or she is unable to perform a review engagement
   d. When he or she prepares financial statements under AR-C 70

2. An accountant is unable to complete his compilation engagement because management has failed to provide records and documents, as requested. What should the accountant do:
   a. The accountant should withdraw from the engagement and explain the reasons why
   b. The accountant should report the client to the third party users
   c. The accountant should go around the client and obtain the information directly from third parties
   d. The accountant should do nothing and complete the engagement without the missing records and documents because it is only a compilation engagement

3. Monti Hall is preparing a compilation report for a client under the new AR-C 80 compilation standards. Which of the following is correct with respect to the new compilation report:
   a. An addressee is required
   b. A report title is not required
   c. The entity is no longer identified in the report
   d. The date and period covered is no longer required

4. Under the new AR-C 80 standards, in a compilation engagement, a legend "See Accountant's Compilation Report" is _________.
   a. Required
   b. Not required
   c. Not permitted
   d. Changes to "See Accountant's Report"

5. Eliah Levin is an accountant who is asked to perform a compilation engagement for his wife's business. How should Eliah address the independence issue in his report:
   a. Eliah has no independence issue because of the special exemption for husband and wife businesses
   b. Eliah must disclose the lack of independence in the report
   c. Eliah must disclose the lack of independence in the notes
   d. Eliah must include a legend on each page of the financial statements stating "Accountant is Not Independent"

6. Jennifer Lopez is issuing a compilation report on financial statements. A schedule of operating expenses is accompanying the financial statements. What are Jennifer's reporting options with respect to the schedule of operating expenses:
   a. Jennifer may review the schedule as supplementary information
   b. Jennifer may audit the schedule as supplementary information
c. Jennifer may compile the schedule as supplementary information
d. Jennifer may treat the schedule as if it were a separate financial statement such as a balance sheet or income statement and report on it as a financial statement and not as supplementary information

7. Which option under SSARS No. 21 does the author suggest offers the best alternative to issuing management-use only financial statements previously authorized by SSARS No. 19:
   a. Perform a compilation engagement and issue a traditional compilation report
   b. Perform a preparation of financial statements engagement under AR-C 70
   c. Upgrade to a review engagement
   d. There is no viable alternative

8. Which of the following is a required item that must be documented in a compilation engagement under AR-C 80:
   a. An engagement letter
   b. A schedule of analytical procedures performed
   c. A list of inquiries performed during the engagement
   d. A management representation letter
AR-C Section 90: Review of Financial Statements

A. Introduction

SSARS No. 21, AR-C section 90, Review of Financial Statements, replaces existing AR 90 found in SSARS No. 19.

Although a significant portion of the existing rules related to review engagements that are found in AR 90 remain intact, AR-C 90 does make several important changes. Some are subtle, while others are far more explicit, such as a change to the review report.

B. Effective Date

AR-C 90 is effective for reviews of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

C. Scope of AR-C 90- Review Engagements

Paragraphs 1 and 2 of AR-C 90 establish the scope for the application of AR-C 90 to review engagements.

1. AR-C 90 applies to the following engagements:
   a. Engagements to review financial statements
   b. Engagements to review other historical financial information

Examples of other historical financial information for which an accountant may be engaged to perform a review engagement include but are not limited to the following:

- Specified elements, accounts, or items of a financial statement such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information, and
- Financial information contained in a tax return.

Note: The accountant may review a single financial statement, such as a balance sheet, and not other related financial statements, such as the statements of income, retained earnings, and cash flows, if the scope of the accountant’s inquiry and analytical procedures have not been restricted.

In reviewing the list of financial information for which an accountant may perform a review engagement, that list does not include prospective information. An accountant is permitted

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13 AR-C 90 states that the SSARS “may also be applied” to engagements to review “other historical financial information” suggesting that there is no requirement to apply SSARS No. 21 to other historical financial information (e.g., information other than financial statements).
to perform a preparation or compilation of engagement on prospective information but is not permitted to review prospective information. The primary reason is because it is difficult to provide limited assurance on prospective information.

2. AR-C 90 does not apply when the accountant is engaged to review interim financial information in accordance with AU-C 930, Interim Financial Information, which applies when:

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

   b. the accountant either:

      • has been engaged to audit the entity's current year financial statements, or

      • audited the entity's latest annual financial statements and, in situations in which it is expected that the current year financial statements will be audited, the engagement of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review, and

   c. the entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

D. Objective

AR-C 90 carries over from existing AR 90 the general objective of a review engagement.

1. The objective of the accountant when performing a review of financial statements is to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, primarily through the performance of inquiry and analytical procedures.

E. Requirements for Performing a Review Engagement Under AR-C 90

AR-C 90 carries over many, but not all, of the existing requirements found in AR-90 related to review engagements.

Those requirements are as follows:

In performing a review engagement, the accountant must:

- Follow the General Principles found in AR-C 60, General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services

- Be independent

- Satisfy Preconditions for acceptance and continuance of client relationships and review engagements, including executing an engagement letter
Communicate with management and those charged with governance matters of significant importance

Understand the industry

Obtain knowledge of the entity

Design and perform review procedures including analytical procedures and inquiries

Reconcile the financial statements to the underlying accounting records

Evaluate evidence obtained from the review procedures performed

Obtain written representations from management (management representation letter), and

Report on the financial statements

Following are the overall requirements to perform a review engagement under the new AR-C 90.

General Principles for Performing and Reporting on Review Engagements

In addition to complying with the rules in AR-C 90 pertaining to a review engagement, an accountant must comply with the requirements in AR-C 60, General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services.

Independence

The accountant must be independent of the entity when performing a review of financial statements in accordance with SSARSs.

1. If, during the performance of the review engagement, the accountant determines that the accountant’s independence is impaired, the accountant should withdraw from the review engagement.

   Note: The AICPA Code of Professional Conduct provides guidance with respect to independence.

2. Nothing prohibits an accountant who is unable to complete a review engagement due to a determination that the accountant’s independence is impaired from performing a compilation engagement on those financial statements, provided the lack of independence is reflected in the accountant's compilation report.

Preconditions: Acceptance and Continuance of Client Relationships and Review Engagements

In order for an accountant to perform a review engagement, the accountant must satisfy certain conditions and preconditions found in AR-C 60 and AR-C 90 as follows:
1. The accountant should not accept a review engagement if any of the following conditions found in paragraph .24 of the general conditions in AR-C 60 exist.

2. The accountant must satisfy certain general conditions found in paragraphs 25(a) and (b) of AR-C 60 general conditions which are discussed in more detail in the section related to AR-C 60.

3. The accountant should obtain the agreement of management (included in an engagement letter) that it acknowledges and understands its responsibilities found in paragraph .25(c.) of AR-C 60, General Principles, and as to certain specific terms related to review engagements found in AR-C 90.

F. Engagement Letter- Review Engagement

The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate.

1. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following:

   a. The objectives of the engagement
   b. The responsibilities of management
   c. The responsibilities of the accountant
   d. The limitations of a review engagement
   e. Identification of the applicable financial reporting framework for the preparation of the financial statements
   f. The expected form and content of the accountant’s review report, and a statement that there may be circumstances in which the report may differ from its expected form and content

2. The engagement letter or other suitable form of written communication should be signed by:

   a. the accountant or the accountant’s firm, and
   b. management or those charged with governance, as appropriate.

   Note: When the agreement on the terms of engagement is only with those charged with governance, the accountant is required to also obtain management’s agreement that it acknowledges and understands its responsibilities.

   When a third party has contracted for a review of the entity’s financial statements, the accountant must also obtain management's agreement with the terms of the review in order to establish that the preconditions for a review are present.

3. A contract may be used as a suitable form of written communication. A verbal understanding is insufficient.
Illustrative Engagement Letter

Source: SSARS No. 21, as modified by the AICPA Guide and the Author.

Illustration 1—An Engagement Letter for an Engagement to Prepare Financial Statements in Accordance With U.S. GAAP and to Perform a Review Engagement With Respect to Those Financial Statements

Facts:
- The accountant is hired to prepare, as a nonattest service, the financial statements, including related notes.
- The accountant is also hired to perform a review engagement on the same financial statements that are prepared.
- U.S. GAAP is the applicable framework.

To the appropriate representative of management of ABC Company:

You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements and perform a review engagement with respect to those financial statements. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

We will also perform the following additional services: preparation of the 20XX federal and state income tax returns, and perform bookkeeping services.

Our Responsibilities
The objective of our engagement is to:

a. Prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you, and

b. Obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA’s Code of Professional Conduct, including ethical principles of integrity, objectivity, professional competence, and due care.

A review engagement includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review engagement is substantially less in scope than an audit engagement, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review engagement does not contemplate obtaining an understanding of the entity's internal control;

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14 The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.
assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement. Accordingly, we will not express an opinion regarding the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our review procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

Your Responsibilities
The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
b. The preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America
c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
d. The prevention and detection of fraud
e. To ensure that the entity complies with the laws and regulations applicable to its activities
f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
g. To provide us with:
   • Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
   • Additional information that may be requested for the purpose of the preparation of the financial statements, and
   • Unrestricted access to persons within ABC Company of whom we determine necessary to make inquiries.
h. To provide us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services. [AICPA ET 1.295- Nonattest Services] (b)

You are also responsible for including the following reference on each page of the financial statements including supplementary information: "See Independent Accountant’s Review Report." (c)

[Insert appropriate reference to the expected form and content of the accountant’s review report. Example follows:]
We will issue a written report upon completion of our review of ABC Company’s financial statements. Our report will be addressed to the board of directors of ABC Company. We cannot provide assurance that an unmodified accountant’s review report will be issued. Circumstances may arise in which it is necessary for us to report known departures from accounting principles generally accepted in the United States of America, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

You agree to include our accountant’s review report in any document containing financial statements that indicates that such financial statements have been reviewed by use and, prior to inclusion of the report, to ask our permission to do so.

**Other relevant information**

Our fees for these services . . .

[The accountant may include language such as the following regarding limitation of or other arrangements regarding the liability of the accountant or the entity, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements):

You agree to hold us harmless and to release, indemnify, defend, us from any liability or costs, including attorney’s fees, resulting from management’s knowing misrepresentations to us.]

If you request us to perform additional services not contemplated or described in this engagement letter, we will provide you with a separate agreement describing those additional services and fees.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a review of those same financial statements, and our respective responsibilities.

Sincerely yours,

_______________________
[Signature of accountant or accountant’s firm]

Acknowledged and agreed on behalf of ABC Company by:

_______________________
[Signed]
[Name and title]

[Date]

(a): If additional nonattest services are to be performed, such as preparation of tax returns and/or bookkeeping services, reference to such services can be made in the beginning or the end of the engagement. Alternatively, the additional nonattest services could be included in a separate engagement letter.

(b): Because a nonattest service (preparation of financial statements) is performed for an attest engagement (review engagement), the accountant is required to include language in the engagement letter in accordance with ET section 1.295 of AICPA Professional Standards, to remain independent.
The legend "See Independent Accountant’s Review Report" or similar language, is no longer required by AR-C 90. Because the financial statements are the responsibility of management, if an accountant wishes to include the legend on each page of the financial statements (including supplementary information), management should agree to it within the engagement letter.

G. Communication with Management and Those Charged With Governance

The accountant should communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the review engagement, all matters concerning the review engagement that, in the accountant’s professional judgment, are of significant importance to merit the attention of management or those charged with governance.

1. In a review engagement, the accountant’s communications with management and those charged with governance take the form of:

   a. Inquiries the accountant makes in the course of performing the procedures for the review, and

   b. Other communications, in the context of having effective two-way communication to understand matters arising and to develop a constructive working relationship for the engagement.

2. The appropriate timing for communications will vary with the circumstances of the engagement based on relevant factors that include:

   a. the significance and nature of the matter, and

   b. any action expected to be taken by management or those charged with governance.

Example: It may be appropriate to communicate a significant difficulty encountered during the review as soon as practicable if management or those charged with governance are able to assist the accountant to overcome the difficulty.

Note: A particular law or regulation may restrict the accountant’s communication of certain matters with those charged with governance. By way of example, a law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the accountant’s obligations of confidentiality and obligations to communicate may be complex. In such cases, the accountant may consider obtaining legal advice.

Communicating Matters Concerning the Review

Matters to be communicated to management or those charged with governance in a review engagement may include:

- The accountant’s responsibilities in the review engagement, as included in the engagement letter or other suitable form of written agreement
• Significant findings from the review, for example:

  o The accountant’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures

  o Significant findings from the performance of procedures, including situations where the accountant considered performance of additional procedures necessary in accordance with this section. The accountant may need to confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events

  o Matters arising that may lead to modification of the accountant’s review report, and

  o Significant difficulties, if any, encountered during the review; for example, unavailability of expected information; unexpected inability to obtain evidence that the accountant considers necessary for the review; or restrictions imposed on the accountant by management. In some circumstances, such difficulties may lead to the accountant’s withdrawal from the engagement.

Note: In some entities, different individuals may be responsible for the management and the governance of an entity. In these circumstances, management may have the responsibility to communicate certain matters to those charged with governance. Communication by management with those charged with governance of matters that the accountant is required to communicate does not relieve the accountant of the responsibility to also communicate with those charged with governance. However, communication of these matters by management may affect the form or timing of the accountant’s communication with those charged with governance.

Communication with Third Parties

The accountant may be required by law or regulation to, for example:

• Notify a regulatory or enforcement body of certain matters communicated with those charged with governance, and

• Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies or, in some cases, make such reports publicly available.

Unless required by law or regulation to provide a third party with a copy of the accountant’s written communications with those charged with governance, the accountant may need the prior consent of management or those charged with governance before doing so.

H. Understanding of the Industry

In order to perform the review engagement, the accountant should possess or obtain an understanding of the industry in which the entity operates, including the accounting principles and practices generally
used in the industry, sufficient to enable the accountant to review financial statements that are appropriate for an entity operating in that industry.

**Note:** AR-C 90 states that the requirement that the accountant possess a level of knowledge of the industry in which the entity operates *does not prevent the accountant from accepting a review engagement for an entity in an industry with which the accountant has no previous experience*. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

### I. Knowledge of the Entity

The accountant should obtain knowledge about the entity sufficient to identify areas in the financial statements where there is a greater likelihood that material misstatements may arise and to be able to design procedures to address those areas.

1. Such knowledge should include an understanding of:
   
a. the entity's business, including a general understanding of the entity's organization, its operating characteristics, and the nature of its assets, liabilities, revenues and expenses, and
   
b. the accounting principles and practices used by the entity.

2. In obtaining the understanding of the entity's accounting policies and practices, the accountant should be alert to accounting policies and procedures that, based on the accountant’s knowledge of the industry are unusual.

3. The accountant may obtain knowledge of the entity through inquiry of the entity’s personnel, the review of documents prepared by the entity, or experience with the entity or the entity’s industry. Such knowledge includes the following:
   
   - An understanding of the entity’s business, and
   
   - An understanding of the accounting principles and practices used by the entity in measuring, recognizing recording, and disclosing all significant accounts and disclosures in the financial statements.

### J. Designing and Performing Review Procedures

AR-C 90 provides procedures that an accountant should perform in a review engagement:

1. The accountant should design and *perform analytical procedures* and *make inquiries* and perform other procedures, as needed, to obtain limited assurance as to whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework based on the accountant’s:
a. understanding of the industry
b. knowledge of the entity, and
c. awareness of the risk that the accountant may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated.

2. The accountant should focus the analytical procedures and inquiries in those areas in which the accountant believes there are increased risks of material misstatements.

3. In addition to analytical procedures and inquiries, in certain circumstances and based on the accountant’s professional judgment, the accountant may perform procedures ordinarily performed in an audit. In such instances, the engagement remains a review, and the accountant is not required to perform an audit of the financial statements.

4. The results of the accountant's analytical procedures and inquiries may modify the accountant's risk awareness. For example, the response to an inquiry that a related party transaction is not disclosed may revise the accountant’s awareness of risk relative to related party transactions.

K. Analytical Procedures

The accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement.

1. Such analytical procedures should include the following:
   a. Comparing the financial statements with comparable information for the prior period, giving consideration to knowledge about changes in the entity’s business and specific transactions
   b. Considering plausible relationships among both financial and, when relevant, nonfinancial information
   c. Comparing recorded amounts or ratios developed from recorded amounts to expectations developed by the accountant through identifying and using relationships that are reasonably expected to exist, based on the accountant’s understanding of the entity and the industry in which the entity operates, and
   d. Comparing disaggregated revenue data, as applicable.

2. When designing and performing analytical procedures, the accountant should:
   a. determine the suitability of particular analytical procedures
   b. consider the reliability of data from which the accountant’s expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available
c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to provide the accountant with limited assurance that a misstatement will be identified that, either individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated, and

d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

Note: Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses. Analytical procedures may be performed at the financial statement level or at the detailed account level. The nature, timing, and extent of analytical procedures are a matter of professional judgment.

Investigating Results of Analytical Procedures

If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the accountant should investigate such differences by:

a. inquiring of management, and
b. performing other review procedures if considered necessary in the circumstances.

Although the accountant is not required to corroborate management's responses with other evidence, the need to perform other review procedures may arise when, for example, management is unable to provide an explanation or the explanation is not considered adequate.

L. Inquiries of Members of Management Who Have Responsibility for Financial and Accounting Matters

Inquiries, along with analytical procedures are critical to the successful completion of a review engagement.

AR-C 90 provides the following requirements in performing inquiries:

Items noted in NEW are added by SSARS No. 21 and were not included in the list of inquiries in SSARS No. 19.

1. The accountant should inquire of members of management who have responsibility for financial and accounting matters concerning the financial statements about:

a. whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied
b. unusual or complex situations that may have an effect on the financial statements
c. significant transactions occurring or recognized during the period, particularly those in the last several days of the period
d. the status of uncorrected misstatements identified during the previous review (that is, whether adjustments had been recorded subsequent to the periods covered by the prior
review and, if so, the amounts recorded and period in which such adjustments were recorded.

e. matters about which questions have arisen in the course of applying the review procedures
f. events subsequent to the date of the financial statements that could have a material effect on the fair presentation of such financial statements
g. its knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others when the fraud or suspected fraud could have a material effect on the financial statements.

**Note:** Management may obtain knowledge of fraud or suspected fraud affecting the entity involving management or others when the fraud could have a material effect on the financial statements through, among other things, communications received from employees, former employees, or others.

h. whether management is aware of allegations of fraud or suspected fraud affecting the entity communicated by employees, former employees, regulators, or others NEW
i. that management has disclosed to the accountant all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements NEW
j. significant journal entries and other adjustments
k. communications from regulatory agencies, if applicable
l. related parties and significant new related party transactions NEW
m. any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management’s response to the accountant’s inquiry NEW
n. whether management believes that significant assumptions used by it in making accounting estimates are reasonable NEW
o. actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements, including:
  - approval of key employee stock option plans
  - approval of officer compensation
  - approval of loan agreements
  - approval of disposition of specific assets or segments of the business, and
  - declaration of stock, cash or other dividends.
p. any other matters that the accountant may consider necessary. NEW

2. In performing inquiries, the accountant should consider the reasonableness and consistency of management’s responses in light of the results of other review procedures and the accountant’s knowledge of the entity’s business. However, the accountant is not required to corroborate management’s responses with other evidence.

3. In addition to members of management who have responsibility for financial and accounting matters, the accountant may determine to direct inquiries to others within the entity and those charged with governance, if appropriate.

**M. Reading the Financial Statements**
As part of a review engagement, an accountant should read the financial statements and consider whether any information has come to the accountant’s attention to indicate that such financial statements do not conform to the applicable financial reporting framework.

N. Using the Work of Other Accountants

If other accountants have issued a report on the financial statements of significant components, such as subsidiaries and investees, the accountant should obtain and read reports from such other accountants.

O. Reconciling the Financial Statements to the Underlying Accounting Records

AR-C 90 adds a new requirement in a review engagement where the accountant should obtain evidence that the financial statements agree or reconcile with the accounting records:

1. To obtain evidence that the financial statements agree or reconcile with the accounting records, the accountant may compare the financial statements to:
   a. the general ledger or trial balance
   b. a consolidating schedule derived from the accounting records, or
   c. other supporting data in the entity’s records

P. Evaluating Evidence Obtained From the Procedures Performed

As part of the review engagement, the accountant should accumulate misstatements, including inadequate disclosures, identified by the accountant in performing the review procedures or brought to the accountant’s attention during the performance of the review.

1. The accountant should evaluate, individually and in the aggregate, misstatements, including adequate disclosure, accumulated to determine whether material modification should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.
   a. Considerations that may affect the evaluation of whether uncorrected misstatements, individually or in the aggregate, are material include the following:
      • The nature, cause (if known), and amount of the misstatements
      • Whether the misstatements originated in the preceding year
      • The potential effect of the misstatements on future periods
      • The appropriateness of offsetting a misstatement of an estimated amount with a misstatement of an item capable of precise measurement, and
      • Recognition that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements in future periods.

2. If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant’s attention is incorrect, incomplete, or otherwise unsatisfactory the accountant should:
a. request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant, and

b. consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be materially misstated.

3. If the accountant believes that the financial statements may be materially misstated, the accountant should perform additional procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework.

4. The accountant should evaluate whether sufficient appropriate review evidence has been obtained from the procedures performed and, if not, the accountant should perform other procedures judged by the accountant to be necessary in the circumstances to be able to form a conclusion on the financial statements.

a. In some circumstances, the accountant may not have obtained the evidence that the accountant had expected to obtain through the design of primarily inquiry and analytical procedures and procedures addressing specific circumstances. In these circumstances, the accountant considers that the evidence obtained from the procedures performed is not sufficient and appropriate to be able to form a conclusion on the financial statements. The accountant may:

- Extend the work performed, or
- Perform other procedures judged by the practitioner to be necessary in the circumstances.

Note: Where neither of the above actions is practicable in the circumstances, the accountant will not be able to obtain sufficient appropriate evidence to be able to form a conclusion and is required by this section to determine the effect on the accountant’s ability to complete the engagement. This situation may arise even though the accountant has not become aware of a matter(s) that causes the accountant to believe the financial statements may be materially misstated.

Q. Materiality

In a review engagement, the accountant’s consideration of materiality is made in the context of the applicable financial reporting framework.

1. Although financial reporting frameworks may discuss materiality in different terms, most generally explain materiality in the following content:

a. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements

b. Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both, and
c. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

2. The accountant’s determination of materiality is a matter of professional judgment and is affected by the accountant’s perception of the needs of the intended users of the financial statements. In this context, it is reasonable for the accountant to assume that users:

- have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence
- understand that financial statements are prepared, presented, and reviewed to levels of materiality
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events, and
- make reasonable economic decisions on the basis of the information in the financial statements.

3. Unless the review engagement is undertaken for financial statements that are intended to meet the particular needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered.

4. The accountant’s judgment about what is material in relation to the financial statements as a whole is the same regardless of the level of assurance obtained by the accountant as a basis for expressing a conclusion on the financial statements.

5. The accountant’s determination of materiality for the financial statements as a whole may need to be revised during the engagement as a result of:

- a change in the circumstances that occurred during the review (for example, a decision to dispose of a major part of the entity’s business).
- new information, or a change in the accountant’s understanding of the entity and its environment as a result of performing review procedures (for example, if during the review it appears actual financial results are likely to be substantially different from anticipated period-end financial results that were used initially to consider materiality for the financial statements as a whole).

R. Written Representations in a Review Engagement

Written Representations as Review Evidence

Written representations are review evidence that are necessary information that the accountant requires in connection with a review of the entity’s financial statements.

1. If management modifies or does not provide the requested written representations, it may alert the accountant to the possibility that one or more significant issues may exist. Further, a request for written rather than oral representations, in many cases, may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.
Management From Whom Written Representations Are Requested

The accountant should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

1. Written representations should be requested from those with overall responsibility for financial and operating matters whom the accountant believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements.

- Written representations may be requested from the entity’s CEO and CFO or other equivalent persons in entities who do not use such titles.

- Other parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

2. Due to its responsibility for the preparation and fair presentation of the financial statements and its responsibility for the conduct of the entity’s business, management is expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements on which to base the written representations.

3. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the accountant to accept such wording if, in the accountant’s judgment, the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

Specific Written Representations

AR-C 90 provides a list of specific written representations that an accountant must obtain from management as part of a review engagement:

1. For all financial statements presented and for all periods covered by the review, the accountant should request management to provide written representations, that are dated as of the date of the accountant’s review report:

   a. that management has fulfilled its responsibility for the preparation and fair presentation of the financial statements, in accordance with the applicable financial reporting framework, as set out in the terms of the engagement
   b. that management acknowledges its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements, including its responsibility to prevent and detect fraud
   c. that management has provided the accountant with all relevant information and access, as agreed upon in the terms of the engagement
   d. that management has responded fully and truthfully to all of the accountant’s inquiries
   e. that all transactions have been recorded and are reflected in the financial statements
f. that management has disclosed to the accountant its knowledge of fraud or suspected fraud affecting the entity involving:
   • management,
   • employees who have significant roles in internal control, or
   • others when the fraud could have a material effect on the financial statements.

g. that management has disclosed to the accountant its knowledge of any allegations of fraud or suspected fraud affecting the entity’s financial statements communicated by employees, former employees, regulators, or others

h. that management has disclosed to the accountant all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements

i. about whether management believes that the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole

Note: A summary of such uncorrected misstatements items should be included in, or attached to, the representation letter.

j. that management has disclosed to the accountant all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements, and it has appropriately accounted for and disclosed such litigation and claims in accordance with the applicable financial reporting framework

k. about whether management believes that significant assumptions used by it in making accounting estimates are reasonable

l. that management has disclosed to the accountant the identity of the entity’s related parties and all of the related party relationships and transactions of which it is aware and it has appropriately accounted for and disclosed such relationships and transactions, and

m. that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Note: Review evidence obtained during the review that management has acknowledged the responsibilities referred to in (a) and (b) above is not sufficient without obtaining representation from management that it believes that it has fulfilled those responsibilities. This is because the accountant is not able to judge solely on other review evidence whether management has prepared and fairly presented the financial statements and provided information to the accountant on the basis of the agreed acknowledgment and understanding of its responsibilities.

SSARS No. 21 expands the written representations relating to fraud. These representations, found in (1) (f) and (g) above, are important for the accountant to obtain, regardless of the size of the entity, because of the nature of fraud and the difficulties encountered by accountants in detecting material misstatements in the financial statements resulting from fraud.

2. If, in addition to the specific representations required by the previous paragraph, the accountant determines that it is necessary to obtain one or more written representations to support other
review evidence relevant to the financial statements, the accountant should request such other written representations.

3. Because the preparation of financial statements requires management to adjust the financial statements to correct material misstatements, the accountant is required to request management to provide a written representation about uncorrected misstatements.

In some circumstances, management may not believe that certain uncorrected misstatements are misstatements. For that reason, management may want to add to their written representation words such as:

“We do not agree that items… and… constitute misstatements because [description of reasons].”

4. Circumstances in which it may be appropriate to obtain written representations about related parties from those charged with governance in addition to management include the following:

- When they have approved specific related party transactions that (a) materially affect the financial statements or (b) involve management
- When they have made specific oral representations to the accountant on details of certain related party transactions, and
- When they have financial or other interests in the related parties or the related party transactions.

5. The written representations should have an "as of" date which is the same as the date of the accountant’s review report on the financial statements.

Note: Because written representations are necessary review evidence, the accountant has not obtained limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework, and the accountant’s review report cannot be dated, before the date of the written representations.

6. The written representations cover all periods referred to in the accountant’s review report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The accountant and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Note: Situations may arise in which current management was not present during all periods referred to in the accountant’s review report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons’ responsibilities for the financial statements as a whole. Accordingly, the requirement for the accountant to request from them written representations that cover the whole of the relevant period(s) still applies.
7. The accountant may request additional representations regarding matters specific to the entity’s business or industry. In addition the accountant is not precluded from obtaining representations regarding services performed in addition to the review engagement.

8. The written representations should be in the form of a representation letter addressed to the accountant.

Note: There are circumstances that may prevent management from signing the representation letter and returning it to the accountant on the date of the accountant’s review report. In those circumstances, the accountant may accept management’s oral confirmation, on or before the date of the accountant’s review report, that management has reviewed the final representation letter and will sign the representation letter without exception as of the date of the accountant’s review report. Possession of the signed management representation letter prior to releasing the accountant’s review report is necessary because SSARS No. 21 requires that the representations be in the form of a written letter from management. Furthermore, when there are delays in releasing the report, a fact may become known to the accountant that, had it been known to the accountant at the date of the accountant’s review report, might affect the accountant’s review report and result in the need for updated representations.

Concerns About the Reliability of Written Representations and Requested Written Representations Not Provided

If, in relation to the written representations:

a. Management does not provide the written representations, or

b. The accountant concludes that there is cause to doubt management’s integrity such that the written representations provided are not reliable,

the accountant should discuss the matter with management and those charged with governance, as appropriate. If management does not provide the required representations or the accountant continues to doubt management’s integrity such that the written representations provided may not be reliable, the accountant should withdraw from the engagement.

Illustrative Representation Letter

(Entity Letterhead)

Date

To [Accountant]

This representation letter is provided in connection with your review of the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity and cash flows for the years then ended, and the related notes to the financial statements, for the purpose of obtaining limited assurance as a basis for reporting whether you are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted.
Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve 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 be changed or influenced by the omission or misstatement.

We represent that [, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves] [as of (date of accountant’s review report)]:

Financial Statements
- We acknowledge our responsibility and have fulfilled our responsibilities for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America.
- We acknowledge our responsibility and have fulfilled our responsibilities for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Guarantees, whether written or oral, under which the company is contingently liable have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Significant estimates and material concentrations known to management that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, Risks and Uncertainties, have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]
- All events subsequent to the date of the financial statements and for which accounting principles generally accepted in the United States of America requires adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. [A summary of uncorrected misstatements is attached to this letter.]
- The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with accounting principles generally accepted in the United States of America.
- [Any other matters that the accountant may consider appropriate.]

Information Provided
- We have responded fully and truthfully to all inquiries made to us by you during your review.
We have provided you with
— access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation and other matters;
— minutes of meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared;
— additional information that you have requested from us for the purpose of the review; and
— unrestricted access to persons within the entity from whom you determined it necessary to obtain review evidence.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have [no knowledge of any][disclosed to you all information that we are aware of regarding] fraud or suspected fraud that affects the entity and involves
- management,
- employees who have significant roles in internal control, or
- others when the fraud could have a material effect on the financial statements.

We have [no knowledge of any][disclosed to you all information that we are aware of regarding] allegations of fraud, or suspected fraud, affecting the entity’s financial statements as a whole communicated by employees, former employees, analysts, regulators or others.

We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.

We have disclosed to you all known instances of noncompliance or suspected noncompliance with law or regulation whose effects should be considered when preparing financial statements.

We [have disclosed to you all known actual or possible] [are not aware of any pending or threatened] litigation and claims whose effects should be considered when preparing the financial statements [and we have not consulted legal counsel concerning litigation or claims]

We have disclosed to you any other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450, Contingencies.

We have disclosed to you the identity of the entity’s related parties and all the related party relationships and transactions of which we are aware.

No material losses exist (such as from obsolete inventory or purchase or sale commitments) that have not been properly accrued or disclosed in the financial statements.

The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.

We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

We are in agreement with the adjusting journal entries [and account classifications] that you have recommended, and they have been posted to the company’s accounts (if applicable).(1)

[Any other matters that the auditor may consider necessary.]

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]
None.

(1): In accordance with AICPA Professional Standards, ET 1.295, Nonattest Services, if an accountant performs nonattest services for an attest client, the accountant is precluded from taking management responsibility for the nonattest work. If the nonattest service involves bookkeeping services, management must approve all adjusting entries and accountant classifications. One way in which an accountant might want to have his or her client sign off on the bookkeeping service is to include a statement in the management representation letter stating that management is in agreement with the adjusting entries and account classifications that the accountant has recommended.

**Observation:** SSARS No. 21 requires that the accountant attach to his or her management representation letter a schedule of uncorrected misstatements. The Illustrated Representation Letter includes a schedule of uncorrected misstatements that shows no misstatements. Even though there is no requirement to include a schedule if there are no uncorrected misstatements, the author suggests including the schedule to demonstrate that the accountant is aware of the requirement particularly when he or she is the subject of a peer review.
S. Reporting on Reviewed Financial Statements

AR-C 90 makes significant changes to the review report to make its format more in line with the version of the audit report under the new auditing standards.

Following is a summary of the requirements of the new review report.

1. The accountant’s review report should be in writing and may be issued in a hard copy format or electronic medium.

2. The accountant may consider including (but is not required to include) a reference on each page of the reviewed financial statements to the accountant’s review report.

An example of a reference to the accountant’s review report included on each page of the reviewed financial statements is:


Note: Existing AR 90 requires than an accountant include a reference (legend) on each page of the reviewed financial statements such as "See Independent Accountant's Review Report.” In AR-C 90, this requirement is eliminated even though it is recommended that the accountant include the reference on each page of the reviewed financial statements. A similar change was made for compiled financial statements where the reference to the compilation report is no longer required.

One reason why the reference (legend) is no longer mandatory for either a compilation or review engagement is because the financial statements are the responsibility of management, and not the accountant. Thus, the accountant really has no authority to require that the financial statements include a reference/legend. If the accountant does, in fact, want a legend on each page of the reviewed financial statements, the accountant should include that requirement in the engagement letter.

3. When the accountant is unable to perform the inquiry, analytical procedures, and other review procedures the accountant considers necessary in the review engagement, or management does not provide the accountant with a representation letter, the review will be incomplete.

a. A review that is incomplete does not provide an adequate basis for issuing a review report.

4. The written review report should include:

a. a title that includes the word independent to clearly indicate that it is the report of an independent accountant.

   An appropriate title would be “Independent Accountant’s Review Report.”

Note: If an accountant is reporting on comparative financial statements and the service performed on the financial statements is different from year to year (e.g., one year reviewed
and one year is compiled), the report title may be generic such as “Independent Accountant’s Report.”

b. an addressee as appropriate for the circumstances of the engagement.

c. an introductory paragraph that:

- identifies the entity whose financial statements have been reviewed,
- states that the financial statements identified in the report were reviewed,
- identifies the financial statements, included the related notes,\footnote{SSARS No. 21 carries forward from auditing standards the requirement that the financial statements include “the related notes.” In previous SSARS No. 19, in listing the financial statements in the first paragraph of the review report, the accountant did identify the “related notes”}
- specifies the date or period covered by each financial statement,
- includes a statement that a review includes primarily applying analytical procedures to management’s (owner’s) financial data and making inquiries of company management (owners), and
- includes a statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole, and that, accordingly, the accountant does not express such an opinion.

d. a section with the heading “Management’s Responsibility for the Financial Statements” that includes an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework.

e. a section with the heading “Accountant’s Responsibility” that includes the following statements:

- The accountant’s responsibility is to conduct the review engagement in accordance with SSARSs promulgated by the Accounting and Review Services Committee of the AICPA. The accountant’s review report should also explain that those standards require that the accountant perform the procedures to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.
- The accountant believes that the review evidence the accountant has obtained is sufficient and appropriate to provide a basis for the accountant’s conclusion.

f. a concluding section with an appropriate heading "Accountant’s Conclusion" that includes a statement about whether the accountant is aware of any material modifications that should be made to the accompanying financial statements for them to be in accordance with the
applicable financial reporting framework and that identifies the country of origin of those accounting principles, if applicable.

**Note:** In an audit report, the heading of the opinion paragraph is “Opinion” which is not appropriate for a review engagement. The reasons is because an accountant provides limited assurance in a review report and does not reach an opinion as to whether the financial statements are fairly stated.

g. the manual or printed signature of the accountant’s firm.

h. the city and state where the accountant practices.

**Note:** The requirement to include the city and state is new and is not required under existing SSARS No. 19. The city and state where the accountant practices may be indicated on letterhead that contains the issuing office’s city and state.

i. the date of the review report, which should be dated *no earlier than* the date on which the accountant completed procedures sufficient to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework including evidence that:

- all the statements that the financial statements comprise, including the related notes, have been prepared, and
- management has asserted that they have taken responsibility for those financial statements.

**Note:** Because the accountant’s conclusion is provided on the financial statements, and the financial statements are the responsibility of management, the accountant is not in a position to conclude that the accountant has obtained limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, until evidence is obtained that all the statements that the financial statements comprise, including the related notes, have been prepared, and management has accepted responsibility for them. Management accepts responsibility for the financial statements by signing the representation letter.

5. If the financial statements include a separate statement of changes in stockholders’ equity accounts or a separate statement of comprehensive income, SSARS No. 21 requires that such statements be separately identified in the introductory paragraph of the report.

6. The accountant’s review report is normally addressed to those for whom the report is prepared. The report may be addressed to:

- the entity whose financial statements are being reviewed, or
- those charged with governance.
Note: A report on financial statements of an unincorporated entity may be addressed as circumstances dictate (for example, to the partners, general partner, or proprietor). Occasionally, an accountant may be retained to review the financial statements of an entity that is not a client; in such a case, the report may be addressed to the entity and not to those charged with governance of the entity whose financial statements are being reviewed.

7. When the accountant is aware that the reviewed financial statements will be included in a document that contains other information, such as an annual report, the accountant may consider, if the form of presentation allows, identifying the page numbers on which the reviewed financial statements are presented. This helps users identify the financial statements to which the accountant’s review report relates.


The accountant should modify the review report when the accountant becomes aware that the financial statements do not include certain elements.

1. Missing elements for which a modification should be made include:
   a. a description of the special purpose framework
   b. a summary of significant accounting policies
   c. an adequate description about how the special purpose framework differs from GAAP. The effects of these differences need not be quantified, and
   d. informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

2. In the case of financial statements prepared in accordance with a contractual basis of accounting, the accountant should modify the review report if the financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based.

3. The accountant’s review report on financial statements prepared in accordance with a special purpose framework should:
   a. when management has a choice of financial reporting frameworks in the preparation of such financial statements, make reference to management’s responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.
   b. when the financial statements are prepared in accordance with a regulatory or contractual basis of accounting, describe the purpose for which the financial statements are prepared or refer to a note in the financial statements that contains that information.

4. The accountant’s review report on financial statements prepared in accordance with a special purpose framework should include an emphasis-of-matter paragraph, under an appropriate heading, that:
indicates that the financial statements are prepared in accordance with the applicable special purpose framework
refers to the note to the financial statements that describes the framework, and
states that the special purpose framework is a basis of accounting other than GAAP.

5. The accountant’s review report on special purpose financial statements should include an other-matter paragraph, under an appropriate heading, that, restricts the use of the accountant’s review report when the special purpose financial statements are prepared in accordance with:

a. a contractual basis of accounting,
b. a regulatory basis of accounting, or
c. an other basis of accounting where:

- measurement or disclosure criteria are determined by the accountant to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria, or
- measurement or disclosure criteria that are available only to the specified parties.

Comparative Financial Statements

Comparative financial statements may be required by the applicable financial reporting framework, or management may elect to provide such information. When comparative financial statements are presented, the accountant’s report should refer to each period for which financial statements are presented.

Updating the Report

When reporting on all periods presented, a continuing accountant should update the report on one or more prior periods presented on a comparative basis with those of the current period.

1. The accountant’s report on comparative financial statements should not be dated earlier than the date that the accountant completed procedures sufficient to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework with respect to the current period.

2. When issuing an updated report, the continuing accountant should consider information that the accountant has become aware of during the review of the current period financial statements.

3. If, during the current engagement, circumstances or events come to the accountant’s attention that may affect the prior-period financial statements presented, the accountant should consider the effects on the review report.

Changed Reference to a Departure From the Applicable Financial Reporting Framework

When the accountant’s report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework, the accountant’s review report should include an other-matter paragraph.
1. That other-matter paragraph should include the following:

   a. the date of the accountant’s previous review report
   b. the circumstances or events that caused the reference to be changed, and
   c. when applicable, that the financial statements of the prior period have been changed.

Reporting When One Period is Audited

When the prior period financial statements were audited and the auditor’s report on the prior period financial statements is not reissued, the review report on the current period financial statements should include an other-matter paragraph.

1. The other-matter paragraph should indicate:

   a. that the financial statements of the prior period were previously audited
   b. the date of the auditor’s report on the prior period financial statements
   c. the type of opinion issued on the prior period financial statements
   d. if the opinion was modified, the substantive reasons for the modification, and
   e. that no auditing procedures were performed after the date of the previous report.

Illustration 1—An Accountant’s Review Report on Comparative Financial Statements Prepared in Accordance With U.S. GAAP When a Review Has Been Performed for Both Periods

Circumstances include the following:

- Review of a complete set of comparative financial statements, including notes
- The financial statements are prepared in accordance with U.S. GAAP

<table>
<thead>
<tr>
<th>Independent Accountant’s Review Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Appropriate Addressee]</td>
</tr>
<tr>
<td>I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.</td>
</tr>
</tbody>
</table>

Management’s Responsibility for the Financial Statements

Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error. |
Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s review report]


SSARS No. 21 retains the emphasis-of-matter paragraph found in SSARS No. 19 and introduces the new "other matter" paragraph that is also available for use in auditing standards.


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

   a. Such a paragraph should refer only to information presented or disclosed in the financial statements.

2. When the accountant includes an emphasis-of-matter paragraph in the accountant’s review report, the accountant should:

   a. include it immediately after the accountant’s conclusion paragraph in the accountant’s review report,

   b. use the heading “Emphasis of Matter” or other appropriate heading that describes the nature of the matter being disclosed or communicated:

      Emphasis of Matter or
      Significant Transactions With Related Parties
c. include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements, and

d. indicate that the accountant’s conclusion is not modified with respect to the matter emphasized.

3. Examples of circumstances when the accountant may consider it necessary to include an emphasis-of-matter paragraph include the following:

- Uncertainty regarding an entity’s ability to continue as a going concern for a reasonable period of time
- Uncertainty relating to the future outcome of unusually important litigation or regulatory action
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position
- Significant transactions with related parties, and
- Unusually important subsequent events.

Other-Matter Paragraph in the Accountant’s Review Report

1. If the accountant considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the accountant’s professional judgment, is relevant to the users’ understanding of the review, the accountant’s responsibilities, or the accountant’s review report, the accountant should do so in a paragraph in the accountant’s review report with the heading “Other Matter” or other appropriate heading.

   a. The accountant should include this paragraph immediately after the accountant’s conclusion paragraph and any emphasis-of-matter paragraph.

   b. The ordering of presentation of an emphasis-of-matter and other-matter paragraphs follows:

   FIRST: ACCOUNTANT’S CONCLUSION PARAGRAPH
   THEN: EMPHASIS-OF-MATTER PARAGRAPH
   THEN: OTHER-MATTER PARAGRAPH

Communication With Management- Emphasis-of-Matter or Other-Matter Paragraph

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

1. In addition to management, the accountant may also consider it appropriate to communicate with those charged with governance regarding the expectation of including an other-matter paragraph in the accountant’s review report and the proposed wording of this paragraph.
The following chart summarizes when an emphasis-of-matter and other-matter paragraph *may be required* in accordance with a review engagement. This list is in addition to other situations in which emphasis-of-matter paragraph may be used.

<table>
<thead>
<tr>
<th>SITUATIONS IN WHICH EMPHASIS-OF-MATTER OR OTHER-MATTER PARAGRAPH ARE USED IN REVIEW ENGAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description</td>
</tr>
<tr>
<td>EMPHASIS-OF-MATTER PARAGRAPH MAY BE CONSIDERED NECESSARY</td>
</tr>
<tr>
<td>Uncertainty regarding an entity's ability to continue as a going concern for a reasonable period of time</td>
</tr>
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<td>Uncertainty relating to the future outcome of unusually important litigation or regulatory action</td>
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<td>A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position</td>
</tr>
<tr>
<td>Significant transactions with related parties</td>
</tr>
<tr>
<td>Unusually important subsequent events</td>
</tr>
<tr>
<td>EMPHASIS-OF-MATTER OR OTHER-MATTER PARAGRAPH REQUIRED</td>
</tr>
<tr>
<td>Restricted use paragraph in a report on special purpose financial statements prepared on a contractual-basis, regulatory-basis, or certain other-bases of accounting.</td>
</tr>
<tr>
<td>Restricted use paragraph in a report for any reason</td>
</tr>
<tr>
<td>Paragraph in a report of the prior period that contains a changed reference to a departure from the applicable financial reporting framework when reporting on comparative financial statements</td>
</tr>
<tr>
<td>Paragraph in a report on comparative financial statements when the prior period is audited</td>
</tr>
<tr>
<td>Paragraph with respect to reporting a known departure from the applicable financial reporting framework that is material to the financial statements</td>
</tr>
<tr>
<td>Paragraph in a report when management revises financial statements for a subsequently discovered fact that became known to the accountant after the report release date and the accountant’s review report on the revised financial statements differs from the accountant’s review report on the original financial statements</td>
</tr>
<tr>
<td>Paragraph with respect to supplementary information that accompanies reviewed financial statements</td>
</tr>
<tr>
<td>Paragraph with respect to required supplementary information that accompanies reviewed financial statements</td>
</tr>
</tbody>
</table>
Known Departures From the Applicable Financial Reporting Framework

1. When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements, if the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

2. If the accountant concludes that modification of the standard report is adequate, the departure should be disclosed in a separate paragraph of the report under the heading “Known Departures From the [identity the applicable financial reporting framework],” including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known to the accountant as the result of the accountant's procedures.

   Known Departure From Accounting Principles Generally Accepted in the United States of America

   As disclosed in note X to these financial statements, accounting principles generally accepted in the United States require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally accepted in the United States on financial position, results of operations, and cash flows have not been determined.

3. If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant’s procedures, the accountant is not required to determine the effects of a departure; however, in such circumstances the accountant should state in the report that such determination has not been made.

4. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the review engagement.

5. The accountant should not modify the standard report to include a statement that the financial statements are not in accordance with the applicable financial reporting framework.

Examples of headings that an accountant may use to disclose departures from an applicable financial reporting framework in the accountant’s review report include the following:

   Known Departures From Accounting Principles Generally Accepted in the United States of America
   Known Departures From International Financial Reporting Standards as Promulgated by the International Accounting Standards Board
   Known Departures From the Cash-basis of accounting
   Known Departures From the Tax-basis of accounting
6. Prior to withdrawing from a review engagement in those circumstances when the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant may wish to consult with legal counsel.

7. SSARS No. 21 states that an accountant is precluded from issuing a review report that states that the financial statements are not in accordance with the applicable financial reporting framework.

**Note:** Stating that the reviewed financial statements are not in accordance with the applicable financial reporting framework is not appropriate as it is tantamount to expressing an adverse opinion on the financial statements. Such an opinion can be expressed only in the context of an audit engagement and, if issued in the context of a review report, may confuse users. In essence, such a statement would contradict the statement about whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

8. Depending on the accountant’s assessment of the possible dollar magnitude of the effect of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effect of the departures, the accountant may include a separate paragraph in the accountant’s review report stating the limitations of the financial statements.

The following is an illustration of such a separate paragraph with respect to an accountant’s review report on financial statements prepared in accordance with accounting principles generally accepted in the United States of America:

**Limitations of the financial statements**

*Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company’s financial position, results of operations, and cash flows if they had accesses to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.*

**Restricting the Use of the Accountant’s Review Report**

In certain instances, an accountant’s review report should include an alert, in a separate other-matter paragraph, that restricts its use when the subject matter of the accountant’s review report.

1. Situations in which the review report should include an alert is when:

   a. there is a measurement or disclosure criteria that are determined by the accountant to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria, or

   b. there is a measurement or disclosure criteria that are available only to the specified parties.
2. The alert that restricts the use of the accountant’s review report should:

a. state that the accountant’s review report is intended solely for the information and use of the specified parties

b. identify the specified parties for whom use is intended, and

c. state that the accountant’s review report is not intended to be and should not be used by anyone other than the specified parties.

**Note:** The alert that restricts the use of the accountant’s review report may list the specified parties or refer to the specified parties listed elsewhere in the accountant’s review report.

**Illustrative Language- Restricted Use**

The following illustrates language for a restricted use report that includes the elements required by SSARS No. 21.

**Restricted Use**

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

3. When the accountant includes an alert that restricts the use of the accountant’s review report to certain specified parties and the accountant is requested to add other parties as specified parties, the accountant should determine whether to agree to add the other parties as specified parties.

a. If the other parties are added after the release of the accountant’s review report, the accountant should take one of the following actions:

- Amend the accountant’s review report to add the other parties. In such circumstances, the accountant should not change the original date of the accountant’s review report.

- Provide a written acknowledgment to management and the other parties that such parties have been added as specified parties. The accountant should state in the acknowledgment that no procedures were performed subsequent to the original date of the accountant’s review report.

4. When the accountant is requested to add other parties as specified parties, the accountant may agree to add other parties as specified parties based on the accountant’s consideration of factors such as the identity of the other parties and the intended use of the accountant’s review report.

**The Accountant’s Consideration of an Entity’s Ability to Continue as a Going Concern**

**Consideration of Conditions or Events That Indicate That There Could be an Uncertainty About the Entity’s Ability to Continue as a Going Concern**
The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant’s attention indicating that there could be an uncertainty about an entity's ability to continue as going concern for a reasonable period of time:

1. A **reasonable period of time** is defined as:

   "a period the same period of time required of management to assess going concern when specified by the applicable financial reporting framework."

   a. For a GAAP framework, the reasonable period of time is **one year from the date the financial statements are available to be issued** (one year from the review report date).

   b. For a non-GAAP framework (such as tax basis), if that non-GAAP framework **does not specify** a period of time for management, a reasonable period of time is **one year from the date of the financial statements being reviewed** (which is one year from the balance sheet date).

2. If, after considering the evidence or information, the accountant believes that there is an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, the accountant should request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for related disclosure.

   a. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management's conclusions, including the adequacy of the related disclosure.

3. If the accountant determines that the entity’s disclosures with respect to the entity’s ability to continue as a going concern for a reasonable period of time are inadequate, a departure from the applicable financial reporting framework exists and the accountant should follow the guidance for known departures from the applicable financial reporting framework.

**Subsequent Events and Subsequently Discovered Facts**

When evidence or information that subsequent events which require adjustment of, or disclosure in, the financial statements comes to the accountant's attention, the accountant should request that management consider whether each such event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

1. If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, the accountant should follow the guidance for known departures found in AR-C 90.

**Reference to the Work of Other Accountants in an Accountant’s Review Report**

If other accountants audited or reviewed the financial statements of significant components, such as consolidated and unconsolidated subsidiaries and investees, and the accountant of the reporting entity decides not to assume responsibility for the audit or review performed by the other accountants, the
accountant of the reporting entity should make reference to the review or audit of such other accountants in the accountant’s review report.

Supplementary Information That Accompanies Reviewed Financial Statements

SSARS No. 21 clarifies the general reporting requirements and options pertaining to supplementary information that accompanies reviewed financial statements. Previously, the authority has been found in AR 90-60 as part of SSARS No. 19.

1. AR-C 90 clarifies the issue of as to how an accountant may report on supplementary information that accompanies reviewed financial statements.

   a. In essence, if an accountant issues a review report on financial statements, he or she may report on supplementary information at any one of three levels:

      • Review the supplementary information
      • Compile the supplementary information, or
      • Disclaim the supplementary information (no opinion)

2. When supplementary information accompanies reviewed financial statements and the accountant’s review report thereon, the accountant should clearly indicate the degree of responsibility, if any, the accountant is taking with respect to such information in either:

   a. an other-matter paragraph in the accountant’s review report on the financial statements, or
   b. a separate report on the supplementary information.

Supplementary information reviewed:

Other Matter

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have reviewed the information and, based on my (our) review, I am (we are) not aware of any material modifications that should be made to the information in order for it to be in accordance with [the applicable financial reporting framework]. I (We) have not audited the information and, accordingly, do not express an opinion on such information.

Required Supplementary Information

Paragraph 80 of AR-C 90 states that with respect to required supplementary information, the accountant should include other-matter paragraph in the accountant’s review report on the financial statements.

1. The other-matter paragraph should include language to explain the following circumstances, as applicable:
a. The required supplementary information is included, and the accountant performed a compilation engagement on the required supplementary information.
b. The required supplementary information is included, and the accountant reviewed the required supplementary information.
c. The required supplementary information is included, and the accountant did not perform a compilation, review, or audit on the required supplementary information.
d. The required supplementary information is omitted.
e. Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines.
f. The accountant has identified departures from the prescribed guidelines.
g. The accountant has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

2. Examples of required supplementary information that may accompany reviewed financial statements include the following:

a. With respect to common interest realty associations, estimates of current or future costs of major repairs and replacements of common property that will be required in the future as required by FASB ASC 972-235-50-3, Real Estate- Common Interest Realty Associations.

b. Management’s discussion and analysis and budgetary comparison statements as required by GASB No. 34, Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments.

Change in Engagement From Audit to Review

If the accountant, who was engaged to perform an audit engagement in accordance with generally accepted auditing standards, has been requested to change the engagement to a review engagement, the accountant should follow rules found in AR-C 90.

1. The accountant should consider the following before deciding whether to agree to the change:

a. The reason given for the request, particularly the implications of a restriction on the scope of the audit engagement, whether imposed by management or by circumstances
b. The additional audit effort required to complete the audit engagement, and
c. The estimated additional cost to complete the audit engagement.

2. In all circumstances, if the audit procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

3. If the accountant concludes, based upon the accountant’s professional judgment, that reasonable justification exists to change the engagement, and if the accountant complies with the standards applicable to a review engagement, the accountant should issue an appropriate review report.

4. The report should not include reference to:
a. the original engagement 
b. any audit procedures that may have been performed, or 
c. scope limitations that resulted in the changed engagement.

5. When the accountant has been engaged to audit an entity's financial statements and management refuses to allow the accountant to correspond with the entity's legal counsel, the accountant, except in rare circumstances, is precluded from accepting an engagement to review those financial statements.

Communicating to Management and Others Regarding Fraud or Noncompliance With Laws and Regulations

SSARS No. 21 carries over from auditing standards the concept of "noncompliance with laws and regulations," a term that replaces the term "illegal acts." The SSARS also provides guidance on addressing fraud in a review engagement.

1. If the accountant becomes aware that fraud (including misappropriation of assets) may have occurred, the accountant should communicate the matter as soon as practicable to the appropriate level of management (at a level above those involved with the suspected fraud, if possible).

2. If the accountant becomes aware of matters involving identified or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements, the accountant should communicate the matters to management, other than when matters are clearly inconsequential.

T. Review Documentation

AR-C 90 provides the following documentation requirements with respect to a review engagement:

1. The accountant should prepare review documentation that is sufficient to enable an experienced accountant, having no previous connection to the review, to understand:
   a. the nature, timing, and extent of the review procedures performed to comply with SSARSs 
   b. the results of the review procedures performed and the review evidence obtained, and 
   c. significant findings or issues arising during the review, the conclusions reached, and significant professional judgments made in reaching those conclusions.

2. The review documentation should include the following:
   a. The engagement letter or other suitable form of written documentation with management, 
   b. Communications to management and others regarding fraud or noncompliance with laws and regulations 
   c. Communications with management regarding the accountant’s expectation to include an emphasis-of-matter or other-matter paragraph in the accountant’s review report 
   d. Communications with other accountants who have audited or reviewed the financial statements of significant components 
   e. The representation letter
f. A copy of the reviewed financial statements and the accountant’s review report

3. Review documentation may be recorded on paper or electronic or other media.

4. The accountant need not include in review documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Note: AR-C 90 states that an accountant is not prevented from supporting the review report by other means in addition to the review documentation, such as written documentation contained in other engagement files or quality control files, and, in limited situations, oral explanations. By themselves, oral explanations by the accountant do not represent adequate support for the work the accountant performed or conclusions reached, but they may be used to explain or clarify information contained in the review documentation.
Review Questions

1. Which of the following is not information on which an accountant may perform a review engagement under AR-C 90:
   a. Balance sheet
   b. Prospective information
   c. Schedule of rental income
   d. Schedule of accounts receivable

2. One requirement made by AR-C 90 is that in a review engagement, the accountant should communicate with management about______________:
   a. Deficiencies in internal control
   b. Matters of significant importance
   c. Calculations of analytical procedures
   d. Matters that are restricted by law or regulation

3. John is an accountant performing a review engagement. John has a limited knowledge of the client's industry. Which of the following is correct:
   a. John cannot perform the engagement because he has no knowledge of the industry
   b. John may perform the engagement only after he receives extensive training for the industry
   c. John may perform the engagement only if he brings on a co-reviewer who has extensive industry experience
   d. John is not precluded from accepting the review engagement

4. Alice is an accountant performing a review engagement. She decides to confirm a bank loan directly with the bank. Which of the following is correct:
   a. By performing an audit procedure (confirmation), Alice must step up her engagement to an audit
   b. Alice is not required to perform an audit engagement
   c. Alice must continue with her audit procedures and then convert the engagement to an audit
   d. Alice is prevented from sending the confirmation if she wants to retain the review engagement

5. Which of the following is a new requirement that AR-C 90 adds for a review engagement:
   a. Accountant should perform analytical procedures
   b. Accountant should make inquiries of management and others
   c. Accountant should obtain evidence that the financial statements agree with the accounting records
   d. Accountant should obtain a management representation letter

6. AR-C 90 provides guidance as to what is deemed a material misstatement. It states that misstatements are material if, individually or in the aggregate ______________.
   a. The misstatements equal or exceed 10 percent of a benchmark such as gross sales, total assets, etc.
   b. The misstatements would influence management's decisions as to how to manage the company
   c. The misstatements could reasonably be expected to influence the economic decisions of users
d. The misstatements would influence the decisions of the largest or most significant user of the financial statements regardless of whether they would influence the decisions of all users taken as a whole.

7. Which of the following is not an appropriate paragraph heading in a review report:
   a. Accountant's Responsibility
   b. Opinion
   c. Management's Responsibility for the Financial Statements
   d. Accountant's Conclusion

8. Which of the following is an example of a circumstance in which an auditor may consider it necessary to include an other-matter paragraph in his or her report:
   a. Significant transactions with related parties
   b. With respect to supplementary information that accompanies reviewed financial statements
   c. Uncertainty regarding an entity's ability to continue as a going concern
   d. Unusually important subsequent events

9. In AR-C 90, the term "illegal acts" is replaced by the term ________________.
   a. Fraudulent activities
   b. Unconventional transactions
   c. Unethical actions
   d. Noncompliance with laws and regulations
Implementation of SSARS No. 21

All of the standards within SSARS No. 21 are effective for the preparation of financial statements for periods ending on or after December 15, 2015. Early implementation is permitted.

In implementing the new standards, the following rules should be followed:

1. If the report covers comparative year’s financial statements, the new reports should cover both years including the prior comparative year which was issued under the previous standards.

   **Example:** John CPA implements SSARS No. 21 for 2015 and issues a review report for both 2015 and 2014.

   **Conclusion:** Even though the new standards are implemented for 2015, the new review report should cover both 2015 and 2014.

2. In the comparative financial statements, the new legends, financial statement titles, and report titles should be applied to both comparative financial statements even though the prior year was issued under the previous standards.

   **Example:** Mary CPA implements SSARS No. 21 for 2015 and issues prepared financial statements under AR-C 70 for 2015. The 2014 financial statements are presented comparatively even though the new preparation standard is not applied until 2015.

   **Conclusion:** Mary should present 2014 financial statements comparatively with 2015 and should apply all of the new conventions under the new SSARS No. 21 to both years such as the "no assurance" legend, financial statement titles, etc.

   *For 2015, the accountant prepares financial statements under AR-C 70 with no compilation engagement performed. What if an accountant compiled financial statements for 2014 and implements SSARS No. 21 in 2015?*

Although 2014 was originally compiled, nothing prevents the accountant from presenting 2014 financial statements comparatively with 2015 in a preparation of financial statements engagement. If so, there is no requirement that the accountant reference that he or she previously compiled the 2014 financial statements.

*What if an accountant had previously compiled financial statements for 2014 under the SSARS No. 19 standard and implements SSARS No. 21 standards for 2015 compilation engagement?*

The same conclusion would be reached if the 2014 financial statements were compiled under the SSARS No. 19 standards and then compiled for 2015 under new SSARS No. 21. All of the 2015 requirements would be presented comparatively for 2015 and 2014, such as the optional "See Accountant's Compilation Report." The new compilation report would be issued referencing both 2015 and 2014. There is no need to reference the accountant's compilation report that was issued for 2014 under SSARS No. 19, nor is there any requirement to reissue the 2014 report.
Chapter 2:
Practice Issues

Learning Objectives

After studying this chapter, you will be able to:

1. Identify the reporting options for controllers who seek to issue financial statements
2. Recognize the accountant’s responsibility for reporting fraud in compilation and review engagements
3. Identify factors that may or may not suggest there is a potential going concern problem in a compilation or review engagement
4. Recognize the threshold to evaluate an Altman Z Score
5. Identify an example of a deferred M-1 that is eliminated by tax-basis financial statements
6. Recognize some of the general rules for tax-basis financial statements
7. Identify the options available to report on supplementary information in a compilation or review engagement
8. Recognize the general disclosure rules when issuing a compilation report on a specified element
9. Identify when a management representation letter is required and some general rules pertaining to such letters
10. Identify a prescribed form and the options for reporting on personal financial statements
11. Recognize some of the recurring deficiencies noted in peer reviews
12. Identify examples of simpler reporting options to full GAAP financial statements
13. Identify provisions to incorporate into engagement letters to protect the accountant against liability claims
14. Recognize the general rules to maintain independence when an accountant performs non-attest services for an attest client
15. Identify when independence is impaired in certain situations in which an accountant performs non-attest services for an attest client
16. Recognize the privity standard as it relates to the accountant’s liability to third parties

II. Practice Issues - Part 1

A. Controllers Issuing Financial Statements

For years, accountants have performed write-up services for clients in addition to performing a compilation, review or even an audit engagement. More recently, those services have expanded to part-time controllership. Because bookkeeping and controllership functions, by themselves, do not necessarily entail issuing a report, many accountants take it for granted that such engagements are risk-free. Yet, recent statistics obtained from major insurance carriers reach a different conclusion:

1. Malpractice cases against accountants in write-up services have risen dramatically in recent years.
a. Undetected fraud is the number one charge against accountants in write-up engagements with the focus on cash and accounts receivable.

b. Accountants in part-time controllership cases are being held to a higher standard than acting as an internal accountant.

2. Accountants may have a lack of independence depending on the degree of services provided.

3. In order to mitigate some of the risks associated with write-up and bookkeeping engagements, the following are a few suggestions:

   a. Make sure you obtain an engagement letter for both write-up services and part-time controllership engagements.

   b. Make sure your malpractice insurance covers controllership since the service could be construed as an employer-employee relationship rather than a professional-client relationship.

   c. Watch out for independence issues if you plan to issue a report.

   d. Part-time controllers should consider whether they need to issue a report and the impact of their position on the ability to do so.

The following section discusses the present developments with the controllership issue.

The general rule is that an accountant in public practice is permitted to issue a compilation report even if he or she is not independent, provided the report identifies the fact that he or she is not independent.

Yet, many accountants provide part- or full-time controllership services including:

- Maintaining the accounting books and records,
- Preparing financial statements, and
- Performing certain management functions for their clients, such as hiring employees, authorizing purchases, investing idle cash, signing checks, or serving as an officer or director of a company.

ET sec. 1.295, Nonattest Services of the AICPA Code of Professional Conduct provides that if an accountant performs certain activities for an attest client that are considered assuming management responsibility, he or she has impaired his or her independence with respect to that particular client.

Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities that would be considered management responsibilities and, as such, impair independence if performed for an attest client, include:

   a. setting policy or strategic direction for the attest client.

   b. directing or accepting responsibility for actions of the attest client’s employees except to the extent
c. permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
d. authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of an *attest client* or having the authority to do so.
e. preparing *source documents*, in electronic or other form, that evidence the occurrence of a transaction.
f. having custody of an *attest client’s* assets.
g. deciding which recommendations of the member or other third parties to implement or prioritize.
h. reporting to *those charged with governance* on behalf of management.
i. serving as an *attest client’s* stock transfer or escrow agent, registrar, general counsel or equivalent.
j. accepting responsibility for the management of an *attest client’s* project.
k. accepting responsibility for the preparation and fair presentation of the *attest client’s financial statements* in accordance with the applicable financial reporting framework.
l. accepting responsibility for designing, implementing, or maintaining internal control.
m. performing ongoing evaluations of the *attest client’s* internal control as part of its monitoring activities.

If the accountant does any of the previously noted activities on behalf of an attest client, **he or she is not independent.**

For years, there was confusion as to the extent to which CPAs could avoid issuing compilation reports on financial statements. On one side of the issue, there were CPAs in public practice who also provided management services (as listed above) for their clients. Some CPAs in this situation argued that because they were both engaged in public practice and performing management services, they could choose to issue financial statements in the capacity as a member of management, not public practice. Thus, they argued that requirements to issue a compilation report under the SSARSs did not apply. The result was that the compilation report was replaced with the issuance of a transmittal letter sent to the third party along with the financial statements.

On the other side of the issue, there were CPAs in industry who were issuing financial statements for their employers. Instead of issuing the financial statements with a transmittal letter, they issued them with a compilation report noting a lack of independence in the report.

Thus CPAs in public practice who performed management services bypassed the requirements of the SSARSs (compilation report), and CPAs in industry issued compilation reports for their employer companies.

There simply was no authority to deal with the cross over between CPAs in industry and public practice. For CPAs in industry who issued a compilation report for their employer, nothing in the SSARSs precluded them from doing so provided they noted the lack of independence.

For CPAs in public practice who issued merely a transmittal letter in the capacity as a member of management, AICPA Ethics Ruling No. 10 gave some guidance for an accountant in industry who was also a stockholder, partner, director, officer or employee of an entity for which he or she prepared financial statements to be transmitted to a third party. Effective December 15, 2014, Ethics Ruling No. 10 is deleted and replaced with Ethics Interpretation 2.300.030, *Submission of Financial Statements* of the AICPA Code of Professional Conduct states:
Ethics Interpretation 2.300.030, Submission of Financial Statements of the AICPA Code of Professional Conduct states:

"When a member (accountant) is a stockholder, a partner, a director, an officer, or an employee of an entity and, in this capacity, prepares or submits the entity’s financial statements to third parties, the member should clearly communicate, preferably in writing, the member’s relationship to the entity and should not imply that the member is independent of the entity."

The Ethics Ruling essentially indicated that an accountant can issue financial statements in his or her capacity as a stockholder, partner, director, officer, or employee of a client, provided he or she indicates his or her relationship to the entity; that is, indicate an employment title or the fact that the accountant is a “part-time controller.”

Thus, existing authority has appeared to authorize the crossover of activities by CPAs in industry and public practice. Yet, many observers have taken the position that, although not stated in the SSARSs, a compilation report is supposed to be issued by an accountant in public practice, not industry. And, use of a transmittal letter and the avoidance of the issuance of a compilation report should be set aside for CPAs who were truly part of management, exclusive of CPAs that provided part-time controllership work.

To add more confusion to the situation, newly issued SSARS No. 21 provides an additional preparation of financial statements engagement which calls to question whether a CPA in industry can perform a preparation engagement under SSARS No. 21.

**Question:** If an accountant is in public practice and provides an entity with controllership or other management services that entail the submission of financial statements, is the accountant required to follow the requirements the SSARSs?

**Interpretation:** Prior to 2015, there was authority to address situations in which an accountant was issuing financial statements in the capacity of a stockholder, partner, director, officer, or employee of an entity. That authority was found in Interpretation No. 8 of AR-80, Applicability of Statements on Standards for Accounting and Review Services When Performing Controllership or Other Management Services.

With the issuance of SSARS No. 21, all previous SSARS interpretations, including Interpretation No. 8, have been superseded. Thus, starting in 2015, there really is no authority to deal with situations in which an accountant issues financial statements in the capacity of being part of management, or a stockholder.

Nevertheless, the author believes that the general framework of Interpretation No. 8 still applies and that accountants should follow it for years 2015 and later.

Here is the general framework to be followed:
a. An accountant is in public practice,¹⁶ and is not a stockholder, partner, director, officer, or employee of the entity:

If engaged (hired) to perform a SSARS No. 21: the accountant must follow the SSARS No. 21 requirements for a preparation, compilation or review engagement.

If not engaged (hired) to perform a SSARS No. 21 engagement: the accountant has no reporting requirements under SSARS No. 21 or any other standards.

b. An accountant is in public practice and is also a stockholder, partner, director, officer, or employee of the entity, the accountant may do one of the following:

Option 1: If engaged (hired) as a CPA in public practice to perform a SSARS No. 21 engagement, follow the SSARS No. 21 requirements as follows:¹⁸

- The accountant may perform a preparation of financial statements engagement
- The accountant may perform a compilation engagement and disclaim lack of independence
- The accountant is not permitted to perform a review engagement due to lack of independence

Option 2: If not engaged (hired) to perform a preparation, compilation or review engagement in the capacity as a CPA in public practice:

- Issue the financial statements to third parties in the capacity as a stockholder, partner, director, officer or employee of the entity with a transmittal letter
- Communicate to the third parties the accountant’s relationship to the entity (for example, stockholder, partner, director, officer, or employee), and
- Do not imply that the accountant is independent.

c. An accountant is not in public practice and is a stockholder, partner, director, officer, or employee of the entity, the accountant may do one of the following:

- Accountant is not permitted to perform a SSARS No. 21 engagement because he or she is not in public practice.
- Accountant may:
  - Issue the financial statements to third parties in the capacity as a stockholder, partner, director, officer or employee of the entity with a transmittal letter

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¹⁶ As defined by the AICPA Code of Conduct which replaces the term practice of public practice with the term public practice.
¹⁷ A SSARS No. 21 engagement is either a preparation of financial statements, compilation or review engagement.
¹⁸ To be hired or engaged to perform a preparation, compilation or review engagement, the CPA should have an engagement letter executed between the client and the CPA’s public practice firm.
- Communicate to the third parties the accountant’s relationship to the entity (for example, stockholder, partner, director, officer, or employee), and

- Do not imply that the accountant is independent.

The following is an example of the type of communication that may be used by the accountant who issues financial statements in his or her capacity as a stockholder, partner, director, officer or employee of the entity:

*The accompanying balance sheet of Company X as of December 31, 20XX, and the related statements of income and cash flows for the year then ended have been prepared by (name of accountant), CPA. I have prepared such financial statements in my capacity (describe capacity, for example, as director) of Company X.*

If an accountant is not in public practice, the issuance of a report under SSARS No. 21 would be inappropriate; however, the previously mentioned communication may be used.

The following chart summarizes the approach that should be used:

**Facts:** An accountant performs management or controllership services for a client:

<table>
<thead>
<tr>
<th>Description</th>
<th>Acceptable action</th>
</tr>
</thead>
</table>
| CPA is in public practice and is *not* a stockholder, partner, director, officer, or employee of the entity. | If engaged (hired) to perform a SSARS No. 21: the accountant must follow the SSARS No. 21 requirements for a preparation, compilation or review engagement.  
If not engaged (hired) to perform a SSARS No. 21 engagement: the accountant has no reporting requirements under SSARS No. 21 or any other standards. |
| CPA is in public practice and *is also* a stockholder, partner, director, officer, or employee of the entity. | CPA has a choice.  
**Option 1:** If engaged *(hired)* as a CPA in public practice to perform a SSARS No. 21 engagement, follow the SSARS No. 21 requirements as follows:  
- The accountant may perform a preparation of financial statements engagement  
- The accountant may perform a compilation engagement and disclaim lack of independence  
- The accountant is not permitted to perform a review engagement due to lack of independence  
**Option 2:** If *not engaged (hired)* to perform a |
| CPA is not in public practice and is a stockholder, partner, director, officer, or employee of the entity. | Accountant is not permitted to perform a SSARS No. 21 engagement because he or she is not in public practice.  
- Accountant may:  
  - Issue the financial statements to third parties in the capacity as a stockholder, partner, director, officer or employee of the entity with a transmittal letter  
  - Communicate to the third parties the *accountant’s relationship to the entity* (for example, stockholder, partner, director, officer, or employee), and  
  - Do not imply that the accountant is independent. |

**Example 1:** An accountant is in public practice and is not a stockholder, partner, director, officer or employee of the entity. In fact, the accountant receives a Form 1099 for his services. The entity needs to issue financial statements to the bank. The company engages (hires) the accountant to perform a compilation engagement.

**Conclusion:** Because the accountant is in public practice, has been engaged (hired) to perform a compilation engagement, and is not a stockholder, partner, director, officer or employee of an entity, the accountant’s only option to issue financial statements is to perform a SSARS No. 21 engagement (preparation, compilation or review engagement).

Issuing financial statements outside of SSARS No. 21 with a transmittal letter is not an option.

**Example 2:** Same facts as Example 1, except the accountant is also a director of the company.

**Conclusion:** An accountant in public practice who is also a stockholder, partner, director, officer or employee of an entity, has a choice of reporting.
Option 1: If the accountant is actually engaged (hired) as an accountant in public practice to perform a SSARS No. 21 engagement, the accountant is limited as to the type of SSARS No. 21 engagement he or she may perform due to the lack of independence. The accountant may perform a preparation engagement because independence is not required. The accountant may perform a compilation engagement disclaiming the lack of independence. The accountant is not permitted to perform a review engagement because the accountant lacks independence because he or she is a director of the company.

Option 2: If the accountant is not engaged (hired) as an accountant in public practice to perform a SSARS No. 21 engagement, the accountant may issue financial statements in his or her capacity as a director of the company and communicate that his relationship with the company – that is, issue a transmittal letter indicating that he or she is a director of the company. In doing so, the accountant should not imply that the accountant is independent.

Example 3: An accountant is a CFO for a company and wishes to issue a compilation report on the company. She is not in public practice.

Conclusion: Where an accountant is not in public practice, the performance of a SSARS No. 21 engagement (preparation, compilation or review engagement) is not appropriate. Thus, the CFO’s only option is to issue financial statements in her capacity as an officer of the company, such as issuing a transmittal letter along with the financial statements.

Definitions:

The AICPA Code of Ethics defines public practice19 as follows:

Public practice. Consists of the performance of professional services for a client by a member or member’s firm.

What is the form of communication made to a third party by an accountant who is in industry, and not public practice?

The previously applicable Interpretation No. 8 gave some recommended language that could be used when an accountant in industry is either permitted or required to issue a communication to accompany financial statements.

Further, Ethics Interpretation 2.300.030 gives guidance in situations in which an accountant wishes to issue financial statements with a transmittal letter to a third party.

Ethics Interpretation 2.300.030, Submission of Financial Statements of the AICPA Code of Professional Conduct further states:

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19 The change to this term is a conforming change to the Code of Professional Conduct. Specifically, the phrase “practice of public accounting” was replaced with the phrase “public practice” which is the term used in the Codification of the Code of Professional Conduct.
"When a member (accountant) is a stockholder, a partner, a director, an officer, or an employee of an entity and, in this capacity, prepares or submits the entity’s financial statements to third parties, the member should clearly communicate, preferably in writing, the member’s relationship to the entity and should not imply that the member is independent of the entity."

In addition, if the communication states affirmatively that the financial statements are presented in conformity with the applicable financial reporting framework, the member should comply with the Accounting Principles Rule of ET 1.320.001."

**ET 1.320.001 Accounting Principles Rule states:**

"A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole...."

Moreover, in using his or her CPA designation, an accountant must ensure that the use of his or her CPA designation does not violate local state law.

Ethics Interpretation 2.4400.100, *Use of the CPA Credential* of the AICPA Code of Professional Conduct states:

"A member should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the Acts Discreditable Rule, ET 2.400.001."

If an accountant in industry wishes to issue a communication (transmittal letter) to accompany financial statements to be given to a third party, the following rules apply:

1. The communication must be on the entity’s letterhead.

2. The accountant can use his or her CPA designation provided he or she notes his or her title related to the entity (stockholder, partner, director, employee).

3. If the accountant does mention in his or her letter that the financial statements are presented in conformity with GAAP, the accountant is subject to the Accounting Principles Rule, 1.320.001 which states that he or she shall not knowingly state that statements are in conformity with GAAP when they are not.

4. The accountant must ensure that the use of the CPA designation does not violate his or her state accountancy laws, rules and regulations (Ethics Interpretation 2.4400.100).
Following is a sample transmittal letter:

Sample Transmittal Letter - Non-Authoritative

<table>
<thead>
<tr>
<th>ACME Manufacturing Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benjamin Bowman, CPA</td>
</tr>
<tr>
<td>Chief Financial Officer</td>
</tr>
</tbody>
</table>

Mr. William No, President
Never Loan Bank and Trust
100 Everywhere Way
Nowhere, USA

March 16, 20X2

Dear Mr. No:

Attached you will find the financial statements of ACME Manufacturing Co. for the month ended February 28, 20X1.

The accompanying balance sheet of ACME Manufacturing as of February 28, 20X1, and the related statements of income and cash flows for the year then ended have been prepared by Benjamin Bowman, CPA. I have prepared such financial statements in my capacity as Chief Financial Officer of the company.

These financial statements have been prepared in accordance with generally accepted accounting principles. (a)

Very truly yours,

Benjamin Bowman, CPA
Chief Financial Officer
ACME Manufacturing Co.

(a): Ethics Interpretation 2.320.001, Accounting Principles Rule, states that a member (CPA) shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements of data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole.
ACME Manufacturing Co.
Balance Sheet
February 28, 20X1

**ASSETS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$XX</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>XX</td>
</tr>
<tr>
<td>Property and equipment, net</td>
<td>XX</td>
</tr>
<tr>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$XX</td>
</tr>
</tbody>
</table>

**LIABILITIES AND STOCKHOLDER'S EQUITY**

**Liabilities:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$XX</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>XX</td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>XX</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>XX</td>
</tr>
<tr>
<td></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$XX</td>
</tr>
</tbody>
</table>

**Stockholders’ equity:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>XX</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>XX</td>
</tr>
<tr>
<td></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total Stockholders’ Equity</strong></td>
<td>$XX</td>
</tr>
</tbody>
</table>

**Internally Generated Financial Statements**
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$XX</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>XX</td>
</tr>
<tr>
<td>Gross profit</td>
<td>XX</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>XX</td>
</tr>
<tr>
<td>Net operating income</td>
<td>XX</td>
</tr>
<tr>
<td>Other income</td>
<td>XX</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td>XX</td>
</tr>
<tr>
<td>Income taxes</td>
<td>XX</td>
</tr>
<tr>
<td>Net income</td>
<td>$XX</td>
</tr>
</tbody>
</table>

**Internally Generated Financial Statements**

**Observation:** The author wishes to make the following observations about the above financial statements.

First, notice that the transmittal letter is placed on the Company’s letterhead and references Benjamin Bowman’s employment title, as CFO.

Second, there is a reference to GAAP in the transmittal letter. This is suggested language but there is no authoritative guidance to address this issue. However, if the accountant does mention in his or her letter that the financial statements are presented in conformity with GAAP, the accountant is subject to Accounting Principles Rule, 1.320.001, which states that *he or she shall not knowingly state that statements are in conformity with GAAP when they are not.* The author recommends that any transmittal letter be silent on the GAAP or tax basis format to provide maximum financial reporting flexibility.
Third, it may be advisable to stamp each statement "Internally Generated Financial Statements" to ensure that the third party fully understands that the statements were generated internally and not with the assistance of an outside CPA. If the above internally generated financial statement format is followed, it would not be appropriate to apply any SSARS No. 21 elements such as a "See Accountant’s Compilation Report" legend. The author recommends that an accountant who is also a stockholder, partner, director, officer or employee consider the risk associated with issuing financial statements with a transmittal letter. Logically, the author believes that if a transmittal letter is issued, the accountant should be protected under the entity veil as being a stockholder, partner, director, officer, or employee of that entity. However, the accountant might wish to consult with legal counsel as to legal liability. For example, could a third party who knows that an accountant is in public practice as well as being a director, attempt to sue the accountant in his capacity as a member of public practice, rather than as a director? The accountant should review his or her malpractice insurance policy and/or consult with legal counsel to consider whether such services are covered under the policy and place the accountant at personal risk with respect to the financial statement issued with a transmittal letter.

**What if an accountant is in public practice, is not hired to perform a SSARS No. 21 engagement (preparation, compilation or review engagement) and is not a stockholder, partner, director, officer or employee of an entity?**

There is a loophole within SSARS No. 21 in which an entity could, in theory, issue financial statements without a report and not come under the requirements of SSARS No. 21 or any other reporting standards.

SSARS No. 21 states that in order to issue financial statements under SSARS No. 21, the accountant must be:

- In public practice, and
- Engaged (hired) to perform a preparation, compilation or review engagement.

**But what happens if the accountant is not in public practice and is not hired to perform a preparation, compilation or review engagement?**

In such a situation, the accountant is not permitted to perform a SSARS No. 21 engagement. Moreover, if the accountant is not a stockholder, partner, director, officer, or employee of the entity, there is also no requirement to follow Ethics Interpretation 2.300.030, *Submission of Financial Statements* of the AICPA Code of Professional Conduct, which states: "When a member (accountant) is a stockholder, a partner, a director, an officer, or an employee of an entity and, in this capacity, prepares or submits the entity’s financial statements to third parties, the member should clearly communicate, preferably in writing, the member’s relationship to the entity and should not imply that the member is independent of the entity."

That means an accountant who is not in public practice, and is not a stockholder, partner, director, partner, director, officer, or employee of an entity, may issue financial statements for that entity without any reporting requirements being in effect. Remember that SSARS No. 21 only applies if an accountant in public practice is engaged (hired) to perform a preparation, compilation or review engagement. Thus, an accountant cannot be forced into performing a SSARS No. 21 engagement.
Hierarchy: Accountants in Public Practice Serving also as Stockholders, Partners, Directors, Officers, or Employees

- Are you in public practice?
  - No: SSARS No. 21 *does not apply.*
    - Financial statements may not be issued with a SSARS 21 report.
    - Accountant has no reporting responsibility.
  - Yes: SSARS No. 21 *applies:*
    - Perform a preparation, compilation or review engagement per SSARS No. 21

- Are you engaged (hired) to perform a preparation, compilation or review engagement?
  - No: SSARS No. 21 *does not apply.*
    - Financial statements may not be issued with a SSARS 21 report.
    - Accountant can issue financial statements with no reporting responsibility.
    - Issuing financial statements with a transmittal letter is one option.
  - Yes: SSARS No. 21 *does not apply.*
    - Financial statements may not be issued with a SSARS 21 report.
    - Financial statements may be issued with a transmittal letter.
    - Issued financial statements must clearly state the relationship the accountant has to the entity

- Are you a stockholder, partner, director, officer, or employee?
  - No: SSARS No. 21 *does not apply.*
    - Financial statements may not be issued with a SSARS 21 report.
    - Accountant can issue financial statements with no reporting responsibility.
    - Issuing financial statements with a transmittal letter is one option.
  - Yes: SSARS No. 21 *does not apply.*
    - Financial statements may not be issued with a SSARS 21 report.
    - Financial statements may be issued with a transmittal letter.
    - Issued financial statements must clearly state the relationship the accountant has to the entity
B. Distributing Draft Financial Statements

In some situations, the accountant may submit a preliminary “draft” set of financial statements for the client’s perusal before the financial statements and related compilation or review engagement is issued.

Prior to the issuance of SSARS No. 21, the SSARSs offered some guidance as to how to handle draft financial statements. That guidance was found in Interpretation No. 5 of AR Section 80, and Interpretation No. 4 of AR Section 90 of SSARS No. 19, Submitting Draft Financial Statements.

Although that guidance has officially been superseded by SSARS No. 21, the concepts are still relevant and represent good practice that practitioners should follow:

An accountant may submit draft statements to a client:

1. when information needed to complete a compilation or review of the financial statements will not be available until a later date, or

2. to provide a client with the opportunity to read and analyze the financial statements before their final issuance.

The accountant may issue draft statements as long as:

1. the statements are marked with the words such as “Draft,” “Draft-Subject to Change,” “Preliminary Draft,” or similar language, and

2. the accountant intends to submit the final financial statements with an appropriate compilation or review report when the information needed to complete the engagement becomes available.

What if the client indicates that he or she plans to submit draft financial statements to a third party such as a bank before issuance of the final statements?

The accountant should inform the client that the best course of action is to wait until the engagement is complete and final statements are issued. However, the accountant is not responsible for and cannot control the distribution of draft financial statements that he or she has submitted to the client.

A previously issued Compilation and Review Alert referenced a case involving draft statements in an audit engagement involving a third party’s reliance on draft financial statements. In a rather old but relevant case (ESCA Corp. v. KPMG Peat Marwick, Wash App), the court found for the plaintiff, a bank who had relied on the financial statements to increase a line of credit. However, the case brings to the forefront that firms should be cautious when issuing draft financial statements. In this particular case, two factors assisted the firm in at least minimizing damages:

1) **Clear labeling** of every page of the draft financial statements with words:

   “Preliminary Draft, For Discussion Purposes Only”

2) **Limited distribution** of the report to selected members of the client’s staff.
C. Consideration of Fraud in a Compilation and Review Engagement

In an audit of financial statements, an auditor must perform functions in planning his or her audit to address fraud and non-compliance with laws and regulations. SAS No. 122, AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99) and SAS No. 122, AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (formerly SAS No. 54), are the governing authority for audit engagements and require an auditor to:

- Assess and document fraud risk, and
- Assessment and document noncompliance with laws and regulations.

Prior to 2012, auditors were responsible for addressing illegal acts. Starting in 2012, SAS No. 54, *Illegal Acts*, was replaced with AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. With the issuance of AU-C 250, now an auditor must assess and document *noncompliance with laws and regulations*, which is a broader concept than illegal acts.

As it relates to SSARS engagements (preparation, compilation and review engagements), many accountants are not sure as to their responsibility for fraud and noncompliance with laws and regulations.

SSARS No. 21 *do not* require the accountant to understand internal control nor assess fraud risk in conducting a compilation or review engagement.

However, SSARS No. 21 does require that an accountant adhere to certain performance requirements in a compilation or review engagement as follows:

1. **Definitions:**

   **Fraud:** An intentional act that results in a misstatement in financial statements.

   **Noncompliance (with laws and regulations):** Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to prevailing laws or regulations. Such acts include transactions entered into, by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. *Noncompliance* does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

2. **Establish an understanding with the client, in writing:** The accountant must include language in his or her engagement letter that states that:

   a. Management acknowledges and understands its responsibility:

      1) for the selection of the financial reporting framework to be applied in the preparation of financial statements
2) for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error, and

3) for preventing and detecting fraud

**Note:** SSARS No. 21 states that with respect to either a preparation, compilation or review engagement, the accountant must document the understanding of the engagement in writing, which means that an engagement letter must be obtained. SSARS No. 21 now requires that the engagement letter be signed by both the client and the accountant, which is a new requirement and a change from previous SSARS No. 19.

b. Management acknowledges that the engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing or noncompliance with laws and regulations.

c. For review engagement only: Accountant agrees to inform the appropriate level of management about fraud, or noncompliance with laws and regulations unless clearly inconsequential.

Sample language found in AR-C 90, SSARS No. 21’s sample review engagement letter follows:

“However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our review procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.”

2. **Make an inquiry about fraud:** With respect to a review engagement, SSARS No. 21 provides the inquiries that an accountant must make regarding fraud.

Specifically, in a review engagement, SSARS No. 21 requires an accountant to make inquiries of management about fraud as follows:

**Whether management:**

a. Has knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others when the fraud or suspected fraud could have a material effect on the financial statements

b. Is aware of allegations of fraud or suspected fraud affecting the entity communicated by employees, former employees, regulators, or others, and

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20 SSARS No. 21 requires the accountant include additional language in the engagement letter that is not required for a compilation or preparation of financial statements engagement.
c. Has disclosed to the accountant all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements.

3. Include in a management representation letter a representation related to fraud:

Sample representations consist of the following:

“We acknowledge our responsibility and have fulfilled our responsibilities for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.”

“We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.”

“We have [no knowledge of any][disclosed to you all information that we are aware of regarding] fraud or suspected fraud that affects the entity and involves:

- management,
- employees who have significant roles in internal control, or
- others when the fraud could have a material effect on the financial statements.”

“We have [no knowledge of any][disclosed to you all information that we are aware of regarding] allegations of fraud, or suspected fraud, affecting the entity’s financial statements as a whole communicated by employees, former employees, analysts, regulators or others.”

4. Communicating to management and others regarding fraud or noncompliance with laws and regulations

SARS No. 21 requires that an accountant communicate fraud or noncompliance with laws and regulations found in a SSARS engagement using the following rules:

a. Fraud:

1) If the accountant becomes aware that fraud (including misappropriation of assets) may have occurred, the accountant should communicate the matter as soon as practicable to the appropriate level of management (at a level above those involved with the suspected fraud, if possible).

Note: SSARS No. 21 differentiates fraud from an error. Fraud is an intentional act while an error is nothing more than a mistake in the financial statements, including arithmetical or clerical mistakes as well as mistakes in the application of accounting principles, and inadequate disclosures. Implicit in the definition of an error is that it is done unintentionally.

b. Noncompliance with laws and regulations:
1) If the accountant becomes aware of matters involving identified or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements, the accountant should communicate the matters to management, other than when matters are clearly inconsequential.

**Note:** A duty to disclose to parties outside of the entity may exist in the following circumstances, for which the accountant may consider it appropriate to consult with legal counsel:

- To comply with certain legal and regulatory requirements
- To a successor accountant when management has given permission for communication between the predecessor accountant and the successor accountant
- In response to a subpoena

**Note:** The threshold for communicating fraud versus noncompliance with laws and regulations differs under SSARS No. 21. An accountant must communicate all fraud to management while communication of noncompliance with laws and regulations is made only if clearly inconsequential.

c. If the fraud or noncompliance with laws or regulations involves senior management or results in a material misstatement of the financial statements, the accountant should communicate the matter directly to those charged with governance.

d. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that:

1) the financial statements are not materially misstated due to fraud, or

2) the entity is in compliance with laws and regulations, and in the accountant’s professional judgment, the effect of the suspected noncompliance may be material to the financial statements,

the accountant should consider the need to obtain legal advice and take appropriate action, including potential withdrawal.

e. The accountant may consider whether withdrawal from the engagement is necessary when:

1) management or those charged with governance do not take the remedial action that the accountant considers necessary in the circumstances, or

2) matters regarding fraud or noncompliance with laws or regulations involve an owner of the business.

When deciding whether withdrawal from the engagement is necessary, the accountant may consider seeking legal advice.

5. Consider the reporting and disclosure impact of fraud or noncompliance with laws and regulations:
a. If, during the performance of a SSARS engagement, any evidence or information comes to the accountant’s attention regarding fraud or noncompliance with laws and regulations that may have occurred the accountant should:

1) Request that management consider the effect of the matter on the financial statements.

2) Consider the effect of the matter on his or her review report.

3) If the accountant believes the financial statements are materially misstated, do the following:
   - For a preparation engagement: Obtain additional or revised information.
   - For a compilation engagement: Obtain additional or revised information.
   - For a review engagement: Perform additional inquiry and analytical procedures necessary to achieve limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP.

**Protecting Against Fraud- Compilation and Review Engagement:**

Accounting firms are being sued for employee fraud and defalcation throughout the gamut of engagements. That’s right: audits, reviews, compilations and even write-up engagements. Most of the problems stem from the client’s lack of understanding as to what CPAs and auditors really do. The majority of clients and third parties still think auditors and CPAs are guarantors. The scope of a compilation or review engagement is considered on a parity with that of an audit. This fact has been documented in jury decisions against CPA firms in which juries have held CPA firms responsible at the level of an audit, even though a compilation engagement was performed. The complexity of accounting and auditing standards adds to this problem when juries and judges cannot understand the differences in scope among the different types of engagements.

As it relates to fraud, as previously noted in this section, an accountant is not responsible for considering fraud in a compilation or review engagement. In fact, management, not the accountant, is responsible for the prevention of fraud. However, SSARS No. 21 does require the accountant to inform management of any material errors, fraud, or noncompliance with laws and regulations that come to the accountant’s attention, regardless of whether a preparation, compilation or review engagement is performed.

An accountant is not required to report noncompliance with laws and regulations that is clearly inconsequential. Further, if the fraud or noncompliance with laws and regulations involves an owner of the business, the accountant should consider resigning from the engagement.

SSARS No. 21 requires that an accountant inquire as to whether any frauds have occurred. This does not mean that the accountant must search for fraud. It only means that if fraud is discovered, it should be communicated. Further, in litigation involving a jury, it is typically difficult to make a jury understand the different degrees of responsibilities in a preparation, compilation, review or audit engagement. Therefore, regardless of the engagement, the accountant should approach the engagement with professional skepticism.
CPAs must take certain precautions in any engagement to help mitigate the risk that a client will sue the accountant if a fraud or employee defalcation occurs and is not detected. These precautions can be taken across the board in preparation, compilation, review, audit and write-up engagements.

**Note:** Further on in this manual, the author discusses the latest results of a survey of prospective jurors.

**Recommendations to minimize exposure to fraud:**

The author has *three recommendations* that an accountant might consider in minimizing the accountant's exposure to fraud risk in compilation, review and write-up engagements.

**Recommendation 1: Make sure the engagement letter is up-to-date for internal control and fraud language**

Many clients still do not fully understand the difference between a compilation, review and audit engagement. Now, the preparation engagement adds another engagement layer to consider. Consequently, if there is an undetected fraud within a SSARS engagement, the client may blame the accountant for failing to communicate internal control weaknesses or detect the fraud, regardless of what the accountant’s actual responsibility is. One way to guard against such a situation is to ensure that the engagement letter is up-to-date with language that clarifies the accountant’s responsibility.

An effectively drafted engagement letter is usually one of the accountant’s best defenses against a client who sues. The accountant may find the engagement letter helpful to clarify and document the understanding regarding the accountant’s responsibility regarding fraud and internal control weaknesses.

Although AU-C Section 240 *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99) relates to audits, it is important that the accountant *update his or her engagement letters* for preparation, compilation and review engagements to incorporate reference to fraud and internal control.

Language that should be included in an engagement letter for preparation, compilation and review engagements is illustrated in SSARS No. 21. (Sample engagement letters are discussed further in this manual.)

Sample language in a preparation or compilation engagement letter follows:

```
We are not required to and will not verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion, nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.
```
Recommendation 2: Make sure the client is fully aware of his or her responsibility to prevent and detect fraud

An effective way to avoid misunderstandings is to educate the client as to the importance of internal control and the prevention of fraud. The accountant is then in a position to work with the client in a separate consulting engagement to improve the client’s internal control.

Review the client profile most susceptible to fraud:

- Small-business owners
- Doctors
- Owners who have weak internal controls and who fail to take even the simplest precautions

Recommendation 3: Send a standard internal control/fraud letter to all clients for all engagements

Many insurance companies strongly recommend that CPAs assist clients with ensuring that basic internal control and defalcation procedures are in place even though the accountant is performing a compilation or review engagement. By doing so, it is difficult for a client to later accuse the accounting firm of not informing the client about weaknesses in internal control that lead to fraud. Remember, even though a review or compilation engagement is being performed, CPAs can be held accountable for undetected fraud. One of the best ways to protect the firm (and the client) is to provide the client with a standard internal control/fraud letter. This letter is useful for small businesses where there tends to be minimal separation of duties and where the client can play an active role in internal control. Consider the following sample letter that can be customized to the client’s needs for preparation, compilation and review engagements.

Sample Internal Control/Fraud Letter to Clients
SSARS Engagement Clients

Dear Client:

Each year many business owners discover that their assets are not as well protected as they thought when they become victims to employee theft. This is particularly true in small-business environments where a single employee manages all the finances. Often there are no “checks and balances” to verify that transactions are accurate. Most employee thefts are perpetrated by highly trusted employees in key positions, involving substantial sums of money.

When proper, consistent procedures are not in place, employees can learn to manipulate the accounting system to their benefit. Whether they take money from the company or their mistakes are undiscovered, the end result can greatly impact your company’s management discussions, financial reports, and tax filings.

Unfortunately, once your financial records have been altered, discovering problems is extremely difficult. Most standard accounting practices are not designed to uncover internal problems such as embezzlement.

Depending on your CPA to protect against acts of one employee is a dependence that is false comfort. A review (compilation or preparation) engagement is not designed nor intended to uncover or search for defalcations. In conducting a review (compilation or preparation) engagement, the accountant does not gather evidence that may be necessary to uncover a defalcation. Also, the accountant concentrates on large transactions and major accounts that, if in error, could have a material effect on the company’s financial statements. For this...
reason, an employee who tampers with a number of small accounts over an extended period will usually escape detection.

Many people holding key financial positions may have gained an understanding of the review (compilation) process and its inherent limitations. Therefore, they are in a position to access the company’s assets by methods not subject to detection. The odds are that you will probably never experience a major defalcation. Yet, statistics are high that at least one of our clients will be victimized every few years.

Therefore, the best way to safeguard your company's assets is to recognize and improve weaknesses in your internal procedures. Defalcations are more likely to be discovered when there is an appropriate separation of duties between asset handling and recording functions. It is also critical that you exercise managerial oversight.

The following business practices can help you minimize potential internal control problems:

1. **Related duties should be assigned to different people:** Certain accounting functions are designed to cross-reference each other for accuracy, writing/signing checks, ordering, paying, receiving materials, handling cash/recording cash, etc. These procedures can reveal inconsistencies in your records in a timely manner.

2. **Reconcile and scrutinize your bank statements every month:** A bank statement can tell you a lot about your business if you review the information in a timely manner. Actions you should do on a monthly basis include the following:
   - Receive the unopened bank statement directly and open it up personally.
   - Scan the front and back of all canceled checks.
   - Question the purpose of all transfers.
   - Compare payroll checks with employee records, and ask questions.

3. **Signing checks:**
   - Never sign a check without inspecting original supporting documentation including the invoice, shipping documents and the purchase order.
   - Cancel all supporting documentation after signing a check.
   - Never sign a check that is not completely filled in.
   - Verify the names of your vendors.

4. **Protection of valuables:**
   - Keep blank checks and the signature stamp secure.
   - Deposit all cash and checks daily.
   - Get fidelity bond insurance for all accounting and key employees.
   - Backup all computer files on a regular basis and store the backup at a secure, remote location.
   - Periodically, change computer system passwords.

5. **Watch out for changes in employee behavior:**
   - Always verify employee references before hiring.
   - Be aware of substance abuse, changes in lifestyle, living beyond one’s means, possessiveness of work.

   These are some of the internal controls that can help you reveal many discrepancies. Our firm can help you develop and implement any of these important internal controls. If you have any questions, we would be happy to assist you any way we can.

Very truly yours,

James J. Fox & Company, CPA

The following checklist can be used in a client interview or can be mailed to a client as an accompaniment to the internal control/defalcation letter.
Client Internal Control/Defalcation Checklist

1. Segregation of Duties:
   - Is the person who handles cash also responsible for recording cash?
   - Does the person who pays or orders inventory also receive materials?
   - Are two or fewer people responsible for the accounting function?
   - Is only one person responsible for reviewing financial statements each month?
   - Is your review of financial journals sporadic?

2. Bank Reconciliations:
   - Do you reconcile the bank statement on a timely basis, at least once a month?
   - Do you review any adjustments and verify reconciling items?
   - Are reconciliations performed by one person and reviewed by another?
   - Is the person who writes checks restricted from signature authority?
   - Do you review canceled checks and endorsements on a monthly basis?
   - Do you compare payroll checks with your current employee records?
   - Do you question funds transferred between bank accounts?
   - Do you track the number of credit card bills you sign each month?

3. Supporting Documentation:
   - Do you ever sign blank checks?
   - Do you ever sign checks without original supporting documentation?
   - Have funds ever been transferred between accounts without review or verification?
   - Do you ever sign checks for new business vendors without knowing or verifying their name and association with your company?

4. Employees: [Know your employees and be aware of changes in their behavior.]
   - Are any employees extremely possessive of their work records and reluctant to share their tasks?
Are any employees apprehensive about taking a vacation and time off, and are also the first one in the office and the last one out?

Have you noticed a substantial change in the lifestyle of any employees?

Do any of your employees have a possible substance abuse problem?

Are any of your employees living beyond their means?

Have you ever hired an employee without checking references?

Do you permit accounting personnel to work longer than a year without taking a vacation?

Do you have any accounting staff who has not been bonded?

5. **Safeguard Assets:**

Are blank checks and signature stamps locked up?

Do you restrictively endorse all checks?

Do you deposit all cash and checks daily?

Do you maintain a list of office furniture, equipment, and vehicles?

Do you back up all computer files on a regular basis and store the backup in a remote location?

Do you have password restrictions for your systems?

Do you maintain adequate insurance coverage on all assets including business interruption insurance?

**Observation:** The above documents can be mailed to clients as a standard document for all SSARS engagements. However, the author believes that a mass mailing or email approach may not be the most effective and prudent way to use these documents and may result in some clients being confused and uncertain as to the accountant's ulterior motive of sending the document in the first place. Instead, the author recommends that the letter and checklist be reviewed and discussed with selected high-risk clients in the engagement exit meeting. You may find that the client looks at your fraud advice as sound, value-added information. You should also review this letter with your malpractice insurance company to ensure that they are in agreement with its use.

*How do the requirements for considering fraud differ in a preparation, compilation, review and audit engagement?*
The following comparison was published in the *Compilation and Review Alert*, as modified by the Author to reflect changes made by SSARS No. 21.

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Preparation</th>
<th>Compilation</th>
<th>Review</th>
<th>Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insert language in the engagement letter about fraud</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, including having a brainstorming session to consider ways in which fraud might be committed.</td>
</tr>
<tr>
<td>Required to gather information about fraud</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes, GAAS requires an auditor to obtain reasonable assurance as to whether the financial statements are free from material misstatement, by fraud Audit is not designed to detect immaterial fraud.</td>
</tr>
<tr>
<td>Identify fraud risks</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes, including having a brainstorming session to consider ways in which fraud might be committed.</td>
</tr>
<tr>
<td>Evaluate internal control including risks of material misstatement due to fraud</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes,</td>
</tr>
<tr>
<td>Respond to the assessment of fraud risk</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes,</td>
</tr>
<tr>
<td>Communicate information about fraud</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes,</td>
</tr>
<tr>
<td>Document the consideration about fraud</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes,</td>
</tr>
<tr>
<td>Further research when information is incomplete or inaccurate</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes,</td>
</tr>
<tr>
<td>Perform additional services related to management’s override of internal control</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes,</td>
</tr>
</tbody>
</table>

Source: *Compilation and Review Alert*- AICPA, as modified by Author

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21 SSARS No. 19 required that the engagement letter include language stating that an accountant would report fraud to the appropriate level of management. SSARS No. 21 removes that language from the standard engagement for compilation engagements and did not include it in the preparation engagement letter. However, SSARS No. 21 did retain the language in the review engagement letter.
D. Analytical Procedures in a Review Engagement

In conducting a review engagement, the accountant performs procedures consisting of inquiries of company personnel and analytical procedures applied to financial statement data. Generally, the accountant does not gather evidence as he or she does in an audit.

Analytical procedures include evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that plausible relationships among data exist. Analytical procedures may help identify potential material misstatements. The results of such procedures should be used as a basis for making additional inquiries and obtaining additional information. Using analytical procedures includes not only calculating ratios and trends, but also analyzing the results and identifying significant fluctuations and their cause.

The rules for applying analytical procedures are found in SSARS No. 21 and include the following:

a. Compare financial statements from year to year, for comparable periods

b. Compare financial statements with budgeted/forecasted information for comparable periods, and

c. Study relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on an entity’s experience and the industry.

Note further that Paragraph 19 of AR-C 90 (SSARS No. 21) emphasizes that the accountant should develop expectations prior to performing analytical procedures.

There are three (3) types of analytical procedures:

1. Trend analysis: Studying the change in accounts over time.

2. Reasonableness tests: Estimating a financial statement amount or the change in an amount from the prior year and comparing it to the existing financial statement amount.

3. Ratio analysis: Studying the relationship between two financial statement amounts.

When analytical procedures identify significant fluctuations and lead the accountant to believe that information may be incorrect, incomplete or otherwise unsatisfactory, SSARS No. 21 requires the accountant to perform the additional procedures he or she deems necessary to achieve limited assurance that no material modifications should be made to the financial statements.

In applying analytical procedures in a review engagement, the accountant may achieve both effectiveness and efficiency by using the following decision approach:
<table>
<thead>
<tr>
<th>Types of account balances</th>
<th>Procedures to Apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Immaterial account balances</td>
<td>Apply no analytical procedures if the risk of understatement is low</td>
</tr>
<tr>
<td>2. Material account balances</td>
<td>Apply analytical procedures and inquiries</td>
</tr>
<tr>
<td>a. Significant other accounting procedures have already been applied</td>
<td>Consider whether the existing evidence is adequate and whether any material errors are likely to occur. Analytical procedures are usually not needed</td>
</tr>
</tbody>
</table>
| b. Significant other procedures have not been applied | Analytical procedures should be applied:  
   - Develop expectations using historical trends  
   - Compare the actual balance to the expected balance. If the result is close, no additional procedures are applied  
   - If the result is a large difference, material errors could exist. Inquiry about valid business reasons for the difference should be made  
   - Other analytical procedures should be applied if needed |

Are analytical procedures required for a compilation engagement?

CPAs are concerned that if analytical procedures are performed in a compilation engagement, the engagement will be upgraded to a review engagement. This thinking, of course, is not true. Paragraph 1 of AR-C 90 (SSARS No. 21) states that an accountant must comply with the provisions for a review engagement if he or she has been engaged to perform a review engagement on the financial statements.

Therefore, an accountant only performs a review engagement and issues a review report if he or she has been engaged (hired) to conduct a review engagement.

The fact that review-type procedures (such as inquiry and analytical procedures) have been performed during a compilation engagement does not, in itself, upgrade the engagement from a compilation to a review. Again, a review engagement is performed only if an accountant is hired (engaged) to perform a review engagement.

No procedures performed by an accountant in a compilation engagement would elevate that compilation to a review engagement.
Paragraph A13 of SSARS No. 21 (AR-C 80) states that in a compilation engagement:

“An accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have performed such inquiries or procedures and the results of those inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that information provided by management is incorrect, incomplete, or otherwise unsatisfactory.”

The author believes that selected analytical procedures should be performed in a compilation engagement even though not specifically required in SSARS No. 21. The reason is that Paragraph A13 of SSARS No. 21 (AR-C 80) states that an accountant who performs a compilation is still responsible for researching “incorrect, incomplete or otherwise unsatisfactory” information received by the client.

**Example:** A gross profit percentage changes from year to year by 12%. The accountant would be required to research that difference. The only way that the accountant would know about this difference is to actually calculate a gross profit percentage even if performing a compilation engagement.

At the conclusion of a compilation engagement, the author suggests that the accountant calculate a few key ratios such as a gross profit percentage, number of days in receivables, and number of days in accounts payable. Because the results of these ratios are not required to be part of the compilation work program, the accountant could quickly review these ratios and, if consistent, dispose of them.

**What if the accountant who is performing a compilation engagement discovers information that suggests that the financial statements could be materially misstated?**

If the accountant believes that there may be a material misstatement of the financial statements, he or she is required to perform additional procedures to research the incorrect or incomplete information. If the client will not provide the requested information, the accountant should withdraw from the engagement.

Additionally, SSARS No. 21 carries over a requirement from SSARS No. 19 for CPAs who perform compilation engagements.

Paragraph 2.98 of the AICPA Guide states that minimum documentation requirements in a compilation engagement may include any findings or issues that, in the accountant’s judgment, are significant. This additional documentation would include, for example, the results of compilation procedures that indicate:

- That the financial statements could be materially misstated
- Actions taken to address such findings, and
- The extent to which the accountant had any questions or concerns as a result of the procedures, and how those issues were resolved.
E. Using Staff in a Compilation or Review Engagement

**Question:** Is an accountant permitted to delegate the performance of a compilation or review engagement to a staff person or paraprofessional?

**Response:** SAS No. 122, AU-C Section 300, *Planning an Audit* (previously SAS No. 108, *Planning and Supervision*), provides guidance on using and supervising staff in conducting an audit. However, similar guidance is not available for compilation and review engagements. The SSARSs are silent as to what guidance an accountant should follow in planning and supervising his or her compilation or review engagement including whether a staff person or paraprofessional is permitted to work on such an engagement. Although not codified in the SSARSs, it is assumed that an accountant may, but is not required to, follow the AU-C 300 guidance or other guidance (e.g., textbooks, articles, etc.) on planning and supervision for a compilation and review engagement.

The general answer is that:

- An accountant may delegate the performance of compilation and review engagements to staff persons and paraprofessionals, as long as the person(s) are qualified to perform the work.

- Delegating responsibility to a staff person or paraprofessional does not reduce the responsibility that the owners, partners or shareholders of the firm have in connection with the engagement.

**Observation:** Prior to the issuance of SSARS No. 21, Interpretation No. 5 of SSARS No. 1, *Planning and Supervision*, permitted, but did not require, an accountant to follow auditing standards in planning and supervising a compilation or review engagement. Interpretation No. 5 was withdrawn in December 2010. Therefore, current compilation and review standards are silent on whether an accountant is permitted to follow auditing standards (AU-C 300) for planning and supervising the compilation or review engagement. Clearly, an accountant is not required to follow AU-C 300 in connection with a compilation or review engagement.

F. Titles on Compilation and Review Reports- SSARS No. 21

**Question:** What are the titles that can be used for a compilation or review report?

**Response:** SSARS No. 21 carried over the requirement initiated in SSARS No. 19 that an accountant’s review report have a title. However, SSARS No. 21 removed the requirement that a compilation report have a title although there is nothing that precludes an accountant from adding a title to his or her compilation report.

Thus, after SSARS No. 21, the rules for report titles follow:

- Compilation report- no title is required
- Review report- title required
- Audit report- title required

Paragraph 17 of SSARS No. 21 (AR-C 80) provides the elements that must be included in an accountant’s compilation report. No requirement exists for a compilation report title.
Although not required, there is nothing in SSARS No. 21 that prevents an accountant from adding a title to a compilation report, similar to the title that was required under SSARS No. 19.

If an accountant chooses to include a report title, the author suggests one of the following:

“Accountant’s Compilation Report” or
“Independent Accountant’s Compilation Report”

The author does not recommend that a title such as “Accountant’s Report” be used because it does not reflect the type of engagement that is being performed.

For a review report, Paragraph 39 of SSARS No. 21 (AR-C 90) requires that a review report be:

“a title that includes the word independent to clearly indicate that it is the report of an independent accountant.”

SSARS No. 21 states that an appropriate title for a review report is:

“Independent Accountant’s Review Report”

Would using the title “Accountant’s Review Report” be appropriate?

Apparently not. SSARS No. 21 clearly states that the word “independent” should be included in the title of the review report. Conversely, if an accountant chooses to include a title in his or her compilation report, that title can be essentially any title and could include or exclude the word “independent.”

G. Legends on Compiled or Reviewed Financial Statements

Facts: Previously issued SSARS No. 19 required that each page of compiled (or reviewed) financial statements bear the legend such as:

**Compilation:**
“See Accountant’s Compilation Report” or
“See Independent Accountant’s Compilation Report”

**Review:**
“See Independent Accountant’s Review Report”

SSARS No. 21 makes a dramatic change to SSARS No. 19 by removing the requirement to include a legend on each page of the compiled or reviewed financial statements and related notes.

**Question 1:** Is an accountant permitted to include a legend on each page of compiled or reviewed financial statements?

**Response:** Although SSARS No. 21 eliminates the requirement to include a legend on each page of the financial statements of compiled or reviewed financial statements, an accountant may choose to retain those legends.
Nothing precludes an accountant from including on each page of the compiled or reviewed financial statements a legend such as:

“See Accountant’s Compilation Report” or

“See Independent Accountant’s Review Report”

If the accountant does, in fact, choose to include such a legend, the author suggests that the legend be included on not only each page of the financial statements, but also each page of the notes.

Placing the legend on the note pages may not be warranted if each page of the financial statements (balance sheet, income statement, cash flows statement and changes in equity) contains a legend “See Notes to Financial Statements which are an integral part of these statements” or similar language.

**Question 2:** If, in a compilation or review engagement, the accountant does include a legend “See Accountant’s Compilation Report” or “See Independent Accountant’s Compilation (Review) Report” on the financial statement pages, would it be prudent to also include it on the pages that contain supplementary information?

**Response:** Yes. The definition of a financial statement excludes supplementary information. Yet, SSARS No. 21 states that if supplementary information is presented with financial statements, the accountant should clearly indicate the degree of responsibility he or she is taking for the supplementary information. That is, an accountant is required to report on supplementary information either in a separate paragraph to his or her compilation or review, or in a separate report on the supplementary information.

If the accountant reports on the supplementary information in a separate paragraph within the compilation or review report, the author suggests that a legend such as, “See Accountant’s Compilation Report” or “See Independent Accountant’s Review Report” be placed on each page of the supplementary information.

**Question 3:** Same facts as Question 2 except that reporting on supplementary information is not included in the compilation (review) report and, instead, is provided in a separate report referred to as Accountant’s Report on Supplementary Information.

**Response:** In this situation, making reference to “See Accountant’s Compilation Report” or “See Independent Accountant’s Compilation (Review) Report” would be useless because the compilation report makes no reference to the supplementary information. Instead, a more meaningful legend to place on the pages of supplementary information may be “See Accountant’s Report on Supplementary Information.”

**Question 4:** How should the legend be worded in the event of either of the following scenarios?

a. Current period financial statements are reviewed and supplementary information is compiled.

b. Current period financial statements have been reviewed while previous year's statements were compiled.
c. Current period financial statements have been reviewed while previous year's statements were audited.

**Response:** In any of the situations in (a) through (c.) above, if the accountant chooses to include an optional legend on each page, the most appropriate legend is "See Accountant's Report" or "See Independent Accountant's Report."

**Question 5:** Is it appropriate to use a more generic legend for all compilation and review engagements such as "See Accountant's Report?"

**Response:** Because the inclusion of a legend on each page is no longer required by SSARS No. 21, the accountant has tremendous latitude in selecting language for a legend if he or she seeks to include an optional legend on each page of the financial statements.

Nevertheless, the author suggests that an accountant avoid use of generic language such as “See Accountant’s Report” where the legend does not identify the type of service performed.

Instead, if a legend is included, the author believes that the accountant ensure language is used such as "See Accountant’s Compilation Report," "See Independent Accountant’s Compilation Report," or "See Independent Accountant’s Review Report." In each instance, the reader specifically knows the type of engagement being performed without reading the report itself. If, instead, the generic term "See Accountant’s Report" is used, there is a question as to what type of engagement was performed. If the report is detached from the financial statements, the reader may not be aware of the accountant's degree of responsibility in connection with the financial statements.

**Observation:** The author's discussion of the generic legend issue is influenced by a court decision against a CPA firm in a compilation engagement. In this case, the accounting firm issued a compilation report with no notes or cash flow statement and forgot to include the "See Accountant’s Compilation Report" legend in the financial statement pages. Subsequently, the client received the statements, intentionally removed the compilation report from the package and sent the financial statements (absent the report) to a third party. The third party was damaged and sued the accounting firm claiming that the "audited" financial statements had deficiencies. The accounting firm claimed that it had issued compiled financial statements and ultimately lost the case because it had failed to include the appropriate legend on the financial statements. The author believes the same type of risk of misunderstanding could exist in cases where the generic legend "See Accountant’s Report" is used and a third party claims that the "report" was an audit report rather than a compilation or review.

**Question 6:** If an accountant does choose to include a legend on each page of the compiled or reviewed financial statements, should the word “independent” be included in the legend?

**Response:** Previously issued SSARS No. 19 required the use of the word “independent” in the review legend, while not required in a compilation legend.

**Compilation:**

*See Accountant’s Compilation Report,* or

*See Independent Accountant’s Compilation Report*

**Review:**

*See Independent Accountant’s Review Report*
The author believes is what is most important in a legend is that the language include the type of engagement performed (e.g., compilation or review engagement). Thus, use of the word “independent” can be included in the legend although it is not necessary.

H. Going Concern: Compilation and Review Engagements

Questions continue to exist regarding the accountant’s responsibility for going concern in a compilation or review engagement.

Background:

Currently, several parties must consider going concern with respect to a company:

- GAAP, in ASU 2014-15, requires management to perform a self-assessment as to whether there is “substantial doubt” of an entity’s ability to continue as a going concern for a reasonable period of time.
- AU-C 570, requires an auditor to consider whether there is “substantial doubt” of an entity’s ability to continue as a going concern for a reasonable period of time.
- SSARS No. 21 requires an accountant to consider whether there is an “uncertainty” ability an entity’s ability to continue as a going concern for a reasonable period of time.

Therefore, several parties may be required to perform their own independent assessments of the same entity’s ability to continue as a going concern for a “reasonable period of time.” For example, an auditor may be required to perform a going concern assessment of an entity at the time that management must perform a going concern assessment on that same entity. Similarly, an accountant who is performing a review may have to consider whether there is uncertainty of an entity’s going concern while management performs the same assessment. Yet, there is nothing to suggest that the accountant or audit is required to compare notes with management in terms of performing the independent assessments although one would expect there would be communication between the parties. Moreover, there is no guarantee that the parties would reach the same independent conclusions as to whether there is substantial doubt (or an uncertainty) about going concern. Bias certainly comes into play. For example, can management really reach an objective conclusion about going concern and its own company’s viability for a reasonable period of time?

Going concern for the GAAP framework- ASU 2014-15:

With respect to GAAP, in August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.

ASU 2014-15 does the following:

- It requires management to perform a self-assessment of an entity's going concern.
• It uses a one-year assessment window that begins on the date on which the financial statements are available to be issued (non-public entities) or issued (for SEC entities).

• It requires management to perform its going concern assessment using a “substantial doubt” threshold.

The date the financial statements are available to be issued is the same as the report date.

**Example:** Sally Fields is reviewing the financial statements for Company X for December 31, 2015 year end. Sally's review report is dated March 25, 2016.

**Conclusion:** For purposes of evaluating going concern, Sally has to consider X's ability to continue as a going concern for the period March 25, 2016 through March 25, 2017, which is one year from the date the financial statements are available to be issued (which, in this case, is the report date.)

**What about going concern as it relates to a compilation or review engagement?**

In both a compilation and review engagement, the accountant may have some responsibility with respect to whether an entity has an uncertainty as to its ability to continue as a going concern.

In a compilation or review engagement, the term “uncertainty” is used instead of the term “substantial doubt.”

**Going concern in a compilation engagement:**

With respect to a compilation engagement, Paragraph A15 of AR-C 80 states that:

> “If the accountant becomes aware that uncertainties exist regarding the entity’s ability to continue as a going concern, the accountant may suggest additional disclosures concerning the entity’s ability to continue as a going concern in order to avoid the financial statements being misleading.”

In a compilation engagement, the accountant is not required to search for going concern. However, if the accountant does become aware that there could be an uncertainty as to whether the entity can continue as a going concern for a reasonable period of time, the accountant should do the following:

1. Request that management include a disclosure about the uncertainty, and

2. Consider including in the compilation report an emphasis-of-matter paragraph

Following is a sample of a compilation report from Illustration 15 of the AICPA Guide:
Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholder’s equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

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

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

Going concern in a review engagement:

In connection with a review engagement, Paragraph 65 of AR-C 90 states:

“\[The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant’s attention indicating that there could be an uncertainty about an entity’s ability to continue as going concern for a reasonable period of time.\]”

1. A **reasonable period of time** is defined as:

   "the same period of time required of management to assess going concern when specified by the applicable financial reporting framework."

a. For a GAAP framework, the reasonable period of time is **one year from the date the financial statements are available to be issued** (one year from the review report date).

   **Note:** Under SSARS No. 21, for a compilation or review engagement on GAAP financial statements, the accountant should consider whether an uncertainty exists using the same one-year window that GAAP uses under ASU 2014-15.

   That window for a nonpublic entity is **one-year from the date the financial statements are available to be issued**.

b. For a non-GAAP framework (such as tax basis), if that non-GAAP framework **does not specify** a period of time for management’s assessment, a reasonable period of time is **one year from the date of the financial statements being reviewed** (which is one year from the balance sheet date).
2. If, after considering the evidence or information, the accountant believes that there is an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, the accountant should:

a. Request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for related disclosure, and

b. Consider whether an emphasis-of-matter paragraph should be included in the review report.

c. Some of the information that might be disclosed includes:

- Principal conditions and events giving rise to the assessment
- The possible effects of such conditions and events
- Management’s evaluation of the significance of the conditions and events
- Possible discontinuance of operations
- Management’s plan
- Information about the recoverability or classification of recorded asset and liability amounts.

**Note:** After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions, including the adequacy of the related disclosure.

**Note:** If the accountant determines that the entity’s disclosures with respect to the entity’s ability to continue as a going concern for a reasonable period of time are inadequate, a departure from the applicable financial reporting framework exists and the accountant should follow the guidance for known departures from the applicable financial reporting framework.

Following is a sample paragraph that an accountant might include in the review report to address an uncertainty about going concern:

**Emphasis of Matter**
The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises an uncertainty about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our conclusion is not modified with respect to this matter.

**Is an accountant required to include an emphasis-of-matter paragraph in a compilation or review report?**

No. SSARS No. 21 states that the accountant should consider whether an emphasis-of-matter paragraph should be included in the compilation or review report.
Going concern assessment period for audits:

SAS No. 122, AU-C Section 570, The Auditor’s Consideration of an Entity's Ability to Continue as a Going Concern (Redrafted) (formerly SAS No. 59), provides guidance on evaluating the adequacy of going-concern disclosure in audited financial statements. AU-C 570 is the only authoritative literature for going concern disclosure found in auditing standards. Continuation of an entity as a going concern is assumed in financial reporting in the absence of information to the contrary.

In an audit engagement, if there is substantial doubt of an entity's ability to continue as a going-concern for a reasonable period of time (generally one year from the balance sheet date), the accountant must seek factors that mitigate this fact such as alternative sources of financing, management's plan of action, etc.

If, after seeking mitigating factors, the auditor still believes there is substantial doubt, AU-C 570 requires a disclosure and an audit report modification as follows:

Separate paragraph in the audit report:

As discussed in Note A, the Company has suffered continued losses from operations and, at December 31, 20X1, has a deficiency in stockholders' equity. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management has a plan of action that is described in Note A. The financial statements do not reflect any adjustments that might result from the outcome of this uncertainty.

Fixing the “reasonable period of time” problem

For years, auditing standards required an auditor to assess going concern for a reasonable period of time which was generally considered to be one year from the balance sheet date.

Yet, both ASU 2014-15 and SSARS No. 21 define a “reasonable period of time” as one year from the date on which the financial statements were “available to be issued” which was one year from the report date.

That inconsistency meant that auditors would be assessing going concern for a different one-year period than management in GAAP and accountants performing compilation and review engagements.

In response to the differences in the one-year assessment period found in GAAP (ASU 2014-15) versus the period required by auditors in AU-C 570, in January 2015, the Auditing Standards Board (ASB) issued an interpretation, AU-C Section 9570, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern: Auditing Interpretations of AU-C Section 570.

a. The auditing interpretation addresses conflicting issues related to GAAP's ASU 2014-15, Presentation of Financial Statements-Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, and the going-concern rules found in AU-C 570.

b. The purpose of the interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelate with the GAAP rules found in ASU 2014-15.
c. The auditing interpretation brings the auditing rules for dealing with going concern in parity with the new GAAP rules found in ASU 2014-15.

The auditing interpretation states the following:

1. When an applicable financial reporting framework (such as GAAP) includes a definition of *substantial doubt* about an entity’s ability to continue as a going concern, that definition should be used by the auditor when applying his or her going-concern assessment.

   For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the definition of substantial doubt about an entity’s ability to continue as a going concern found in GAAP would be used by the auditor.

2. When the applicable financial reporting framework (such as GAAP) requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time *greater than one year* from the date of balance sheet, the auditor’s assessment of management’s going concern evaluation should be for the *same period of time as required by the applicable financial reporting framework* (such as GAAP).

   For example, if an entity is required to comply with ASU 2014-15, the auditor’s assessment of management’s going concern evaluation should be for the *same period of time as required by ASU 2014-15* (that is, *one year after the date that the financial statements are issued or available to be issued*).

What the auditing interpretation does is put the auditor’s assessment of going concern on parity with the GAAP rules in terms of the definition of “substantial doubt” and the one-year assessment period.

Thus, the one-year assessment period is now the same for GAAP, compilation and review engagements and audit engagements, which is for a non-public entity:

*one-year from the date the financial statements are available to be issued*

**What is the going-concern period if an entity issues tax-basis financial statements?**

An accountant performing a compilation or review engagement has an interesting issue to address when he or she has a going concern assessment required for a client and the financial statements are issued using a special purpose framework, such as tax basis.

SSARS No. 21 states that an accountant should assess going concern in a compilation or review engagement for a reasonable period of time which is defined as:

"*a period the same period of time required of management to assess going concern when specified by the applicable financial reporting framework.*"

For GAAP, that period is ASU 2014-15's one-year window which is one year from the date the financial statements are available to be issued for nonpublic entities.

SSARS No. 21 states that:
If the applicable financial reporting framework does not specify a period of time for management, a reasonable period of time is one year from the date of the financial statements being reviewed (e.g., one year from the balance sheet date).

For tax-basis financial statements, there is no authoritative period of time specified for management to perform its assessment of going concern. Therefore in a tax-basis engagement, an accountant (in a compilation or review engagement) or an auditor in an audit engagement performs his or her assessment of going concern using a one-year period from the balance sheet date.

Oddly enough, the accountant or auditor’s assessment period for tax-basis financial statements begins at the balance sheet date, while for GAAP financial statements, the one-year period begins on the date the financial statements are available to be issued (generally the report date).

**Example:** Company X has severe cash flow problems.

Arnold is a CPA for X and is asked to perform either a review or audit on X’s December 31, 2015 year-end financial statements. The client is not sure if it wants GAAP or tax-basis financial statements.

**Conclusion:** If GAAP financial statements are issued, the going concern assessment period for management’s assessment is one year from the date on which the financial statements are available to be issued (or issued for an SEC company). That available to be issued date should be the same date as the report date.

Under SSARS No. 21 and the auditing interpretation, the accountant’s or auditor’s going concern assessment period would follow the same assessment period used by management to assess going concern under GAAP. That period is one year from the available to be issued date.

In this case, because the available to be issued date is March 31, 2016, the one-year assessment period is March 31, 2016 to March 31, 2017.

**Changes the facts:** Assume the same facts as the previous example except that tax-basis financial statements are being issued.

**Conclusion:** If non-GAAP financial statements are issued and the non-GAAP framework (tax basis in this case) has no authoritative period of time for management to perform its going concern assessment, the accountant’s or auditor’s assessment period is one year from the balance sheet date, and not one year from the available to be issued date. In this case, the assessment period would be December 31, 2015 to December 31, 2016.

The following chart compares the going concern assessment period for a GAAP versus tax-basis financial statements:
### Accountant’s or Auditor’s Going Concern Assessment Period

**GAAP vs. Tax-Basis Financial Statements**

<table>
<thead>
<tr>
<th>BS date</th>
<th>Available to issue date</th>
<th>Available to issue date</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2015</td>
<td>March 31, 2016</td>
<td>March 31, 2017</td>
</tr>
</tbody>
</table>

**GAAP:**

- Comp/Review assessment
- Audit assessment

**Tax Basis:**

- Comp/Review assessment
- Audit assessment

### Going concern considerations:

SSARS No. 21 provides guidance related to an entity’s ability to continue as a going concern. Many of the considerations found in the following exhibit mirror those found in auditing literature in AU-C 570 (formerly SAS No. 59).

### Going Concern Considerations

**Conditions or events that may indicate an uncertainty about going concern**

<table>
<thead>
<tr>
<th>Condition</th>
<th>Examples of conditions</th>
</tr>
</thead>
</table>
| Negative trends | • Recurring operating losses and working capital deficiencies  
| | • Negative cash flows  
| | • Adverse key financial ratios such as the Altman Z Score |
| Indications of possible financial difficulties | • Default on loan or similar agreements  
| | • Arrearage in dividends  
| | • Denial of usual trade credit  
| | • Restructuring of debt  
| | • Noncompliance with statutory capital requirements  
| | • Need to seek new sources or methods of financing  
| | • Disposal of substantial assets  
| | • Unusually liberal credit terms to customers including dating of receivables  
| | • Maximizing a working capital line of credit |
Internal matters

- Work stoppages or other labor difficulties
- Substantial dependence on the success of a particular project
- Uneconomic long-term commitments
- Need to significantly revise operations

External matters that have occurred

- Legal proceedings, legislation, or similar matters that might jeopardize an entity’s ability to operate
- Loss of key franchise, license, or patent
- Loss of key customer or supplier
- Uninsured or underinsured catastrophe such as a drought, earthquake, or flood

Altman Z score:
The Altman Z Score has become generally accepted as a ratio that is highly correlated with bankruptcy. It is used to evaluate companies within most traditional industries such as retailers, wholesalers and manufacturers. For others, such as real estate developers, and certain highly leveraged industries, the score may be distorted.

ALTMAN Z SCORE: Consists of a weighted average of four separate ratios:

Ratio 1: **Working Capital**
\[
\text{Working Capital} = \frac{\text{Total assets}}{\text{Retained earnings}}
\]

Ratio 2: **Retained earnings**
\[
\text{Retained earnings} = \frac{\text{Total assets}}{\text{Net earnings before interest and income taxes}}
\]

Ratio 3: **Net earnings before interest and income taxes**
\[
\text{Net earnings before interest and income taxes} = \frac{\text{Total assets}}{\text{Net worth}}
\]

Ratio 4: **Net worth**
\[
\text{Net worth} = \frac{\text{Total debt}}{\text{Total assets}}
\]

All four ratios are weighted to compute an overall Z score as follows:

\[
6.56 \text{ (ratio 1)} + 3.26 \text{ (ratio 2)} + 6.72 \text{ (ratio 3)} + 1.05 \text{ (ratio 4)} = Z \text{ score}
\]

Results:
1.00 or less: Headed toward bankruptcy
1.01 to 2.50: Could have problems
2.51 or greater: Strong, unlikely risk of bankruptcy

Observation: In most engagements involving strong, solvent companies, the Altman Z score usually is in the 5.00 to 9.00 range. Several accounting software packages include the Altman Z score as part of the analytical procedures (ratios). The author recommends that practitioners compute the Altman Z Score for all engagements.
Once an accountant has identified conditions and events that may indicate that there is an uncertainty as to an entity’s ability to continue as a going concern, the accountant should request that management consider the possible effects of the going concern uncertainty on the financial statements, and to provide management’s plans to deal with the conditions and events.

Management’s plans can be categorized as:

- Plans to dispose of assets
- Plans to borrow money or restructure debt
- Plans to reduce or delay expenditures
- Plans to increase ownership equity

The following chart presents examples of actions that management might take as part of its plan to deal with the conditions and events identified by the accountant:

<table>
<thead>
<tr>
<th>Management’s plan</th>
<th>Examples of the plan</th>
</tr>
</thead>
</table>
| Plans to dispose of assets                     | • Restrictions on disposal of assets, such as covenants limiting such transactions in loan agreements  
                                                | • Apparent marketability of assets that management plans to sell                        
                                                | • Direct or indirect effects of disposal of assets                                    |
| Plans to borrow money or restructure debt      | • Availability of debt financing                                                     
                                                | • Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity |
                                                | • Possible effects on management’s borrowing plans of existing restrictions on additional borrowings |
| Plans to reduce or delay expenditures          | • Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or R&D projects, or to lease rather than purchase assets |
| Plans to increase ownership equity             | • Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital |
                                                | • Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors |

After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions (and management’s plans) including the adequacy of the related disclosures, if applicable.

**What if a disclosure of an uncertainty is required?**

Disclosure requirements with respect to uncertainties are included in ASC 275, *Risks and Uncertainties* (formerly SOP 94-6), ASC 450, *Contingencies* (formerly FASB No. 5), and other authoritative accounting literature.
In accordance with SSARS No. 21, the accountant should disclose an uncertainty about an entity's ability to continue as a going concern, whether a compilation or review engagement is performed.

SSARS No. 21 provides that when management concludes there is uncertainty about an entity’s ability to continue as a going concern for a reasonable period of time (not more than one year from the available for issuance date), management should consider the following disclosures as to the uncertainty:

1. Principal conditions and events giving rise to the assessment of the uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time (not more than one year from the available for issuance date).
2. The possible effects of such conditions and events
3. Management’s evaluation of the significance of those conditions and events and any mitigating factors
4. Possible discontinuance of operations
5. Management’s plan, including relevant prospective financial information, and
6. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

When management concludes that there is uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time is alleviated, the entity should consider the need for disclosure of the principal conditions and events that initially caused it to believe there was an uncertainty, including the possible effects of such conditions and events, and any mitigating factors, including management’s plans.

Question: If there is an uncertainty about an entity’s ability to continue as a going concern and a disclosure is made, what report modification must be made for a compilation or review engagement?

Response: No report modification is required for a compilation or review engagement when there is an uncertainty as to going concern. An accountant may choose to include an emphasis-of-matter paragraph in either the compilation or review report, although such a paragraph is not required. In fact, Paragraph A114 of AR-C 90 states:

“the accountant is not required to include an emphasis-of-matter paragraph with respect to a going concern uncertainty.”

Question: Are there any limitations as to what information an accountant can include in an emphasis-of-matter paragraph to address an uncertainty of going concern?

Response: There are limitations in using an “emphasis-of-matter” paragraph in a compilation or review report.

Following are some guidelines for use of an emphasis-of-matter paragraph, as noted by SSARS No. 21 and modified by the author:

1. The paragraph should not introduce new information to the reader.
2. The paragraph should only highlight or emphasize a matter already disclosed in the financial statements.

3. The paragraph should not address a matter beyond what is presented or disclosed in the financial statements. To do so, may raise questions about the appropriateness of such presentation or disclosure.

4. An emphasis-of-matter paragraph differs from a GAAP violation paragraph.

   Example: If an accountant believes that certain information is not properly disclosed, he or she is required to state, in a separate paragraph of the report, a GAAP departure. The GAAP departure paragraph differs from an emphasis-of-matter paragraph because its purpose is to make the reader aware of a financial statement deficiency. The purpose of an emphasis-of-matter paragraph is to point out additional information that is already disclosed in the financial statements.

5. An emphasis-of-matter paragraph should not contain information about procedures the accountant has or has not performed or conclusions or opinions concerning the entity’s status as a going concern.

6. An emphasis-of-matter should not use the term “substantial doubt” which is an auditing term and not appropriate for a compilation or review engagement that does not gather audit evidence.

Question: What if the note disclosure of the uncertainty of going concern is not adequate?

Response: If the accountant determines that the disclosure of the uncertainty regarding the entity's ability to continue as a going concern is not adequate, he or she should follow the guidance in SSARS No. 21 with respect to departures from generally accepted accounting principles. That guidance would generally require that a GAAP departure, due to an inadequate disclosure, be included in the report.

Question: What if there is an uncertainty and an accountant issues a compilation report on financial statements that omits substantially all disclosures required by GAAP?

Response: Paragraph A16 of AR-C 80 states that:

“Disclosure of items, such as an uncertainty, is not required in financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted.”

Consequently, there is no requirement to disclose the uncertainty in the accountant’s report in this situation. Because notes are not presented, the reader may not become aware of the going concern problem.

SSARS No. 21 is quite clear that an emphasis-of-matter paragraph in a compilation report should not be used in lieu of management disclosures.

Paragraph A95 of AR-C 90 states;
Therefore, the accountant should not include an emphasis-of-matter paragraph in a compilation report on financial statements that omit substantially all disclosures unless that matter is also disclosed in the financial statements.

Thus, if no footnotes are provided, emphasizing an uncertainty in a compilation report would not be appropriate.

**Observation:** Although there is no requirement to disclose the uncertainty in the compilation report where there are no notes, an accountant should be extremely careful in this situation. Given the litigious environment, an accountant could conceivably be held liable if the user is not informed of the going concern problem. An injured third party could argue that the omission of the disclosures was intentional to disguise the going concern problem. Yet, SSARS No. 21 precludes an accountant from including an emphasis-of-matter paragraph in the report if the uncertainty is not otherwise disclosed in the notes. The author believes that where there is uncertainty of going concern in a compilation engagement, the accountant should issue a compilation report with notes and disclosure of the uncertainty in both the footnotes and in an emphasis-of-matter paragraph in the compilation report.

**Question:** Is an emphasis-of-matter paragraph in a compilation report allowed for an uncertainty of going concern, if the entity includes selected disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled “Selected Information—Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example, “Accepted Accounting Principles Generally accepted in the United States of America”) ] Are Not Included?”

**Response:** Including an emphasis-of-matter paragraph in a compilation report for an uncertainty of going concern would be permitted as long one of the selected disclosures included disclosure of the uncertainty of going concern.

**Question:** Is an accountant permitted to include an “other-matter” paragraph in a compilation or review report to disclose an uncertainty of going concern?

**Response:** SSARS No. 21 makes reference to the option to include an “emphasis-of-matter” paragraph with a corresponding disclosure in the notes. The SSARS does not provide any guidance for including an other-matter paragraph. In reality, the only situation in which using an other-matter paragraph in lieu of an emphasis-of-matter paragraph would be if an accountant issues a compilation report and substantially all disclosures are omitted. An other-matter paragraph does not require a corresponding disclosure in the notes so that one would argue it could be included in a compilation report when substantially all disclosures are omitted. However, SSARS No. 21 does not offer any opportunity for using an other-matter paragraph to identify an uncertainty as to going concern.

I. Responsibility For Incomplete Information- Compilation Engagement

**Facts:** An accountant compiles financial statements for a client and notices that the client’s cash disbursements journal shows monthly disbursements for certain leased equipment. When the
accountant asks the client whether the equipment is rented or whether the client is making payments on purchased equipment, the client indicates that she is uncertain. The client does not have documentation concerning the leased equipment, and telephone calls to the lessor do not resolve the matter. This is the first year of the engagement and the accountant does not have information from prior years.

**Question:** How much work must an accountant perform in a compilation engagement to discharge his or her responsibility for identifying financial statement misstatements?

**Response:** Paragraph 14 of AR-C 80 (SSARS No. 21) states the following in connection with a compilation engagement:

> “If, in the course of the engagement, the accountant becomes aware that the records, documents, explanations, and other information, including significant judgments, provided by management are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information.”

Paragraph A13 of AR-C 80 expands upon Paragraph 14 as follows:

> “The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have performed such inquiries or procedures and the results of those inquiries or procedures, knowledge gained from prior engagements, or the financial statements themselves may cause the accountant to become aware that information provided by management is incorrect, incomplete, or otherwise unsatisfactory.”

In the above situation, the accountant should:

- Request that the client contact the lessor and obtain copies of the lease agreements.

- Not issue a compilation report indicating that management has not determined the appropriateness of the accounting treatment for the leases and that any potential GAAP departures have not been determined. The use of such language is not appropriate because it allows the accountant to avoid responsibility for identifying GAAP departures.

**Observation:** Absent information to the contrary, SSARS No. 21 does not require an accountant to search for additional information or perform additional procedures such as inquiries, etc. when performing a compilation engagement. What it does require is for an accountant to obtain additional information if it is obvious that the submitted information is incorrect or incomplete. In this situation, the accountant is not allowed to disregard the obvious signs that the financial statements are incorrect.
Review Questions

1. Which of the following is correct regarding accountants who perform write-up services for attest clients:
   a. Such engagements are not risk free
   b. Malpractice cases against accountants in such engagements have declined dramatically in recent years
   c. Such engagements automatically result in a lack of independence for the accountant and precludes the accountant from performing an attest engagement for that client
   d. There is no need for an accountant to obtain an engagement letter for such services

2. John is an accountant who is asked to perform certain activities for a client. Which of the following would not impair John’s independence:
   a. John prepares purchase orders for the client
   b. John is the custodian for certain investments of the client
   c. John is an advisor to the board of directors
   d. John serves as an escrow agent on behalf of the client

3. If an accountant is in public practice and performs controllership services as an employee of the entity, the accountant ____________:
   a. Must comply with the requirements of SSARS No. 21 because he or she is in public practice
   b. Must communicate, preferably in writing, the accountant’s relationship to the entity
   c. May have the option of complying with SSARS No. 21 or communicate his or her relationship to the entity as a controller, depending on the circumstances.
   d. Is not permitted to issue any kind of report unless he or she is an executive of the entity

4. Which of the following is true regarding the issuance of draft financial statements:
   a. An accountant may not issue draft financial statements under any circumstances
   b. An accountant may issue draft financial statements to provide a client with the opportunity to read and analyze the financial statements before their final issuance
   c. If draft statements are issued, they should not contain any special markings or limitations
   d. An accountant has full control over the distribution of draft financial statements that he or she submits to the client

5. As defined in SSARS No. 21, an intentional act that results in a misstatement in compiled or reviewed financial statements is considered a(an):
   a. Fraud
   b. Noncompliance with a law
   c. Error
   d. Irregularity

6. As it relates to fraud in a review engagement, an accountant is:
   a. Not responsible for considering fraud
   b. Responsible for the prevention of fraud
   c. Not required to inform management of any fraud that comes to their attention
   d. Is not required to inquire as to whether any frauds have occurred
7. For which of the following engagements is the accountant required to evaluate internal controls, including risks of material misstatement due to fraud:
   a. Compilation engagement
   b. Review engagement
   c. Audit engagement
   d. Agreed upon procedures engagement

8. Which of the following is an analytical procedure that studies the relationship between two financial statement amounts:
   a. Trend analysis
   b. Reasonableness tests
   c. Ratio analysis
   d. Altman Z Score

9. Which of the following is correct regarding analytical procedures in a compilation engagement:
   a. If performed in a compilation engagement, the engagement must be upgraded to an audit
   b. If performed in a compilation engagement, the engagement must be upgraded to a review engagement
   c. The fact that review-type procedures are performed, in and of itself, does not upgrade the engagement from a compilation to a review engagement
   d. Analytical procedures should never be performed in a compilation engagement

10. SSARS No. 21 provides the option of which of the following being placed on each page of compiled or reviewed financial statements:
    a. Page numbers
    b. Accountant’s letterhead
    c. A legend like “See Independent Accountant’s Compilation (Review) Report”
    d. Initials of the accountant

11. Which of the following is correct regarding going concern in a compilation or review engagement:
    a. SSARS No. 21 provides no guidance on going concern in a compilation and review engagement
    b. The concept of substantial doubt is the basis for evaluating going concern in a compilation or review engagement
    c. A report modification is generally required for a compilation or review engagement when there is a going concern issue
    d. An accountant may add a paragraph to a report to emphasize a going concern matter

12. Which of the following is correct regarding the Altman Z Score:
    a. The Altman Z Score has become generally accepted as a ratio that is highly correlated with bankruptcy
    b. The Altman Z Score works well in evaluating real estate developers
    c. The Altman Z Score consists of a weighted average of three separate ratios
    d. An entity with an Altman Z Score that exceeds 1.0 is generally considered strong
J. Using Tax-Basis Financial Statements for Engagement Profitability

1. General

As CPAs seek ways to reduce overall engagement time for compilation and review engagements, they seem to overlook using tax-basis financial statements. The author observes that few CPAs use tax basis for engagements beyond limited disclosure compilation engagements. That is, the majority of engagements related to nonpublic entities (e.g., full disclosure compilations, reviews and even audits) continue to be performed using traditional GAAP as the framework.

Major differences can exist between GAAP and taxable income due to the upheaval of the tax code starting in the 1980s through the current period. As a result, nonpublic entities find a continued conflict between balancing a desired lower taxable income for tax planning with higher financial statement income necessary to appease the bank or third party investor. In certain cases, tax-basis financial statements act to bridge this gap so that tax-basis and GAAP financial statements are more aligned. This is particularly true with respect to a traditional nonpublic manufacturer, retailer or wholesaler who may be a perfect candidate for income tax-basis accrual financial statements. With respect to cash-basis financial statements, many smaller businesses, in particular professional practices, can easily use cash or hybrid-basis financial statements instead of a more costly accrual basis GAAP format. Let's not forget that the accountant can benefit from use of tax-basis financial statements if the time saved can be used to either reduce the billing to the client or be retained by the accountant to make the engagement more profitable.

Prior to the issuance of SSARS No. 21, the term “other comprehensive basis of accounting (OCBOA) was used to describe non-GAAP financial reporting frameworks, such as income tax basis, cash basis, regulatory and contractual basis of accounting.

SSARS No. 21 introduces a new definition of non-GAAP financial reporting frameworks, referred to as a “special purpose framework,” which is carried over from the auditing standards that were revised in SAS Nos 122-124.

SSARS No. 21 defined a special purpose framework as any one of the following bases of accounting:

**Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

**Tax basis:** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.

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

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22 SSARS No. 21 changed the term “income tax basis” to “tax basis.”
**Contractual basis:** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.

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

Although the term other comprehensive basis of accounting (OCBOA) is no longer used in the formal sense, in practice it’s use is still common to refer to non-GAAP bases of accounting.

For most situations, tax-basis financial statements are the most meaningful as follows:

1. Tax basis is usually based on the Federal income tax laws and regulations found in the Internal Revenue Code (IRC), although other tax codes can be used such as state or local taxation.

2. Accrual basis is the most meaningful form of tax-basis financial statements although financial statements using the cash, modified cash, or any other method that clearly reflects income under Section 446 of the IRC, may be used.

**Observation:** One of the advantages of tax-basis financial statements is that there are few accounting issues that need to be addressed. Essentially, all transactions are accounted for in accordance with the Internal Revenue Code or another code of taxation. Of course, there may be instances where the tax treatment of an item is at issue.

2. **When to Use Tax-Basis Financial Statements**

In determining whether tax-basis financial statements are appropriate for a client, major factors that should be considered include who the users of the financial statements will be and whether there are any contractual agreements or regulatory requirements that prohibit issuance of non-GAAP financial statements.

Generally, tax-basis financial statements are best used and most useful in the following situations:

a. There is a less financially sophisticated, nonpublic client who is:
   - Tax motivated and interested in cash flows, and
   - Actively involved in the day-to-day operations.

b. The company is in a strong financial position and will not be forced into debt covenant violations by presenting a lower taxable income.

c. There is incentive to reduce overall engagement time.
   - The accountant is motivated to reduce overall engagement time either through pressure from the client or to improve the profitability of the engagement.

**Observation:** The author suggests that an accountant should seriously consider the time savings in convincing his or her client to use tax-basis financial statements. Based on experience, the author estimates an overall engagement time savings of 10% for compilations, 15-18% for reviews, and 15-25% for audits. For fixed-fee engagements, any savings will usually inure to the benefit of the accounting firm. Moreover, most third parties, particularly banks, will accept tax-basis financial
statements for compilation and review engagements, albeit less so for audited financial statements. If loan documents do not make reference to GAAP in the description of the financial statements to be issued at year-end, the author believes that the accountant may report on tax-basis financial statements as a matter of right.

3. When Not to Use Tax-Basis Financial Statements

It may be prudent not to use tax-basis financial statements if the statements may be perceived to be intentionally misleading by a third party, or may violate loan covenants. Examples of situations in which a third party may perceive the use of tax basis to be intentionally misleading include:

a. Having a large amount of uncollectible receivables for which the tax basis would not provide an allowance for doubtful accounts.

b. Having a large contingency for environmental liabilities and litigation for which an accrual would not be recorded using the tax basis.

c. A situation in which a contract or loan agreement explicitly states that GAAP financial statements must be issued to comply with that agreement.

Accountants do, in fact, have to deal with the third situation identified above; that is, when a loan agreement requires that GAAP statements be issued. Without a waiver from that lender, it is difficult for an accountant to report on tax-basis financial statements knowing that the issuance and submission of those statements violates the loan agreement. A better choice is for the accountant or his or her client to seek a waiver from the lender to issue tax-basis financial statements.

SSARS No. 21 requirement to ensure tax basis is “acceptable”

SSARS No. 21 adds a new requirement under which the accountant must determine that any non-GAAP framework, such as tax basis, is “acceptable” as a condition to performing the SSARS engagement.

a. Paragraph .25 of AR-C 60 states that a condition for an accountant accepting a SSARS engagement is that the accountant must:

- Determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable, and
- Make reference in the compilation or review report to management’s responsibility for determining that the tax basis framework is acceptable in the circumstances when management has a choice of financial reporting frameworks in the preparation of such financial statements.

b. Factors that SSARS No. 21 states are relevant to the accountant’s determination that the tax-basis framework selected by management is acceptable include the following:

- Consideration of the nature of the entity
- The intended purpose of the financial statements
• The users of the financial statements
  Example: Are they prepared to meet the common financial information needs of a wide range of users), and
• Whether law or regulation prescribes the applicable financial reporting framework.

The key factor that should be considered in determining whether tax-basis financial statements would be “acceptable” is whether the users of the financial statements (such as a bank) will accept them and find the tax-basis framework to be useful.

4. Tax-Basis Accrual Financial Statements - Differences from GAAP

When using tax-basis financial statements prepared under the Internal Revenue Code, there are clear differences between GAAP and taxable income. In particularly, in tax-basis financial statements all deferred M-1 items are eliminated while permanent, flow-through M-1 items are retained. Deferred M-1 items are all M-1 items that reverse and, on which, deferred income taxes are computed. Conversely, permanent M-1 items consist of all M-1s that do not reverse such as meal and entertainment and key-man life insurance. A listing of these items follows:

a. All deferred M-1 items are eliminated:

  • Depreciation- MACRS depreciation is used for tax-basis financial statements, including the Section 179 and bonus depreciation.
  • Unicap difference- IRC Section 263A adjustment under the uniform capitalization rules, is capitalized to tax-basis financial statement inventory.
  • No unrealized gains on securities- securities are recorded at cost and not recorded at fair value per GAAP’s ASC 320 (formerly FASB No. 115).
  • No related-party or vacation-pay accruals- all related party and vacation-pay accruals are recorded on a cash basis.
  • Amortization follows the 15-year tax life- most intangibles, including goodwill, are amortized over their tax life of 15 years.
  • No allowance for bad debts-the direct write-off method is used.
  • No impairment of assets issues- assets are recorded at cost and no writedowns for impairments are recorded.
  • No goodwill impairment- goodwill is amortized over the 15-year tax life and no impairment losses are recorded.

b. All permanent differences are retained within tax-basis financial statements such as:

  • Meals and entertainment
  • Key-man life insurance
  • Dividend exclusion
• Penalties and fines
• Non-taxable interest income
c. Deferred income taxes are eliminated
d. No statement of cash flows is required per ASC 230 (formerly FASB No. 95)\textsuperscript{23}
e. Tax-basis financial statements can be perfect for non-profits that wish to avoid the requirements of ASC 958 (formerly FASB Nos. 116 and 117) such as:

• Donated services are not recorded
• Statement of cash flows is not required
• Statement of functional expenses and the presentation of the amount of unrestricted, temporarily restricted and permanently restricted net assets are not required.
f. GAAP consolidation rules do not apply:

• Consolidation of variable interest entities under ASC 810 (formerly FIN 46R) is not applicable.

\textbf{Note:} ASC 810 is not applicable so that there is no risk that a rental entity would have to be consolidated with its related party operating entity lessee.

• Consolidation is based on the IRC threshold of 80\% ownership for tax-basis financial statements.

5. \textbf{The Four Disclosures Required for Tax-Basis Financial Statements:}

If special purpose framework financial statements are issued, those financial statements must include \textit{four disclosures} related to the special purpose framework as follows:

a. A description of the special purpose framework in the financial statement titles, notes or on the face of the financial statements

b. A summary of significant accounting policies

c. Basis of accounting: an adequate description about how the special purpose framework \textit{differs} from GAAP. The effects of these differences need not be quantified, and
d. Informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

If, however, management elects to omit substantially all disclosures, and such an omission is not undertaken with the intention to mislead potential users of such financial statements, the above presented four disclosures are not required.

\textsuperscript{23} A statement of cash flows is only required for GAAP financial statements.
Disclosure 1: Description of the special purpose framework (tax basis)

The first disclosure for tax-basis financial statements required by SSARS No. 21 is that financial statements prepared on a special purpose framework (such as tax basis) must provide a description of the special purpose framework unless the entity elects to omit substantially all disclosures.

The SSARS states that the description may be included either:

- In the financial statement titles
- In the notes to the financial statements, or
- On the face of the financial statements.

SSARS No. 21 clarifies that traditional GAAP titles, such as balance sheet, statement of financial position, statement of income, etc. may be used for special purpose framework financial statements, provided such titles are "appropriately modified."

Examples of financial statement titles that are suitable for special purpose framework financial statements include, but are not limited to the following:

Modified cash basis:
- Income Statement-Modified Cash Basis
- Statement of Income- Modified Cash Basis**
- Statement of Cash Receipts and Disbursements

Tax-basis of accounting:
- **Balance Sheet- Tax Basis**
- Statement of Assets, Liabilities, and Equity-Tax Basis
- Statement of Operations-Tax Basis
- Statement of Revenue and Expenses-Tax Basis
- **Statement of Income- Tax Basis**

Regulatory Basis:
- Statement of Income- Regulatory Basis
- Balance Sheet- Regulatory Basis

** Added to list by author.

Observation: For years there has been confusion as to the titles that could be used for non-GAAP financial statements such as income tax-basis financial statements. The general rules were originally found in SAS No. 62, Special Reports, which stated that other comprehensive basis of accounting (OCBOA) financial statements should be "suitably titled" so as not to imply they are GAAP financial statements. SAS No. 62 provided limited guidance as to what was "suitably titled" and what was not.

Although not codified within SAS No. 62, some commentators, including the author, have believed that suitably titled financial statements could use the terms "balance sheet" and "statement of income" provided there was an appropriate suffix such as "income tax basis" or "cash basis" etc. Thus, the titles "balance sheet-income tax basis" and "statement of income-income tax basis" were appropriate titles if
reporting on income tax-basis financial statements under the pre-SSARS No. 21 rules. Yet, some peer reviewers and other parties had taken a far more narrow position that the terms "balance sheet" and "statement of income" could not be used in an OCBOA title regardless of whether an "income tax basis" suffix was attached. Thus, many practitioners have used titles such as "statement of assets, liabilities and equity-income tax basis" and "statement of revenues and expenses-income tax basis" even though titles such as "balance sheet-income tax basis" and "statement of income-income tax basis" could have been used.

SSARS No. 21 finally brings clarity to the situation by stating that with respect to special purpose frameworks, (such as tax basis), GAAP titles may be used provided such titles are "appropriately modified." SSARS No. 21 does offer some examples of titles that are considered "appropriately modified."

Following are examples of "appropriate" special purpose framework titles:

- Balance Sheet- Tax Basis**
- Statement of Income- Tax Basis**
- Statement of Income- Regulatory Basis
- Balance Sheet- Regulatory Basis

** Title included by author but not included in list found in SSARS No. 21.

Must the term “tax basis” be included on each page of the notes to financial statements?

Yes. SSARS No. 21 requires that financial statements have a description of the special purpose framework, such as tax basis. The definition of “financial statements” includes not only the individual financial statements (balance sheet, income statement, etc.) but also the related notes to those financial statements.

Thus, not only should each page of the individual financial statements include a suffix similar to “balance sheet-tax basis” but each page of the notes should also reference “tax basis.”

XYZ Company
Notes to Financial Statements- Tax Basis
December 31, 20X1

Does SSARS No. 21 permit use of the suffix “income tax basis” instead of “tax basis”?

SSARS No. 21 changed the definition of a special purpose framework to include the “tax basis” which is defined in Paragraph .07 of AR-C 70 as a “basis of accounting that an entity uses to file its tax return for the period covered by the financial statements.”

Previously, the term “income tax basis” was used within the concept of other comprehensive basis of accounting (OCBOA) financial statements.

Although SSARS No. 21 does not explain the reason for using the term “tax basis” in lieu of “income tax basis,” the author believes it was changed to reflect the fact that certain tax authorities define their
tax as something other than an income tax. For example, the Massachusetts state corporate tax is called an excise tax, not an income tax.

So, the question is whether tax-basis financial statements can be titled with an “income tax basis” suffix instead of “tax basis.”

The answer is that nothing precludes the use of the term “income tax basis” instead of “tax basis.” In fact, although SSARS No. 21 uses “tax basis” in its examples and financial statement titles, the AICPA Guide uses the term “income tax basis.”

Thus, in using tax basis financial statement titles, all of the following are acceptable:

- Balance Sheet- Tax Basis
- Balance Sheet- Income Tax Basis
- Statement of Income- Tax Basis
- Statement of Income- Income Tax Basis
- Statement of Income and Retained Earnings- Tax Basis
- Statement of Income and Retained Earnings- Income Tax Basis
- Statement of Stockholders’ Equity- Tax Basis
- Statement of Stockholders’ Equity- Income Tax Basis
- Statement of Cash Flows- Tax Basis
- Statement of Cash Flows- Income Tax Basis

**Disclosure 2: Summary of significant accounting policies**

SSARS No. 21 requires that financial statements prepared under a special purpose framework, such as the tax basis, include a summary of significant accounting policies. This disclosure should include policies similar to those required for GAAP financial statements including the policies employed such as:

- Tax life for depreciation
- Amortization period for amortization
- Revenue recognition
- Other significant policies used in the tax-basis financial statements

SSARS No. 21 states that a summary of significant accounting policies is not required if such statements:

a. Omit substantially all disclosures, and

b. The omission of substantially all disclosures is not undertaken with the intention to mislead expected users of the financial statements.

**Disclosure 3: Basis of accounting- description of how the special purpose framework differs from GAAP**

SSARS No. 21 states that the description of how the special purpose framework differs from GAAP ordinarily only includes the material differences between GAAP and the special purpose framework.
For example, if several items are accounted for differently in accordance with the special purpose framework than they would be in accordance with GAAP, but only the differences in how depreciation is calculated are material, a brief description of the depreciation differences is all that would be necessary, and the remaining differences need not be described or quantified.

The basis of accounting footnote for tax-basis financial statements may be brief with only the primary differences from GAAP being described. For example, assume that there are several differences between tax basis and GAAP as follows:

<table>
<thead>
<tr>
<th>Allowance for bad debts</th>
<th>Insignificant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation difference</td>
<td>Significant</td>
</tr>
<tr>
<td>UNICAP- Section 263A adjustment</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

In the basis of accounting footnote, only a brief description of the depreciation difference would be required with no mention of the other insignificant differences. Quantifying the differences is not required.

**Example:**

**Basis of Accounting:**

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which **differs** from the accrual basis of accounting required under accounting principles generally accepted in the United States of America. The **primary difference** between the Company’s method and the method required by accounting principles generally accepted in the United States of America is that **depreciation has been recorded using accelerated methods authorized by the Internal Revenue Code.**

**Disclosure 4: Informative disclosures similar to those required by GAAP**

Financial statements prepared when applying a special purpose framework, such as tax basis, are not considered appropriate in form unless the financial statements include **informative disclosures similar to those required by GAAP** if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

1. **Tax-basis financial statements** must have disclosures that are similar to those required for GAAP statements, when such tax-basis financial statements contain items that are the same as, or similar to, those in GAAP statements.

   a. If tax-basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide a relevant disclosure or provide information that effectively communicates the substance of that disclosure.

      - Qualitative information may be substituted for quantitative information required by GAAP.
      - Modification of the financial statement format is **not required**.

**Example:** GAAP requires disclosure of the future principal payments on long-term debt over the next five years. For tax-basis financial statements, this disclosure could be satisfied by merely
disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule.

b. GAAP disclosures that are not relevant to tax-basis financial statements are not required.

Examples include:

1) Fair value information required for investments accounted for at fair value in accordance with ASC 320, *Investments-Debt and Equity Securities* (formerly FASB No. 115). Fair value information would not be relevant for OCBOA because investments are recorded at cost.

2) Information based on actuarial calculations that ASC Topic 715, *Compensation-Retirement Benefits* (formerly FASB No. 158) would require for defined benefit plans would not be relevant to income tax or cash-basis financial statements.

c. The tax basis financial statement format should comply with GAAP requirements or provide information that communicates the substance of those requirements. Such information may be communicated using qualitative information without modifying the financial-statement format.

d. **Statement of Cash Flows Issues:**

A statement of cash flows is not required for tax-basis financial statements. However, if the cash receipts and disbursements basis of accounting is used, the income statement is effectively a cash flow statement.

1) If a statement of cash flows is presented in tax-basis financial statements, the cash flow statement should either conform to the requirements for a GAAP statement of cash flows, or disclose the substance of those requirements.

**Example:** A Company issues tax-basis accrual financial statements and decides to include a statement of cash flows, although not required.

**Conclusion:** The statement of cash flows should either conform to the GAAP requirements for a cash flow statement, or the same types of cash flow disclosures should be made either on the statement or in the notes. For example, noncash transactions such as purchasing a fixed asset with borrowings should be disclosed in the notes.

e. **Other disclosures:**

If GAAP would require disclosure of other matters such as contingent liabilities, going concern, and significant risks and uncertainties, the accountant should consider the need for that same disclosure. However, disclosures that are irrelevant to tax-basis financial statements need not be included.

**Example:** A disclosure about the use of estimates that is required by ASC 275, *Risks and Uncertainties* (formerly SOP 94-6), would not be relevant in a cash receipts and cash disbursements basis of accounting which has no estimates.
6. The Move Toward the Tax-Basis Review Engagement

The author is not alone in stating that recent FASB statements have gone too far by inundating small, nonpublic businesses with irrelevant disclosures and GAAP implementation standards. In particular, several issued statements lead to a practitioner revolt as these statements apply to both SEC and nonpublic entities:

a. **Consolidation of Variable Interest Entities - ASC 810 (formerly FIN 46R)**

b. **Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity – ASC 480 (formerly FASB No. 150)**

c. **Uncertain Tax Positions - ASC 740 (formerly FIN 48)**

These three statements are presented in the form in which they were originally issued but have since been codified within the Accounting Standards Codification (ASC).

The above statements have an extreme impact on small businesses. FIN 46R requires the consolidation of certain off-balance sheet entities (variable interest entities), while ASC 480 (formerly FASB No. 150) requires that mandatorily redeemable shares of stock be classified as liabilities on an entity’s balance sheet. ASC 740 (formerly FIN 48) requires an entity to consider the likelihood that a tax position will be sustained by IRS or state examination.

All of these statements were adopted by the FASB to resolve the problems with SEC companies. However, under pressure from the AICPA and other groups, the FASB has permanently deferred the application of ASC 480 (formerly FASB No. 150) to nonpublic entities with respect to mandatory redeemable shares of stock. The Statement still applies to public entities.

Effective in 2012, the FASB established the Private Company Council (PCC) to provide GAAP modifications for private companies. However, as of 2016, the PCC has adopted only four modifications for private companies. That leaves an entire body of GAAP that inundates private (nonpublic) entities with useless and voluminous disclosures that users do not want or need.

In addition to the changes in GAAP, in the early 2000s, the Auditing Standards Board issued SAS No. 99, **Consideration of Fraud in a Financial Statement Audit** which required auditors to expand the amount of audit work conducted with respect to fraud. The Auditing Standards Board followed up with the issuance of a series of standards, SAS No. 104-111, collectively referred to as the risk assessment standards. Effective in 2012, SAS Nos. 99 and 104-111 are superseded by SAS No. 122 under the Auditing Standards Board’s Clarity Standards.

The result of the expanded GAAP changes, coupled with the changes in auditing standards related to fraud and risk assessment, has CPA firms moving toward what is likely to be the engagement of the future: the tax-basis review.

**Tax-Basis Review Engagement = Most Profitable Engagement**

The author is advocating that accountants consider performing a review engagement on **tax-basis accrual financial statements**.

The following chart illustrates the profit drainers and profit gainers for different types of engagements.
The result of the above chart illustrates the following:

1. Accountants should consider shifting their clients downstream from an audit to a review engagement.

2. Accountants should push their clients from GAAP to tax-basis accrual financial statements.

In doing so, the *tax-basis review engagement* becomes the engagement of choice in many, but not all, instances.

*Oh, but the banks won’t accept tax-basis financial statements!*  
The author continues to hear the skeptics; that is, accounting firms who claim that the banks will not accept tax-basis financial statements.

From experience, the author notes the following:

1. Most bankers have no idea what tax-basis financial statements are.
2. Most bankers will accept tax-basis financial statements if the accountant or client explains the benefits.

   a. Make sure the loan commitment letter does not state “GAAP financial statements.”

   b. If the loan agreement references GAAP financial statements, ask the bank for a waiver to issue tax-basis financial statements.

3. Selling the client on tax-basis financial statements is easy based on the following:

   a. The statements are more in line with the tax returns and easier to understand.

   b. Using tax basis will save time and keep the engagement fee down.

Observation: The author notes that throughout his career, he has converted several clients from GAAP to tax-basis financial statements. The author has convinced certain clients to convert to tax-basis accrual financial statements based on the argument that there would be a significant increase in accounting fees if the company remained on GAAP financial statements due to the consolidation requirements.

Sample Commitment Letter Language:

Following is a section of a bank commitment letter related to one of the author’s clients on which the author’s firm prepares a review engagement on tax-basis financial statements.

\[\begin{align*}
\text{ANNUAL FINANCIAL STATEMENTS:} & \quad \text{The Borrower will provide monthly accounts receivable and inventory listings as well as a Borrowing Base Certificate to the Bank in addition to at least quarterly management prepared financial statements. The Borrower and the Trust guarantor must also furnish the Bank, within NINETY (90) days after the end of each fiscal year, a balance sheet, a statement of annual income and expenses and a statement of changes in financial position in form and substance and in detail satisfactory to the Bank, \textit{reviewed, with a review report thereon, by a certified public accountant}. \textit{Borrower may elect to prepare tax-basis accrual financial statements}. The Borrower will also provide, promptly, such other information, concerning the Borrower or any guarantor, as the Bank may request from time to time. The individual guarantors shall provide personal financial statement and tax returns on an annual basis which must be satisfactory to the Bank in all respects. Prior to closing the Borrower will provide the Bank a 20X2 financial projection and cash flow budget.}
\end{align*}\]
7. Reports on Tax-Basis Financial Statements- Compilation and Review Engagements

The following is an example of a compilation report under SSARS No. 21 and financial statements where substantially all disclosures and the statement of cash flows have been omitted.

Example 1: Compilation Report on Tax-Basis Financial Statements- Substantially All Disclosures Omitted- C Corporation

Facts:
- Standard compilation report for a single year on tax-basis financial statements
- Management elects to omit substantially all disclosures ordinarily included in tax-basis financial statements
- No statement of cash flows is presented

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings-tax basis, for the year then ended in accordance with the **tax-basis of accounting, and for determining that the tax-basis of accounting is an acceptable financial reporting framework.**

We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the **tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.**

Management has elected to omit substantially all the disclosures *ordinarily included* in financial statements prepared in accordance with the **tax-basis of accounting.** If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

**Observation:** Notice that in the above report, the language “*ordinarily included*” has been used in lieu of the traditional language “Management has elected to omit substantially all disclosures and the statement of cash flows required by GAAP.” The reason for this change in language is because there is no authority as to which disclosures are specifically required by tax basis. Further, a statement of cash

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24 AR-C 80 states that when special purpose framework financial statements are prepared and management has a *choice* of frameworks, the accountant’s compilation report should reference management’s responsibility for determining that the framework is *acceptable.*

25 The term “ordinarily included” is used when tax-basis financial statements are issued in lieu of the term "required" for GAAP statements.
flows is not required for non-GAAP financial statements and, therefore, not mentioned in this report paragraph.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Accounts receivable - trade</td>
<td>300,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>450,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>50,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td><strong>1,000,000</strong></td>
</tr>
<tr>
<td><strong>Plant and equipment:</strong></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>500,000</td>
</tr>
<tr>
<td>Total plant and equipment</td>
<td><strong>700,000</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$1,700,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND STOCKHOLDERS’ EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$300,000</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>100,000</td>
</tr>
<tr>
<td>Short-term note payable</td>
<td>500,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td><strong>900,000</strong></td>
</tr>
<tr>
<td><strong>Long-term debt:</strong></td>
<td>700,000</td>
</tr>
<tr>
<td><strong>Stockholders’ equity:</strong></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>99,900</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td><strong>100,000</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td><strong>$1,700,000</strong></td>
</tr>
</tbody>
</table>

**Note:** SSARS No. 21 no longer requires that a legend be included on each page such as, “See Accountant’s Report,” “See Accountant’s Compilation Report” or "See Independent Accountant's Compilation Report." Therefore, both the sample balance sheet and statement of income noted above do not include any such legend.
Statement of Income- Tax Basis- C Corporation

Option 1: Income Statement- M-1 Items Shown in Separate Section on Income Statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ Company</td>
<td>Statement of Income and Retained Earnings- Tax Basis</td>
</tr>
<tr>
<td>For the Year Ended December 31, 20XX</td>
<td></td>
</tr>
<tr>
<td>Net sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales- tax return</td>
<td>800,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
</tr>
<tr>
<td>Deductible expenses:</td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>State excise taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>5,000</td>
</tr>
<tr>
<td>Total deductible expenses</td>
<td>148,000</td>
</tr>
<tr>
<td>Taxable state income</td>
<td>52,000</td>
</tr>
<tr>
<td>State income taxes</td>
<td>(5,000)</td>
</tr>
<tr>
<td>** Taxable federal income</td>
<td>47,000**</td>
</tr>
<tr>
<td>Non-taxable and non-deductible item:</td>
<td></td>
</tr>
<tr>
<td>Federal income tax expense</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Non-deductible life insurance</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Nondeductible meals and entertainment</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Non-taxable interest</td>
<td>3,000</td>
</tr>
<tr>
<td>Net income</td>
<td>28,000</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>$99,900</td>
</tr>
</tbody>
</table>

** Agrees with line 28 of tax return

Observation: The Option 1 income statement format is one that is a copy of a Form 1120 with a subtotal that agrees with the tax return. The advantage of this format is that it is user-friendly for the less financially sophisticated user.
<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales- tax return</td>
<td>800,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
</tr>
<tr>
<td>Deductible expenses:</td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>State excise taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>5,000</td>
</tr>
<tr>
<td>Total deductible expenses</td>
<td>148,000</td>
</tr>
<tr>
<td>Taxable state income</td>
<td>52,000</td>
</tr>
<tr>
<td>State income taxes</td>
<td>(5,000)</td>
</tr>
</tbody>
</table>

**Taxable federal income**  
47,000**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>Non-taxable and non-deductible item:</td>
<td></td>
</tr>
<tr>
<td>Federal income tax expense</td>
<td>(7,500)</td>
</tr>
<tr>
<td><strong>Non-deductible life insurance</strong></td>
<td>(12,000)</td>
</tr>
<tr>
<td>Nondeductible meals and entertainment</td>
<td>(2,500)</td>
</tr>
<tr>
<td><strong>Non-taxable interest</strong></td>
<td>3,000</td>
</tr>
<tr>
<td>End of year</td>
<td>$99,900</td>
</tr>
</tbody>
</table>

** Agrees with line 28 of tax return.
Example 2: S Corporation Income Statement

Same facts as Example 1 except that the company is an S corporation.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales- tax return</td>
<td>800,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
</tr>
<tr>
<td>Deductible expenses:</td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>State excise taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>10,000</td>
</tr>
<tr>
<td>Total deductible expenses</td>
<td>153,000</td>
</tr>
<tr>
<td>Taxable ordinary income</td>
<td>47,000*</td>
</tr>
<tr>
<td>Other taxable income (deductible expenses):</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>1,000</td>
</tr>
<tr>
<td>Ordinary dividends</td>
<td>5,000</td>
</tr>
<tr>
<td>Additional depreciation deduction</td>
<td>(19,000)</td>
</tr>
<tr>
<td>Total taxable income</td>
<td>34,000**</td>
</tr>
<tr>
<td>Non-taxable and non-deductible items:</td>
<td></td>
</tr>
<tr>
<td>Nondeductible life insurance</td>
<td>(12,000)*</td>
</tr>
<tr>
<td>Nondeductible meals and entertainment</td>
<td>(2,500)*</td>
</tr>
<tr>
<td>Non-taxable interest</td>
<td>3,000*</td>
</tr>
<tr>
<td>Net income</td>
<td>$22,500</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>$94,400</td>
</tr>
</tbody>
</table>

* Agrees with ordinary income on page 1 of Form 1120S.
** Agrees with total per Schedule K of Form 1120S.
Example 3: Tax-Basis Financial Statements- Compilation Report- Full Disclosure

Facts:
- Standard compilation report for a single year
- Tax-basis financial statements
- No statement of cash flows is presented

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings-tax basis, and the related notes to the financial statements for the year then ended in accordance with the tax-basis of accounting, and for determining that the tax-basis of accounting is an acceptable financial reporting framework. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

As disclosed in Note X, the financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

Example 4: Review Report on Tax-Basis Financial Statements and Disclosures

Facts:
- Review of a complete set of financial statements (single year)
- Tax-basis financial statements
- Statement of cash flows is included
- Management has a choice of financial reporting frameworks

Independent Accountant’s Review Report

[Appropriate Addressee]

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of December 31, 20XX, and the related statements of income and retained earnings-tax basis and cash flows-tax basis, for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, I (we) do not express such an opinion.

26 AR-C 80 states that when special purpose framework financial statements are prepared and management has a choice of frameworks, the accountant’s compilation report should reference management’s responsibility for determining that the framework is acceptable.
Management’s Responsibility for the Financial Statements
Management is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the tax-basis of accounting; this includes determining that the tax-basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances. Management is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the Company uses for income tax purposes. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the tax-basis of accounting.

Basis of Accounting
I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s review report]

XYZ Company
Balance Sheet - Tax Basis
December 31, 20XX

ASSETS

Current assets:
- Cash $200,000
- Accounts receivable - trade 300,000
- Inventories 250,000
- Prepaid expenses 150,000
  Total current assets 900,000

Plant and equipment:
- Cost 1,150,000
- Less accumulated depreciation 500,000
  Total plant and equipment 650,000

27 When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management’s responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

28 When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled “Basis of Accounting” or a similar title.
Other assets:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreement not to compete</td>
<td>100,000</td>
</tr>
<tr>
<td>Investment in mutual funds</td>
<td>50,000</td>
</tr>
<tr>
<td>Total other assets</td>
<td>150,000</td>
</tr>
</tbody>
</table>

$1,700,000

**LIABILITIES AND STOCKHOLDERS’ EQUITY**

Current liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$700,000</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>200,000</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>100,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

Long-term debt (net of current portion):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>600,000</td>
</tr>
</tbody>
</table>

Stockholders’ equity:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>99,900</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>100,000</td>
</tr>
</tbody>
</table>

$1,700,000

**Note:** SSARS No. 21 no longer requires that a legend be included on each page such as “See Independent Accountant’s Review Report.” Therefore, each page of these financial statements and notes does not include any such legend.
XYZ Company
Statement of Income- Tax Basis
For the Year Ended December 31, 20XX

Net sales $1,192,000

Cost of sales- tax return 800,000

Gross profit 392,000

Deductible expenses:
Officer's compensation 25,000
Salaries and wages 25,000
Utilities 10,000
Advertising and promotion 5,000
Insurance 2,000
Uncollectible accounts 21,000
Rent expense 94,000
Retirement plan expense 23,000
Payroll taxes and fringe benefits 12,000
State excise taxes 5,000
Amortization 10,000
Interest 18,000
Depreciation 85,000
Sundry other expenses 5,000
Total deductible expenses 340,000

Taxable state income 52,000
State income taxes (5,000)

** Taxable federal income 47,000**

Non-taxable and non-deductible item:
Federal income tax expense (7,500)
**Non-deductible life insurance** (12,000)
Non-deductible meals and entertainment (2,500)
**Non-taxable interest income** 3,000

Net income 28,000

Retained earnings:
Beginning of year 71,900
End of year **$99,900**

** Agrees with line 28 of tax return.
# XYZ Company

**Statement of Cash Flows - Tax Basis**

For the Year Ended December 31, 20XX

## Cash flows from operating activities:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$28,000</td>
</tr>
<tr>
<td>Adjustments to reconcile net income</td>
<td></td>
</tr>
<tr>
<td>To net cash provided by operating activities</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>95,000</td>
</tr>
<tr>
<td>Change in trade receivables</td>
<td>100,000</td>
</tr>
<tr>
<td>Change in inventories</td>
<td>60,000</td>
</tr>
<tr>
<td>Change in accounts payable</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Change in accrued expenses</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Change in prepaid expenses</td>
<td>(10,000)</td>
</tr>
<tr>
<td></td>
<td>223,000</td>
</tr>
</tbody>
</table>

## Cash flows from investing activities:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases of equipment</td>
<td>(150,000)</td>
</tr>
<tr>
<td></td>
<td>(150,000)</td>
</tr>
</tbody>
</table>

## Cash flows from financing activities:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repayment of long-term debt</td>
<td>(100,000)</td>
</tr>
<tr>
<td></td>
<td>(100,000)</td>
</tr>
</tbody>
</table>

## Decrease in cash and cash equivalents

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(27,000)</td>
</tr>
</tbody>
</table>

## Cash and cash equivalents:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning of year</td>
<td>227,000</td>
</tr>
<tr>
<td>End of year</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

## Supplementary cash flow disclosures:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest paid</td>
<td>$18,000</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>12,500</td>
</tr>
</tbody>
</table>

**Observation:** A statement of cash flows is not required to be presented in tax-basis financial statements. If a statement of cash flows is included in tax-basis financial statements, all the requirements related to the statement of cash flows must be followed including the various disclosures that are required.

XYZ Company

Notes to Financial Statements - Tax Basis

For the Year Ended December 31, 20XX

**NOTE 1. NATURE OF OPERATIONS**
The Company is a manufacturer of fine widgets used in the medical community. The Company has three retail outlets located in Notown, Everytown and Whichtown, Massachusetts. The majority of the company's sales are made to customers engaged in medical distribution within New England.

**Note:** The above disclosure satisfies the nature of business disclosure (ASC 275 (formerly SOP 94-6)) and the concentration of accounts receivable (ASC 825).

## NOTE 2. BASIS OF ACCOUNTING

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which **differs** from the accrual basis of accounting required under accounting principles generally accepted in the United States of America. The **primary differences** between the Company’s method and the method required under accounting principles generally accepted in the United States of America is that **a)** depreciation has been recorded using accelerated methods authorized in the Internal Revenue Code, **b)** Uncollectible accounts on accounts receivable are recorded when deemed uncollectible without use of an allowance account, **c)** Certain accruals for compensation and other expenses are recorded when paid rather than when incurred, and **d)** Certain costs are capitalized to inventory that are not typically capitalized under generally accepted accounting principles.

## NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Cash equivalents policy:**
(only if a statement of cash flows is presented.) For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.29

The majority of the Company's cash is placed within one local banking institution. At times, the balance on deposit exceeds federally insured limits. To date, the Company has not experienced any losses in such account and believes it is not exposed to any significant credit risk on its cash and cash equivalents. (ASC 825).

**Investments:**
Investments are stated at amortized cost and consisted of amounts deposited in a mutual fund with a balance of $50,000.

**Note:** Because the statements are presented on a tax basis, fair value accounting for investments per ASC 320 (formerly FASB No. 115) does not apply.

---

29 A statement of cash flows is not required for non-GAAP financial statements. However, if an entity chooses to include a statement of cash flows, all of the GAAP disclosures required for the statement of cash flows should be included.
Certain agreements not to compete in connection with asset acquisitions are amortized on a straight-line basis over fifteen years.

**Trade receivables:**
Trade receivables are recorded at net realizable value. Interest is not accrued on past due balances.

The Company uses the *direct write-off method* to account for uncollectible accounts that are not recoverable. Using the direct write-off method, trade receivable balances are written off to bad debt expense when an account balance is deemed to be uncollectible.

Accounts are considered past due once the unpaid balance is 90 days or more outstanding, unless payment terms are extended by contract. When an account balance is past due and attempts have been made to collect the receivable through legal or other means, the amount is considered uncollectible and is written off to expense.

The company’s policy is not to charge interest on past due trade receivable balances.

At December 31, 20XX, trade receivables had a balance in the amount of $300,000.

**Note:** The above disclosure is the tax basis equivalent of the ASC 310 disclosure requirement in which an entity must disclose, among other items, the basis at which receivables are presented on the balance sheet.

**Inventories:**
The Company values its inventories at cost using the first-in, first-out (FIFO) basis. Additionally, in accordance with Internal Revenue Code, certain general and administrative, and storage costs are capitalized which approximates 5% of ending inventory.

**Plant and equipment:**
Plant and equipment is stated at cost. Depreciation is computed using accelerated methods authorized under the Internal Revenue Code based on the following recovery periods:

<table>
<thead>
<tr>
<th>Recovery period (in years)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Motor vehicles</td>
<td>5</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>7</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>39</td>
</tr>
<tr>
<td>Building</td>
<td>39</td>
</tr>
</tbody>
</table>

XYZ Company
Notes to Financial Statements - Tax Basis
For the Year Ended December 31, 20XX

**Plant and equipment (continued):**
In accordance with the Internal Revenue Code, the Company records additional depreciation in the year of acquisition of certain assets. The Company recorded additional first-year depreciation in the amount of $24,000 in 20XX. After deducting first-year depreciation, the remaining cost is depreciated using the recovery periods noted above.

Advertising:
Advertising is expensed as incurred and totaled $5,000.

Use of estimates:
The preparation of financial statements in conformity with the tax-basis of accounting requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Subsequent events:
The Company has evaluated subsequent events through March 31, 20X1, which is the date through which the financial statements were available to be issued.

Note: ASC 855, Subsequent Events, requires management to evaluate subsequent events through the date through which the financial statements are available to be issued, and to disclose that information. A similar disclosure is required for tax-basis financial statements.

NOTE 4: INVENTORIES

Inventories consist of the following, by component:

- Raw materials and supplies $50,000
- Work in progress 50,000
- Finished goods 120,000
- Additional general and administrative and storage costs capitalized 30,000

Total $250,000

NOTE 5: RELATED PARTY TRANSACTIONS

From time to time, the company borrows from a shareholder to accommodate cash flow requirements. Interest is payable at 5% per annum and is recorded as an expense when paid in accordance with Internal Revenue Code requirements.
NOTE 6: PLANT AND EQUIPMENT

The components of fixed assets and accumulated depreciation are as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and equipment</td>
<td>$200,000</td>
</tr>
<tr>
<td>Computer and office fixtures</td>
<td>50,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>900,000</td>
</tr>
<tr>
<td></td>
<td>1,150,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>650,000</td>
</tr>
</tbody>
</table>

Depreciation expense was $85,000, including $24,000 of additional first-year depreciation on certain equipment.

NOTE 7: LONG-TERM DEBT

Long-term debt consisted of the following at December 31, 20XX:

Bank Note: Mortgage loan payable in monthly principal payments of $6,667 (annual of $80,000) plus interest at 3% per annum, which approximates the effective interest rate. The unpaid note balance is due on December 31, 20X6. The note is secured by a first mortgage on certain company real estate. $500,000

Shareholder: Unsecured term note requiring semiannual principal payments of $10,000 through June 30, 20X20, plus interest at 110% of the treasury bill rate (3.3% rate at December 31, 20XX which approximates the effective interest rate). 200,000

Less current portion 100,000

$600,000

A summary of the annual maturities of long-term debt for the five years subsequent to year end follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$100,000</td>
</tr>
<tr>
<td>20X2</td>
<td>100,000</td>
</tr>
<tr>
<td>20X3</td>
<td>100,000</td>
</tr>
<tr>
<td>20X4</td>
<td>100,000</td>
</tr>
<tr>
<td>20X5</td>
<td>100,000</td>
</tr>
</tbody>
</table>
NOTE 7: LONG-TERM DEBT (continued)

Note: The five-years of annual maturities is not required in this example. The reason is that the reader can obtain the principal payments for the five years based on the description of the loan terms above. A GAAP format does not have to be followed for disclosures provided the reader can obtain the same result from the information given. Qualitative information prevails. Also, interest expense would normally be disclosed in this note. However, it is already disclosed on the face of the statement of income.

NOTE 8: INCOME TAXES

The provision for income taxes consists of federal and state income taxes currently payable. A summary of the provision follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income taxes</td>
<td>$7,500</td>
</tr>
<tr>
<td>State income taxes</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>$12,500</td>
</tr>
</tbody>
</table>

Note: Using the format of this statement of income, this disclosure is not required because the components of federal and state taxes are already presented on the statement of income.

NOTE 9: PENSION PLANS

The Company is the sponsor of a profit-sharing plan. All employees, exclusive of those covered by collective bargaining agreements, are eligible to enter the Plan within one year of the commencement of employment. Pension expense was $23,000.

NOTE 10: CONTINGENCIES

The Company has been named in a lawsuit that involved use of the company's product by a customer. The possible loss from this lawsuit could range from $50,000 to $200,000. Management believes that this suit is frivolous and, any liability, if any, will not have a material effect on the company.

NOTE 11: SUBSEQUENT EVENT

On February 5, 20X1, the Company entered into an agreement to purchase certain assets of ABC Corporation for $300,000. The assets to be purchased consist of certain plant and equipment, inventories and selected accounts receivable, along with a three-year agreement not to compete from an officer of ABC Corporation.
NOTE 12: CAPITAL STRUCTURE

As of December 31, 20XX, the company had 100 shares of no-par common stock issued and outstanding. Dividends are paid at the discretion of the board of directors. No dividends were paid in 20X1.

NOTE 13: LEASES

The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20X6. A summary of the future minimum lease payments under these operating leases follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum lease payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$96,000</td>
</tr>
<tr>
<td>20X2</td>
<td>96,000</td>
</tr>
<tr>
<td>20X3</td>
<td>96,000</td>
</tr>
<tr>
<td>20X4</td>
<td>96,000</td>
</tr>
<tr>
<td>20X5</td>
<td>96,000</td>
</tr>
<tr>
<td>Beyond 20X5</td>
<td>75,000</td>
</tr>
<tr>
<td>Total minimum lease payments</td>
<td>$555,000</td>
</tr>
</tbody>
</table>

Total rent expense under these leases was $94,000.

Note: Similar to the long-term debt note, the table above could be replaced with qualitative information that provides the reader with the same information. For example, insert the following additional language into the description and remove the table as follows:

The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20X6. Total lease payments under these leases will approximate $50,000 per year during the next five years, with the balance beyond five years totaling approximately $75,000. Total rent expense under these leases was $94,000.

NOTE 14: AGREEMENT NOT TO COMPETE

As part of a previous acquisition of certain assets of Z Company, the company entered into an agreement with the former owner of Z Company. The terms of the agreement provide that for a payment of $150,000, the owner will not compete in the medical market for a period of five years through September 30, 20X4. The agreement is amortized on a straight-line basis over a fifteen-year period in accordance with Internal Revenue Code requirements. As of December 31, 20XX, the unamortized balance of the agreement was $100,000.
NOTE 15: MAJOR CUSTOMERS

Approximately 30% of the company's sales were made to one customer.

---end of notes---

Example 5: Review Report on Tax-Basis Financial Statements With a Tax-Basis Departure

Facts: Same as Example 4 except that an allowance for bad debts is set up for $10,000, which is a departure from the tax-basis of accounting. Assume that the tax effect on the entry is not material.

<table>
<thead>
<tr>
<th>Independent Accountant’s Review Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Appropriate Addressee]</td>
</tr>
<tr>
<td>I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of December 31, 20XX, and the related statements of income and retained earnings-tax basis and cash flows-tax basis, for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, I (we) do not express such an opinion.</td>
</tr>
</tbody>
</table>

Management's Responsibility for the Financial Statements
Management is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the tax-basis of accounting; this includes determining that the tax-basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances. Management is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the Company uses for income tax purposes. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant's Conclusion
Based on my (our) review, except for the issue noted in the Known Departure From the Tax-basis of accounting paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the tax-basis of accounting.

Known Departure From the Tax-basis of accounting
As described in Note XX, the tax-basis of accounting requires that write offs on uncollectible trade receivables be recorded using the direct write-off method. Management has informed us that the allowance method has been used to record an estimate of uncollectible accounts. If the direct write-off method had been used, stockholders’ equity and net

30 When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management’s responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.
income would have increased by $7,000, net of the related tax effect.

**Basis of Accounting**
I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

| Signature of accounting firm or accountant, as appropriate |
| Accountant’s city and state |
| Date of the accountant’s review report |

### Reviewed Financial Statements- Tax Basis with Tax Basis Departure

XYZ Company  
Balance Sheet- Tax Basis  
December 31, 20XX

<table>
<thead>
<tr>
<th><strong>ASSETS</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Accounts receivable- trade (net of allowance: $10,000)</td>
<td>290,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>450,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td><strong>990,000</strong></td>
</tr>
<tr>
<td><strong>Plant and equipment:</strong></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>1,050,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Total plant and equipment</strong></td>
<td><strong>550,000</strong></td>
</tr>
<tr>
<td><strong>Other assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Agreement not to compete</td>
<td>100,000</td>
</tr>
<tr>
<td>Investments</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total other assets</strong></td>
<td><strong>150,000</strong></td>
</tr>
<tr>
<td><strong>LIABILITIES AND STOCKHOLDERS’ EQUITY</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$500,000</td>
</tr>
<tr>
<td>Accrued expenses and taxes</td>
<td>300,000</td>
</tr>
<tr>
<td><strong>Current portion of long-term debt</strong></td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>900,000</strong></td>
</tr>
<tr>
<td><strong>Long-term debt:</strong></td>
<td>700,000</td>
</tr>
</tbody>
</table>

31 When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled "Basis of Accounting" or a similar title.
Stockholders’ equity:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>89,900</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td><strong>90,000</strong></td>
</tr>
<tr>
<td><strong>$1,690,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** SSARS No. 21 no longer requires that a legend be included on each page such as, “See Independent Accountant’s Review Report.” Therefore, each page of these financial statements and notes does not include any such legend.

---

**XYZ Company**  
Statement of Income and Retained Earnings - Tax Basis  
For the Year Ended December 31, 20XX

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales</strong></td>
<td><strong>$1,000,000</strong></td>
</tr>
<tr>
<td><strong>Cost of sales- tax return</strong></td>
<td><strong>800,000</strong></td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td><strong>200,000</strong></td>
</tr>
<tr>
<td><strong>Deductible expenses:</strong></td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>State excise taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total deductible expenses</strong></td>
<td><strong>148,000</strong></td>
</tr>
<tr>
<td><strong>Taxable state income</strong></td>
<td><strong>52,000</strong></td>
</tr>
<tr>
<td>State income taxes</td>
<td>(5,000)</td>
</tr>
<tr>
<td><strong>Taxable federal income</strong></td>
<td><strong>47,000</strong></td>
</tr>
</tbody>
</table>

**Non-taxable and non-deductible item:**

<p>| | |
|                      |       |
| Federal income tax expense | (7,500) |
| <strong>Additional writeoffs of uncollectible accounts</strong> | <strong>(10,000)</strong> |
| Non-deductible life insurance | (12,000) |
| Nondeductible meals and entertainment | (2,500) |
| Non-taxable interest       | 3,000  |</p>
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$18,000</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>$71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>$89,900</td>
</tr>
</tbody>
</table>

** Agrees with line 28 of tax return.

---

**XYZ Company**  
**Statement of Cash Flows- Tax Basis**  
**For the Year Ended December 31, 20XX**

### Cash flows from operating activities:

- **Net income**: $18,000
- **Adjustments to reconcile net income to net cash provided by operating activities**:
  - Depreciation and amortization: $85,000
  - **Change in trade receivables**: $110,000
  - Change in inventories: $70,000
  - Change in accounts payable: ($50,000)
  - Change in prepaid expenses: ($10,000)
  - **Total**: $223,000

### Cash flows from investing activities:

- **Purchases of investments**: ($50,000)
- **Purchase of equipment**: ($100,000)
  - **Total**: ($150,000)

### Cash flows from financing activities:

- **Repayment of long-term debt**: ($100,000)
  - **Total**: ($100,000)

### Decrease in cash and cash equivalents:

- **Total**: ($27,000)

### Cash and cash equivalents:

- **Beginning of year**: $227,000
- **End of year**: $200,000

### Supplementary cash flow disclosures:

- **Interest paid**: $16,000
- **Income taxes paid**: $12,500

---

**Additional Note: Example 5**

The following note would be added to the notes to financial statements, to reflect the tax basis departure:

---

203
Uncollectible Accounts:

The tax-basis of accounting requires that writeoffs on uncollectible trade receivables be recorded using the direct write-off method, which records the writeoff and related expense when the account is deemed uncollectible. Management has informed us that the allowance method has been used whereby an estimate of uncollectible accounts has been recorded prior to the accounts actually becoming uncollectible. If the direct write-off method had been used, stockholders’ equity and net income would have increased by $7,000, net of the related tax effect.

Is an entity that uses the cash-basis of accounting to prepare its federal income tax return permitted to use the tax-basis of accounting using the accrual basis?

SSARS No. 21 defines tax basis as:

“A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.”

What this means is that the entity must use the basis to prepare its tax return. Thus, if the tax return is prepared on the cash basis, the tax-basis financial statements must also be on a cash basis. Further, if the entity wishes to prepare tax-basis financial statements on an accrual basis, it must file its income tax return on an accrual basis.

This situation is problematic for many companies who file their income tax return on a cash basis, yet wish to prepare tax-basis financial statements on an accrual basis, as it is more meaningful to do so. Such a scenario is not authorized by SSARS No. 21 under the tax basis definition.

The solution - the tax-basis of accounting departure!

One way to issue tax-basis financial statements on an accrual basis, while continuing to file cash basis income tax returns, is to issue a report with a tax-basis of accounting departure, similar to a GAAP departure. The difference is that there is a departure from the rules for the tax-basis of accounting (found in SSARS No. 21 rather than GAAP). SSARS No. 21 requires the basis to be the same as the one used for filing the income tax return. By preparing accrual basis, tax-basis financial statements, the entity is violating the definition of the tax-basis of accounting which requires that the entity actually uses the cash basis to file the entity’s tax return.

Following are sample reports:
Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of the year ended December 31, 20XX, and the related statement of income and retained earnings-tax basis, for the year then ended in accordance with the tax-basis of accounting, and for determining that the tax-basis of accounting is an acceptable financial reporting framework. \(^{32}\) I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

The tax-basis of accounting requires that financial statements prepared on the tax-basis of accounting use the same basis used to file the Company’s income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash-basis of accounting. If the cash basis had been followed, net income and stockholders’ equity would have decreased by $100,000.

Management has elected to omit substantially all the disclosures ordinarily included \(^{33}\) in financial statements prepared in accordance with the tax-basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]

---

\(^{32}\) AR-C 80 states that when special purpose framework financial statements are prepared and management has a choice of frameworks, the accountant’s compilation report should reference management’s responsibility for determining that the framework is acceptable.

\(^{33}\) The term “ordinarily included” is used when tax-basis financial statements are issued in lieu of the term “required” for GAAP statements.
Independent Accountant’s Review Report

[Appropriate Addressee]

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet-tax basis as of December 31, 20XX, and the related statements of income and retained earnings-tax basis and cash flows-tax basis, for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the tax-basis of accounting; this includes determining that the tax-basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances.34 Management is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the Company uses for income tax purposes. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) review, except for the issue noted in the Known Departure From the Tax-basis of accounting paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the tax-basis of accounting..

Known Departure From the Tax-basis of accounting
As described in Note XX, the tax-basis of accounting requires that financial statements prepared on tax-basis of accounting use the same basis used to file the Company’s income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash-basis of accounting. If the cash basis had been followed, net income and stockholders’ equity would have decreased by $100,000.

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34 When management has a choice of financial reporting frameworks, AR-C 90 requires that the review report make reference to management’s responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.
TIS Section 1400, Consolidated Financial Statements Combining Financial Statements Prepared in Accordance With the Income Tax-Basis of Accounting

In July 2010, the AICPA issued a Technical Practice Aid (TPA) that, although applying to audit engagements, has a parallel effect on compilation and review engagements on income tax-basis financial statements.

The TPA was issued under the previous income tax basis guidance found in AU section 623, Special Reports. Effective 2012, AU-C 800, Special Considerations- Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks, supersedes AU section 623. Although AU 623 no longer exists, the application of the TPA still applies to the new AU-C 800, and to financial statements issued in compilation and review engagements.

Inquiry—Paragraph .04 of AU section 623, (SAS No. 62) Special Reports (AICPA, Professional Standards, vol. 1) (superseded by AU-C 800), provides as an example of an other comprehensive basis of accounting (OCBOA) “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.” In the case of brother-sister corporations in which each entity maintains its books and records on the basis of accounting used, or expected to be used, to file each entity’s income tax return, may an auditor report on combining financial statements in accordance with the income tax-basis of accounting even though a combined income tax return is not filed?

Reply—Nothing in AU section 623 (SAS No. 62) (as superseded by AU-C 800) prohibits or precludes an auditor from reporting on a combining presentation as long as the basis of accounting for each of the entities presented is the basis that they use, or expect to use, to file their income tax returns. In many instances, combining financial statements of brother-sister companies is more useful to users than the individual uncombined financial statements. As with all tax basis presentations, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

Observation: The author believes that an accountant should follow the same conclusion made for the above noted TPA for a compilation or review engagement. Specifically, if an accountant performs a

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35 When a special purpose framework report is issued, the review report must include an emphasis-of-matter paragraph labeled “Basis of Accounting” or a similar title.

36 TIS Section 1400 was issued in 2010 at which time SAS No. 62 was in effect. Starting in 2012, SAS No. 62 was replaced by AU-C 800.
compilation or review engagement involving combined financial statements of related entities that do not file a combined tax return, the accountant is permitted to issue that report under the tax-basis of accounting. Even though a combined tax return is not filed with the IRS, the accountant is permitted to report on a tax basis combined financial statement as long as the financial statements of the individual entities are on the same basis used to file each entity’s federal income tax return.

K. Miscellaneous Practice Issues

1. An accountant’s name that is included in a written document or communication containing unaudited financial statements

There may be instances in which an accountant’s name may be included in a document or written communication that also contains client-prepared financial statements of a nonpublic entity.

Example: A client prepared a financial package to be submitted to a bank or other third party. The package included various legal and financial documents including tax returns, client-prepared cash flows, and client-prepared financial statements that have not been audited, review, compiled or prepared by the accountant. The client also includes the accountant’s name and address in the package as a contact person.

**What is the accountant’s responsibility for reporting on such information under SSARS No. 21?**

Response: Prior to the issuance of SSARS No. 21, the SSARSs had guidance to address this situation. In fact, SSARS No. 19 had carried over previous guidance that stated that an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements unless the accountant had either compiled or reviewed the financial statements, or the financial statements were accompanied by an indication that the accountant had not compiled or reviewed the financial statements and assumed no responsibility for them.

Things changed with the issuance of SSARS No. 21 in that the new SSARS eliminated all previously issued SSARSs and related interpretations thereby leaving no guidance as to how to handle the example.

Moreover, SSARS No. 21 profoundly differs from SSARS No. 19 in that it requires the performance of a preparation of financial statements, compilation or review engagement only if the accountant is actually engaged (hired) to perform such a service. Thus, an accountant cannot be forced to perform a SSARS engagement regardless of the circumstances.

In the example noted above, the accountant has not been engaged (hired) to perform a preparation, compilation or review engagement on the financial statements found in the financial package. Consequently, the reporting requirements of SSARS No. 21 do not apply and no report is required. That means the accountant has no requirement to do anything with respect to his or her name being included in the package that includes the client-prepared financial statements.

Because the accountant is not subject to the rules of SSARS No. 21, the accountant can essentially take whatever action he or she deems necessary in the circumstances which might include:
a. Do nothing and allow the financial package to be issued with the accountant’s contact information included in it.

b. Include an indication statement before the financial statements that might be worded as follows:

   The accompanying balance sheet of X Company as of December 31, 20X1, the related statements of income, and cash flows for the year then ended were not audited, reviewed, compiled or prepared by us and, accordingly, we do not express an opinion or any other form of assurance on them.

c. Ask the client to remove the accountant’s name from the financial package.

Note: The language found in item (b) above was previously found in SSARS No. 19, as modified by the author. The author believes that inclusion of such language may be prudent to avoid any misconception as to the accountant’s degree of responsibility with respect to the financial statements included in the financial package. If the indication statement is included in the package, the author suggests it be placed immediately before the financial statements similar to the placement of other reports.

Item (c.) above offers the accountant another option. If the accountant becomes aware that his or her name is being used improperly in a client-prepared document containing unaudited financial statements, the accountant may wish to advise the client that the use of his or her name is inappropriate and should consider taking other actions, including consulting with his or her attorney.

2. Reporting responsibility related to the statements of retained earnings and comprehensive income

Retained earnings:

There is confusion in practice as to whether the change in retained earnings must be presented in the financial statements or related notes; moreover, if presented, whether the report must reference the statement.

A statement of retained earnings is not required by GAAP. However, ASC 310, Receivables (formerly found in APB No. 12), requires that all changes in capital must be disclosed. The change can be presented in one of three ways:

a. Separate statement of retained earnings

b. Combination statement of income and retained earnings

c. Disclosure of the change in the notes to financial statements

In terms of dealing with a statement of retained earnings, the following rules should be applied in a compilation or review engagement:

a. A statement of retained earnings is not a required statement, and
b. If a statement of retained earnings is not presented, reference to the statement is not required in the compilation and review report.

c. If the change is presented in statement form either as a separate statement or as the statement of income and retained earnings, the statement should be referenced in the compilation or review report.

d. If the change in retained earnings is not presented in statement form, ASC 310 still requires that the change be disclosed in the notes, in which case, there is still no need to reference the statement of retained earnings in the compilation or review report.

Observation: Although disclosing the change in retained earnings (either in statement or footnote format) is useful to the reader, there are instances in practice where not presenting the change may be useful. Assume for example, that a compilation report is issued whereby substantially all disclosures are omitted. The accountant may wish to merely issue a compilation report, balance sheet and statement of income all of which are generated from a standard format such as QuickBooks®. The program may not present the change in retained earnings on the statement of income, thus requiring the accountant to export the data and customize it. In such a case, the accountant may wish to not present the change in retained earnings on the statement of income. If so, no reference to retained earnings needs to be made in the compilation report. Note, however, that in a review engagement, disclosure of the change in retained earnings (in financial statement or footnote format) is required and, not to do so results in a GAAP departure.

What if the accountant issues a compilation report in which management omits substantially all disclosures required by GAAP? Is the accountant required to present the change in retained earnings in the financial statements?

No. ASC 310, Receivables (formerly found in APB No. 12) requires that the “change in capital” be disclosed. If management elects to omit substantially all disclosures, presumably one of those disclosures is the change in capital (retained earnings). Absent the footnotes, the accountant is not required to present the change in financial statement form such as a separate statement of retained earnings or a statement of income and retained earnings.

Should the change in retained earnings be disclosed if tax-basis financial statements are presented?

Yes. SSARS No. 21 states that if tax-basis financial statements are presented, all “informative disclosures similar to those required by GAAP.” Therefore, with tax-basis financial statements, the change in capital (retained earnings) must be either disclosed in the notes or presented in financial statement format. However, if in using tax-basis financial statements, management elects to omit substantially all disclosures ordinarily included in tax-basis financial statements, one of the disclosures omitted would be the change in capital (retained earnings). Thus, presenting the change in retained earnings either in the notes or in the financial statements would not be required.

Following are three sample reports that illustrate the application of the requirements with respect to the change in retained earnings.

Example 1: XYZ Corporation discloses the change in retained earnings in the form of a statement of income and retained earnings.
**Conclusion:** Because the change in retained earnings is presented in a statement form, it should be presented in the compilation report.

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**Sample Compilation Report-SSARS No. 21**

**Change in Retained Earnings Presented in a Statement Form**

Management is responsible for the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related **statements of income and retained earnings**, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

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**Example 2:** XYZ Corporation discloses the change in retained earnings in the form of a footnote.

**Conclusion:** Because the change in retained earnings is presented in a footnote, and not in a statement form, there is no requirement to mention it in the report.

---

**Sample Compilation Report-SSARS No. 21**

**Change in Retained Earnings Presented in the Notes to Financial Statements**

Management is responsible for the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related **statements of income**, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

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**Example 3:** The accountant for XYZ Corporation issues a compilation report in which management elects to omit substantially all disclosures and the statement of cash flows, and **does not** disclose the change in retained earnings in a footnote or financial statement format.
Conclusion: ASC 310 requires that the change in capital (retained earnings) be disclosed either in statement form or in the notes to financial statements. But, because management has elected to omit substantially all disclosures, one of those missing disclosures can be the change in retained earnings. Thus, there is no disclosure of the change in retained earnings either in statement or footnote form and no reference to the change anywhere in the compilation report.

Sample Compilation Report- Change in Retained Earnings is Not Presented in a Report or in the Notes to Financial Statements

Management is responsible for the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3
Example 4: XYZ Corporation discloses the change in retained earnings in the form of a footnote. A review report is issued.

Conclusion: Because the change in retained earnings is presented in a footnote, and not in a statement form, there is no requirement to mention it in the report.

<table>
<thead>
<tr>
<th>Sample Review Report- Change in Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presented in the Notes to Financial Statements</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Independent Accountant’s Review Report</th>
</tr>
</thead>
</table>

Board of Directors  
XYZ Corporation  
Nowhere, Massachusetts  

I (we) have reviewed the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements  
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility  
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion  
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company  
Burlington, Massachusetts  
March 31, 20X3
**Example 5:** XYZ Corporation does not disclose the change in retained earnings in the form of a footnote or in a statement form. A review report is issued.

**Conclusion:** Because the change in retained earnings is not presented in a footnote or statement form, and a review report is being issued, there is a GAAP violation of ASC 310. Thus, a report modification should be presented as noted in bold below.

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**Sample Review Report-Change in Retained Earnings is Not Presented in the Report or in the Notes to Financial Statements- GAAP Departure**

**Independent Accountant’s Review Report**

Board of Directors
XYZ Corporation
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

**Management’s Responsibility for the Financial Statements**
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

**Accountant’s Responsibility**
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

**Accountant’s Conclusion**
Based on my (our) reviews, except for the issue noted in the Known Departure From Accounting Principles Generally Accepted in the United States of America paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

**Known Departure From Accounting Principles Generally Accepted in the United States of America**
As disclosed in note X to these financial statements, accounting principles generally accepted in the United States require that the change in retained earnings be disclosed in the financial statements. The Company did not disclose the change in retained earnings in the accompanying financial statements.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3
**Comprehensive income:**

ASC 220, *Comprehensive Income* (formerly FASB No. 130), requires a company to present all components of comprehensive income in a financial statement format if a full set of financial statements is presented.

a. The definition of comprehensive income is stated as follows:

\[
\text{Net income} \quad \text{xx} \\
+ \quad \text{Other comprehensive income items:} \\
\text{[separately presented based on their nature]} \\
\begin{align*}
\text{Foreign exchange gains and losses} & \quad \text{xx} \\
\text{Unrealized gains and losses on} \\
\text{securities available for sale} & \quad \text{xx} \\
\text{Loss on excess of pension liability over} \\
\text{unrecognized prior service cost} & \quad \text{xx} \\
\text{Unrealized gains and losses arising from} \\
\text{certain derivative transactions} & \quad \text{xx}
\end{align*}
\]

\[
= \quad \text{TOTAL COMPREHENSIVE INCOME} \quad \text{xx}
\]

b. The formula includes *four components* of other comprehensive income: foreign exchange gains and losses; unrealized gains/losses on securities available for sale; the loss on excess pension liability; and changes in the market value of futures contracts.

c. ASC 220 (formerly FASB No. 130) requires that comprehensive income be presented in a financial statement format.

In 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, an amendment of ASC 220. In the ASU, the FASB eliminates the option to present comprehensive income as a section within the statement of stockholders’ equity (Option 3 above). Thus, starting in 2012, an entity is permitted to use only one of two formats to present comprehensive income as follows:

An entity with other comprehensive income items must report comprehensive income either in:

1. One single continuous statement of income and comprehensive income:
2. Two separate, but consecutive financial statements consisting of:
   - Statement of income, followed by a
   - Statement of comprehensive income

The following are two examples of financial statements:
FORMAT 1: ONE SINGLE CONTINUOUS STATEMENT APPROACH

[Combined Statement of Income and Comprehensive Income]

XYZ Corporation
Statement of Income and Comprehensive Income
For The Year Ended December 31, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>800,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>200,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>80,000</td>
</tr>
<tr>
<td>Net income</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Other comprehensive income:37

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized gain on securities available for sale (net of tax of $20,000)</td>
<td>30,000</td>
</tr>
<tr>
<td>Foreign currency translation adjustments (net of tax of $16,000)</td>
<td>24,000</td>
</tr>
<tr>
<td>Total other comprehensive income</td>
<td>54,000</td>
</tr>
</tbody>
</table>

Comprehensive income                                              $174,000

37 Alternatively, the tax effect of other comprehensive income could be presented as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized gain</td>
<td>$50,000</td>
</tr>
<tr>
<td>Foreign currency adjustments</td>
<td>40,000</td>
</tr>
<tr>
<td>Other comprehensive income, before taxes</td>
<td>90,000</td>
</tr>
<tr>
<td>Income tax expense allocated</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>$54,000</td>
</tr>
</tbody>
</table>
FORMAT 2: TWO-STATEMENT APPROACH

[Two separate but consecutive financial statements]

- Statement of income, followed by a
- Statement of Comprehensive Income

---

**Separate Statement of Income**

**XYZ Corporation**  
**Statement of Income**  
**For The Year Ended December 31, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>800,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>200,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>80,000</td>
</tr>
<tr>
<td>Net income</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Retained earnings:
- Beginning of year                    | 2,000,000 |
- End of year                          | $2,120,000 |

---

**Separate Statement of Comprehensive Income**

**XYZ Corporation**  
**Statement of Comprehensive Income**  
**For The Year Ended December 31, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$120,000</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Unrealized gain on securities available for sale (net of tax of $20,000)</td>
<td>30,000</td>
</tr>
<tr>
<td>Foreign currency translation adjustments (net of tax of $16,000)</td>
<td>24,000</td>
</tr>
<tr>
<td>Total other comprehensive income</td>
<td>54,000</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$174,000</td>
</tr>
</tbody>
</table>
Note: If Format 1 or 2 above is selected, the title of the financial statement is changed to either *Statement of Comprehensive Income* or *Statement of Income and Comprehensive Income*.

For most companies, unrealized gains and losses on securities available for sale is the most likely other comprehensive income item. ASC 320 (formerly FASB No. 115) requires that unrealized gains and losses on securities available for sale must be presented in stockholders’ equity as a separate component of other comprehensive income, net of the tax effect. The cumulative unrealized gains or losses are presented under the caption, “accumulated other comprehensive income.”

If a company does not have any of the four components of other comprehensive income, ASC 220 (formerly FASB No. 130) does not apply and a presentation of comprehensive income is not required.

SSARS No. 21 states that if the statement of comprehensive income is presented, that statement should be separately identified in the introductory paragraph in the report.

Thus, if a statement of comprehensive income is required, the compilation and review reports should be modified to include reference to the statement as follows.

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**Example: Compilation Report- Statement of Comprehensive Income Presented**

Management is responsible for the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, **comprehensive income**, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

James J. Fox & Company  
Burlington, Massachusetts  
March 31, 20X3
Example: Review Report-
Statement of Comprehensive Income Presented

Independent Accountant’s Review Report

Board of Directors
XYZ Corporation
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, comprehensive income, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3
Omission of the Display of Comprehensive Income in Compiled Financial Statements

ASC 220 (formerly FASB No. 130) has a special rule as follows:

a. If a full set of financial statements is not presented, a statement of comprehensive income does not have to be displayed in a financial statement format even though the company has one of the four components of other comprehensive income.

How does this special rule impact the language found in the compilation report that states the company has elected to omit substantially all disclosures and the statement of cash flows?

The statement of comprehensive income is not required unless a full set of financial statements is presented. If management elects to omit the statement of cash flows in a compilation engagement, a full set of financial statements is not present and the statement of comprehensive income is not required.

Prior to the issuance of SSARS No. 21, the ARSC issued Interpretation No. 10 of AR Section 80 of SSARS No. 19: Omission of the Display of Comprehensive Income in Compiled Financial Statements, which deals with the reporting requirements for a compilation engagement in which a statement of comprehensive income is omitted.

Although SSARS No. 21 supersedes Interpretation No. 10, the author believes its application is still relevant and recommends that practitioners follow its guidance until the ARSC issues a replacement interpretation.

Question: When an element of other comprehensive income is present, can the display of comprehensive income be omitted when issuing a compilation report that omits substantially all disclosures required by accounting principles generally accepted in the United States of America?

Response: Yes. ASC 220, Comprehensive Income (formerly FASB No. 130), requires the display of comprehensive income when a full set of financial statements is presented in conformity with accounting principles generally accepted in the United States of America. However, the display of comprehensive income may be omitted by identifying the omission in the compilation report or, if the engagement is to compile financial statements that are not expected to be used by a third party and the accountant does not report on those financial statements, in the engagement letter. The following is suggested modified wording (shown in italic) to the paragraph in the compilation report:

Management has elected to omit substantially all the disclosures, the statement of cash flows, and the display of comprehensive income required by accounting principles generally accepted in the United States of America. If the omitted disclosures, the statement of cash flows, and the display of comprehensive income were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

In addition, if the accountant compiles financial statements that omit substantially all disclosures and the display of comprehensive income but includes the statement of cash flows, the following is suggested modified wording (shown in italic) to the compilation report:
Management has elected to omit substantially all the disclosures and the display of comprehensive income required by accounting principles generally accepted in the United States of America. If the omitted disclosures and the display of comprehensive income were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

If the accountant compiles financial statements that include substantially all disclosures required by GAAP, but omits the display of comprehensive income, the omission is a departure from GAAP.

Additionally, if an element of other comprehensive income has not been computed, for example, unrealized gains and losses arising from investments in marketable securities classified as “available for sale,” then the accountant should consider a departure from generally accepted accounting principles and follow that guidance.

3. Miscellaneous reporting issues

Dates of reports:

SSARS No. 21 provides the following requirements for determining the date of a compilation or review report:

a. **In a compilation engagement:** The date of the compilation report is the date the accountant has completed the (compilation) procedures required.

b. **In a review engagement:** The date of the review report should be dated no earlier than the date on which the accountant completed procedures sufficient to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with GAAP or the applicable financial reporting framework.

That means the review report is dated no earlier than the date on which there is evidence that:

- all the financial statements, including the related notes, have been prepared, and
- management has taken responsibility for those financial statements as evidenced by the signing of the management representation letter.

**Note:** Because the accountant’s conclusion is provided on the financial statements, and the financial statements are the responsibility of management, the accountant is not in a position to conclude that the accountant has obtained limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with GAAP or the applicable financial reporting framework, until evidence is obtained that all the statements that the financial statements comprise, including the related notes, have been prepared, and management has accepted responsibility for them. Management accepts responsibility for the financial statements by signing the representation letter.
**Must the accountant’s report be printed on the firm’s letterhead?**

No. The SSARSs do not require the accountant’s report to be printed on the firm’s letterhead. However, letterhead does add a level of formality to the presentation. SSARS No. 21 does, however, require the accountant’s city/town and state where he or she practices be presented on the report page. The city/town and state may be indicated on letterhead that contains the issuing office’s city/town and state.

**To whom should the accountant’s report be addressed?**

It depends on the type of engagement.

a. In a compilation report, SSARS No. 21 removes the requirement that the compilation report have an addressee at all, although the accountant may choose to include an addressee.

b. In a review report, SSARS No. 21 does require an addressee “as appropriate for the circumstances of the engagement.”

Typically, the accountant’s review report is addressed to those for whom the report is prepared such as:

- the entity whose financial statements are being reviewed, or
- those charged with governance.

**Note:** A report on financial statements of an unincorporated entity may be addressed as circumstances dictate (for example, to the partners, general partner, or proprietor). Occasionally, an accountant may be retained to review the financial statements of an entity that is not a client; in such a case, the report may be addressed to the entity and not to those charged with governance of the entity whose financial statements are being reviewed.

**Who should sign the report?**

SSARS No. 21 states that the signature of the accountant is required, either in a manual or printed (stamped, electronic, digital or typed) form. If there is a firm, the firm’s signature rather than the individual’s signature should accompany the report.

**4. Supplementary information reporting**

a. **General**

One recurring error detected in peer reviews is the mishandling of the reporting on supplementary information. As a result, the author believes it is important to identify the rules associated with presenting supplementary information and the reporting thereon as it relates to compilation and review engagements.

The rules for dealing with supplementary information in compilation and review engagements are found in SSARS No. 21.
The following chart summarizes the options for reporting on supplementary information for both compilation and review engagements:

<table>
<thead>
<tr>
<th>Reporting Options- Supplementary Information</th>
<th>Compilation Engagement</th>
<th>Review Engagement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review the supplementary information</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Compile the supplementary information</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Disclaim responsibility for the supplementary information: (Do not compile, review or audit the supplementary information)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Reporting on Supplementary Information in a Compilation Engagement**

SSARS No. 21 expands some of the language found in SSARS No. 19 with respect to supplementary information that accompanies a compilation report.

1. If an accountant issues a compilation report on the financial statements, the accountant may report on any supplementary information as follows:

   Option 1: Compile the supplementary information, or

   Option 2: Disclaim the supplementary information

   **Note:** An accountant who compiles the financial statements is *not permitted* to review the supplementary information. The accountant is also not permitted to audit the supplementary information in compiled financial statements.

2. When supplementary information accompanies compiled financial statements and the accountant’s compilation report, the accountant should *clearly indicate the degree of responsibility*, if any, the accountant is taking with respect to such information in either:

   a. An other-matter paragraph in the accountant’s compilation report on the financial statements, or

   b. A separate report on the supplementary information.

**Option 1- Compile the Supplementary Information:** When the accountant has performed a compilation engagement with respect to *both the financial statements and the supplementary information*, the accountant should either:

   a. Include an *other-matter paragraph* in the accountant’s compilation report on the financial statements, or

   b. Issue a *separate report* on the supplementary information,

   Either an other-matter paragraph or a separate report should state the following:
The information is presented for purposes of additional analysis and is not a required part of the financial statements

The information is the representation of management

The accountant performed a compilation engagement in accordance with SSARSs promulgated by the AICPA on information that is the representation of management, and

The accountant has not audited or reviewed the information and, accordingly, does not express an opinion, a conclusion, or provide any form of assurance on such information.

The following is an example of a separate other-matter paragraph in the accountant’s compilation report addressing supplementary information when the accountant has performed a compilation engagement on both the financial statements and the supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

**Option 2- Disclaim the Supplementary Information:** When the accountant has performed a compilation engagement with respect to the financial statements but has not performed a compilation engagement with respect to the supplementary information (disclaimed the supplementary information), the accountant should either:

a. Include an other-matter paragraph in the accountant’s compilation report on the financial statements, or

b. Issue a separate report on the supplementary information

Either an other-matter paragraph or separate report should state the following:

- The information is presented for purposes of additional analysis and is not a required part of the financial statements

- The information is the representation of management, and

- The information was not subject to the compilation engagement and, accordingly, the accountant does not express an opinion, a conclusion, nor, provide any assurance on such information.

The following is an example of how an accountant may word a separate paragraph in the accountant’s compilation report addressing supplementary information when the accountant has performed a compilation engagement on the financial statements but has not performed a compilation on the supplementary information:
The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, or provide any assurance on such information.

3. The accountant may request that management include a reference to the accountant’s compilation report or a separate report on supplementary information, on each page of the supplementary information.

An example of a reference (legend) to the accountant’s compilation report or a separate report on supplementary information, that may be included on each page of the supplementary information is:

"See Accountant’s Report"
"See Accountant’s Compilation Report"
"See Independent Accountant’s Compilation Report"
See Accountant’s Report on Supplementary Information

Observation: SSARS No. 21 makes a significant change to existing SSARS No. 19 by eliminating the requirement that each page of compiled financial statements include a reference (legend) such as "See Accountant’s Compilation Report." Although the inclusion of a legend on each page is no longer required, the author recommends that an accountant include a legend on each page of the financial statements, notes and supplementary information. Interestingly, now that there is no required compilation report title, if a legend such as "See Accountant’s Compilation Report" is included on each page of the compiled financial statements, query how the user knows where the "compilation report" is located if there is no longer a report title to identify a compilation report?

Sample Reports on Supplementary Information- Compilation Engagement

SAMPLES A: Supplementary Information is Reported on As Part of Compilation Report

OPTION 1: Compilation Report- Supplementary Information is Compiled and Included in an Other-Matter Paragraph in the Compilation Report

An accountant is performing a compilation engagement. Management has elected to omit substantially all disclosures and the statement of cash flows.

The financial statements and supplementary information consist of the following:
- Balance sheet and Statement of income and retained earnings
- Schedule of operating expenses (supplementary information)

The accountant compiles the supplementary information (schedule of operating expenses) and reports on it in an other-matter paragraph as part of the compilation report.
Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

OPTION 2: Compilation Report- Supplementary Information is Disclaimed and Included in an Other-Matter Paragraph in the Compilation Report

An accountant is performing a compilation engagement. Management has elected to omit substantially all disclosures and the statement of cash flows.

The financial statements and supplementary information consist of the following:

- Balance sheet and Statement of income and retained earnings
- Schedule of operating expenses (supplementary information)

The accountant disclaims the supplementary information (schedule of operating expenses) and reports on it in an other-matter paragraph as part of the compilation report.

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I
(we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

SAMPLES B: Supplementary Information is Reported on in Separate Report

OPTION 1: Compilation Report- Supplementary Information is Compiled and Included in a Separate Report

An accountant is performing a compilation engagement. Management has elected to omit substantially all disclosures and the statement of cash flows.

The financial statements and supplementary information consist of the following:
- Balance sheet and Statement of income and retained earnings
- Schedule of operating expenses (supplementary information)

The accountant compiles the supplementary information (schedule of operating expenses) and reports on it in a separate report.

Compilation Report on Financial Statements

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by
accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

Separate Report on Compiled Supplementary Information

The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

Note: the separate report on supplementary information above should be positioned on the page immediately before the supplementary information.

OPTION 2: Compilation Report - Supplementary Information is Disclaimed and Included in a Separate Report

An accountant is performing a compilation engagement. Management has elected to omit substantially all disclosures and the statement of cash flows.

The financial statements and supplementary information consist of the following:
- Balance sheet and Statement of income and retained earnings
- Schedule of operating expenses (supplementary information)

The accountant disclaims the supplementary information (schedule of operating expenses) and reports on it in a separate report.

Compilation Report on Financial Statements

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income and retained earnings for the years then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.
Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

Separate Report on Disclaimed Supplementary Information

The schedule of operating expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. The information was not subject to our compilation engagement. I (We) do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

Observation: SSARS No. 21 eliminates the requirement to include an addressee and report title in a compilation report. Thus, the above sample reports have no such addressee or report titles although an accountant may choose to include a title and addressee.

Reporting on Supplementary Information in a Review Engagement

SSARS No. 21 clarifies the general reporting requirements and options pertaining to supplementary information that accompanies reviewed financial statements. Previously, the authority has been found in AR 90.60 as part of SSARS No. 19. That authority was superseded by AR-C 90 of SSARS No. 21.

1. AR-C 90 clarifies the issue of as to how an accountant may report on supplementary information that accompanies reviewed financial statements.

   a. In essence, if an accountant issues a review report on financial statements, he or she may report on supplementary information at any one of three levels:

      • Review the supplementary information
      • Compile the supplementary information, or
      • Disclaim the supplementary information (no opinion)

2. When supplementary information accompanies reviewed financial statements and the accountant’s review report thereon, the accountant should clearly indicate the degree of responsibility, if any, the accountant is taking with respect to such information in either:

   a. an other-matter paragraph in the accountant’s review report on the financial statements, or

   b. a separate report on the supplementary information.
Reviewed supplementary information in a review engagement:

1. When the accountant has *reviewed both the financial statements and the supplementary information*, an other-matter paragraph in the accountant’s review report on the financial statements or the separate report on the supplementary information should state that:

   a. The information is presented for purposes of additional analysis and is not a required part of the financial statements

   b. The information is the representation of management

   c. The accountant has reviewed the information, and, based on the accountant’s review, whether the accountant is aware of any material modifications that should be made to the information in order for it to be in accordance with the applicable financial reporting framework, and

   d. The accountant has not audited the information and, accordingly, does not express an opinion on such information.

   The following is an example of how an accountant may word an other-matter paragraph addressing supplementary information when the accountant has *reviewed both the financial statements and the supplementary information*:

   **Supplementary information reviewed:**

   **Other Matter**
   The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. *I (We) have reviewed the information* and, based on my (our) review, I am (we are) not aware of any material modifications that should be made to the information in order for it to be in accordance with [the applicable financial reporting framework]. *I (We) have not audited the information* and, accordingly, do not express an opinion on such information.

2. When the accountant has *reviewed the financial statements and compiles the supplementary information*, the accountant should report on the compiled supplementary information either an other-matter paragraph in the accountant’s review report on the financial statements, or in a separate report on the supplementary information should state that:

   **Supplementary information compiled:**

   **Other Matter**
   The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. *I (We) have compiled the information* and, it has not been subjected to the inquiry and analytical procedures applied in the review of the basic
financial statements. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion on such information.

3. To minimize the possibility that a user of the information may infer, through the accountant’s association with the information, an unintended level of reliance on the information, the accountant may consider including a reference to the accountant’s review report or the separate report on supplementary information on each page of the information.

An example of a reference to the accountant’s review report or separate report on supplementary information that may be included on each page of the supplementary information is:

“See Independent Accountant’s Review Report”
“See Independent Accountant’s Report on Supplementary Information”

Disclaimer on supplementary information in a review engagement

1. When the accountant has reviewed the financial statements but has not reviewed or compiled the supplementary information, the other-matter paragraph in the accountant’s review report on the financial statements or the separate report on the supplementary information should state that:

a. The information is presented for purposes of additional analysis and is not a required part of the financial statements

b. The information is the representation of management, and

c. The accountant has not audited or reviewed the information and, accordingly, does not express an opinion, a conclusion, or provide any assurance on such information.

The following is an example of how an accountant may word an other-matter paragraph addressing supplementary information when the accountant has reviewed the financial statements but has not reviewed the supplementary information:

Disclaimer on supplementary information:

Other Matter
The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have not audited, reviewed [or compiled] such information and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

Note: In the sample other-matter paragraph found in paragraph A130 of AR-C 90, the language states that "we have not audited or reviewed such information." There is no mention about not compiling the information. The author believes that the insertion of "compiled" is appropriate and has included it in brackets above.

Option 1: Review Engagement: Supplementary Information is Reviewed

Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Other Matter
The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have reviewed the information and, based on my (our) review, I am (we are) not aware of any material modifications that should be made to the information in order for it to be in accordance with [the applicable financial reporting framework]. I (We) have not audited the information and, accordingly, do not express an opinion on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

Option 2: Review Engagement: Supplementary Information is Compiled

Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Other Matter
The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have compiled the information and, it has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3
**Sample A: Report on the Supplementary Information That Is Reported on As Part of the Review Report on the Financial Statements**

**Option 3: Review Engagement: Supplementary Information is Disclaimed**

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**Independent Accountant’s Review Report**

Board of Directors  
XYZ Company  
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

**Management’s Responsibility for the Financial Statements**

Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

**Accountant’s Responsibility**

My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

**Accountant’s Conclusion**

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

**Other Matter**

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have not audited, reviewed [or compiled] such information and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

James J. Fox & Company  
Burlington, Massachusetts  
March 31, 20X3
Sample B: Report on the Supplementary Information in a Report That is Separate from the Review Report on the Financial Statements

Option 1: Review Engagement: Supplementary Information is Reviewed

Review Report on Financial Statements

<table>
<thead>
<tr>
<th>Independent Accountant’s Review Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Directors</td>
</tr>
<tr>
<td>XYZ Company</td>
</tr>
<tr>
<td>Nowhere, Massachusetts</td>
</tr>
</tbody>
</table>

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3
A separate report on reviewed supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have reviewed the information and, based on my (our) review, I am (we are) not aware of any material modifications that should be made to the information in order for it to be in accordance with [the applicable financial reporting framework]. I (We) have not audited the information and, accordingly, do not express an opinion on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

A separate report on compiled supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have compiled the information and, it has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

A separate report on disclaimed supplementary information:

The schedule of operating expenses [or other identified supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have not audited, reviewed [or compiled] such information and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

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38 To be shown in the page immediately before supplementary information.
Saving time by disclaiming supplementary information in a review engagement

Too many practitioners are in the habit of reviewing supplementary information in a review engagement. By doing so, the practitioners must perform review procedures (analytical procedures and inquiry) on the supplementary information, including the detailed line items found within that supplementary information.

If, instead, the accountant disclaims the supplementary information while reviewing the financial statements, the accountant has no responsibility to perform review procedures on the individual line items and detail of the supplementary information. Instead, the accountant is only responsible for performing review procedures (analytical procedures and inquiry) on the totals or subtotals of the supplementary information that are found in the reviewed financial statements.

**Example:** An accountant is reviewing financial statements that include the following supplementary information that is presented in separate schedules:

- Schedule of cost of goods sold
- Schedule of selling expenses
- Schedule of general and administrative expenses

The accountant decides to review the schedules as part of his or her overall review engagement on the financial statements.

**Conclusion:** The accountant must perform review procedures on the schedules including performing analytical procedures on the individual line items of each schedule.

**Change the facts:** The accountant decides to disclaim the supplementary schedules while reviewing the financial statements.

**Conclusion:** Because a disclaimer report is issued on the supplementary schedules, the accountant has no responsibility for the schedules. Moreover, certainly, the accountant is not responsible for performing analytical procedures on the individual line items in each schedule. Thus, the accountant is not responsible for performing any analytical procedures or other procedures on the individual line items within the schedules.

In terms of performing review procedures on the supplementary information, the accountant is performing her review engagement on the financial statements, not the supplementary information. Thus, she is only responsible for performing review procedures (analytical procedures and inquiry) on the totals and subtotals of the supplementary information that are presented on the statement of income, and not the individual line items found within the schedules.

Therefore, in performing her review engagement on the financial statements, she would perform analytical procedures on the total costs of goods sold, total selling expenses, and total general and administrative expenses, as presented on the statement of income.

**Is an accountant permitted to compile supplementary information if that information is presented directly on the reviewed financial statements?**
Yes. An accountant may choose to provide detailed information directly on the financial statements, but the accountant does not wish to take responsibility for that information.

Examples include:

- Providing a detailed listing of all operating expenses on the statement of income
- Providing expired budgeted information side by side with the historical statement of income.

If the accountant includes detailed information on the financial statements and wishes to compile that information, instead of reviewing it, the accountant is permitted to do so. In such a case, the accountant should include reference the supplementary information in the review report instead of providing a separate report on supplementary information.

**Example:** Mary Jones, CPA reviews the financial statements of XYZ Company for the year ended December 31, 20X2. Mary *compiles the supplementary information of operating expenses*. Instead of presenting the operating expenses in a separate schedule of operating expenses, Mary decides to present the detail directly on the statement of income as follows:
**XYZ Company**  
Statement of Income  
For the Year Ended December 31, 20X2

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>70,000</td>
</tr>
<tr>
<td>Workers compensation insurance</td>
<td>30,000</td>
</tr>
<tr>
<td>Health insurance</td>
<td>50,000</td>
</tr>
<tr>
<td>Office expenses</td>
<td>10,000</td>
</tr>
<tr>
<td>Insurance- general</td>
<td>40,000</td>
</tr>
<tr>
<td>Rent and utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>20,000</td>
</tr>
<tr>
<td>Commissions</td>
<td>300,000</td>
</tr>
<tr>
<td>Advertising</td>
<td>70,000</td>
</tr>
<tr>
<td>Shipping expenses</td>
<td>200,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>30,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>2,200,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>800,000</td>
</tr>
<tr>
<td>Other income</td>
<td>100,000</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td>900,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$800,000</td>
</tr>
</tbody>
</table>

**Note:** Bold items represent detailed operating expenses that are compiled, not subject to the review engagement.
Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Other Matter
The detailed operating expense information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have compiled the information and, it has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion on such information.

James J. Fox & Company
Burlington, Massachusetts

March 31, 20X3
Note: Because Mary is compiling the detailed operating expenses information, Mary is not responsible for performing review procedures on the individual line items. Instead, Mary is responsible for performing review procedures on the total operating expenses ($2,200,000) that would include analytical procedures comparing the total operating expenses of $2,200,000 with an expected total.

b. What is supplementary information?

SSARS No. 21 defines supplementary information as:

“Financial information presented outside the financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.”

Although SSARS No. 21 does not expand upon the above definition, auditing standards do, in fact, offer additional guidance that can be used in compilation and review engagements.

Specifically, AU-C 725, Supplementary Information in Relation to the Financial Statements as a Whole (formerly SAS No. 119), paragraphs A7 and A8, offer the following:

“Supplementary information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.”

“Supplementary information may be prepared in accordance with an applicable financial reporting framework, by regulatory or contractual requirements, in accordance with management's criteria, or in accordance with other requirements.”

As a general rule, practitioners should consider supplementary information to include:

- Attached schedules that relate to line items on the financial statements including:
  - Operating expense schedule(s)
  - Schedule of cost of sales
  - Schedule of selling and G&A expenses
  - Details of marketable securities
  - Schedule of property and equipment
  - Aging analysis of accounts receivable
  - Detailed analysis of sales by product line, territory, or salesperson

- Modifications to basic financial statements:
  
  Example: Expired budgeted financial information presented alongside historic income statement

- Graphs and charts of the information presented on the financial statements (e.g., pie charts, etc.)
• Schedule of financial data for individual companies within a consolidated group
• Condensed financial statements for previous years
• Statistical data including division analyses
• Detailed analysis of inventories and accounts receivable
• Supplementary information related to specialized industries (e.g., common interest realty association supplementary information)
• Other material, some of which may be from sources outside the accounting system or outside the entity
• Detailed analysis of companies included in consolidated financial statements along with the eliminating entries

Are percentages that accompany an income statement considered supplementary information?

Although statistical data is usually considered supplementary information, most practitioners do not treat financial statement percentages as supplementary information. For example, an income statement may present percentages in a separate column. Generally, this information would not be considered supplementary information and the author believes there is no additional reporting requirement in connection with this information.

Are charts and graphs considered supplementary information?

Today’s software makes it easy to generate graphs and to include them in financial statement presentations. As a result, many CPAs continue to inquire about their reporting responsibility for graphs that accompany financial statements in compilation and review engagements.

Graphs may depict information:

• **Identified in the financial statements** such as a pie chart depicting various components of sales, cost of sales and operating expenses.

• **Derived from the accounting records** such as a bar graph depicting sales by product line.

• **Derived from sources outside the financial statements and accounting records**: Example: a pie chart depicts square feet of selling space by product line.

Presently, SSARS No. 21 does not address the reporting on graphs accompanying financial statements although the term “financial information” should include such graphs. Further, AU-C 725 does reference that supplementary information includes “statistical data.”

Absent authority, an accountant may wish to consider the graphs and charts as supplementary information and report on them as such.
**Procedures for reviewing or compiling supplementary information**

Although SSARS No. 21 does not identify procedures to follow in compiling or reviewing supplementary information, it would appear that an accountant should follow the *same procedures* that are utilized to compile or review the underlying financial statements. That assumes the accountant is compiling or reviewing the supplementary information and not disclaiming it.

Although not binding, it may be prudent that supplementary information in the form of graphs and charts be compiled regardless of whether the underlying financial statements are compiled or reviewed. By doing so, the accountant takes a more practical and conservative approach given the absence of authoritative standards and criteria for these presentations.

Examples of procedures that might be employed to compile supplementary information charts and graphs include:

- Reading the title, captions, and numerical information included in the graph to determine whether that information agrees with the information presented in the financial statements.

- Considering whether the graph's pictorial representation agrees with the quantities and relationships it purports to represent.

**Example of a misrepresentation of a graph:** Comparative financial statements might indicate that the increase in net income from 20X1 to 20X2 is ten percent, and the captions in the accompanying bar graph might accurately identify the amount of net income in each year consistent with the income statement. However, the graph is drawn so that the increase in the height of the bar is significantly greater than ten percent.

**Conclusion:** If an accountant concludes that there is a material inconsistency between the graph and the financial statements, the accountant should determine whether the financial statements, the graph, or both require revision, and, if appropriate, should ask the client to revise the incorrect or misleading information. If the information is not revised to eliminate the problem, the accountant should consider revising the report to describe the inconsistency or misleading information, or should consider withdrawing from the engagement.

**c. How to present supplementary information**

There is no authority on how supplementary information should be presented. However, the author recommends that the pages of supplementary information be easily identified versus the financial statement pages. In order to do so, the author suggests the following is good form:

**Page Legend:** Make sure each page of supplementary information makes reference to the accountant's report.39

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39 There is no requirement within SSARS No. 21 that a legend referencing the accountant’s report be included in the pages of supplementary information. The author recommends that an accountant ensure that such a legend be included on each page even though not required.
<table>
<thead>
<tr>
<th>Condition</th>
<th>Recommended Legend on Each Page of the Supplementary Information&lt;sup&gt;40&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplementary information is included in the primary report on financial statements</td>
<td>See Accountant’s Compilation Report, or See Independent Accountant’s Review Report</td>
</tr>
<tr>
<td>Supplementary information is presented in a separate report</td>
<td>Disclaim supplementary information: See Accountant’s Report on Supplementary Information, or Compiled supplementary information: See Accountant’s Report on Supplementary Information, or See Accountant’s Compilation Report on Supplementary Information Reviewed supplementary information: See Independent Accountant’s Review Report on Supplementary Information</td>
</tr>
</tbody>
</table>

**Titles on pages of supplementary information:** Although not authoritative, titles should be selected that ensure that the reader clearly differentiates the supplementary information from the primary financial statements.

**Examples:**

**ABC Company**
**Schedule of Operating Expenses**
**For the Year Ended December 31, 20X1**
*(See Accountant's Compilation Report on Supplementary Information)*<sup>41</sup> or

**ABC Company**
**Supplementary Analysis of Operating Expenses**
**For the Year Ended December 31, 20X1**
*(See Independent Accountant's Review Report on Supplementary Information)*<sup>42</sup>

In addition to the above legends and titles, some practitioners include a separate introductory title page for supplementary information that follows the notes to financial statements. The author does not

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<sup>40</sup> Effective for 2015, SSAR No. 21 eliminates the requirement to include a legend on each page of the financial statements including supplementary information. Such an inclusion is now elective.

<sup>41</sup> A legend is not required in SSARS No. 21 but is highly recommended by the author.

<sup>42</sup> A legend is not required by SSARS No. 21 but is highly recommended by the author.
believe this is necessary provided that the reader can differentiate between the financial statements and supplementary information.

d. Reporting on budgets presented alongside historic statements

An accountant may be asked to present financial statements for the fiscal year along with budgeted financial statements on a comparative basis.

Example: Actual financial statements for the year ended June 30, 20X1 are presented with the budget for the year ended June 30, 20X1.

If an accountant is engaged to report on such a presentation, the budgeted information for the expired period should be treated as supplementary information.\(^4^3\)

That means that the accountant must identify the degree of responsibility for the supplementary information in his or her report.

Note: Although the budgeted information was once prospective information, it is no longer prospective information once the period has expired.

Sample Report: Compiled Financial Statements Are Accompanied by a Budgeted Income Statement for an Expired Period

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX and the related statement of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

The supplementary budget information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X3

\(^{43}\) Guidance on this treatment was previously found in par 2.53 of SSARS No. 19. That guidance is not addressed in SSARS No. 21 even though the general concept, that the expired budgeted information is treated as supplementary information, still prevails.
# Sample Statement of Income: Actual and Expired Budgeted Income Statement

<table>
<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Budgeted</th>
<th>Variance Over (Under) Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$500,000</td>
<td>$666,000</td>
<td>$166,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>340,000</td>
<td>440,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>160,000</td>
<td>226,000</td>
<td>-66,000</td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td>90,000</td>
<td>166,000</td>
<td>76,000</td>
</tr>
<tr>
<td>Net operating income</td>
<td>70,000</td>
<td>60,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Other income, net</td>
<td>10,000</td>
<td>8,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>80,000</td>
<td>68,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>32,000</td>
<td>36,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Net income</td>
<td>48,000</td>
<td>32,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>128,000</td>
<td>128,000</td>
<td>0</td>
</tr>
<tr>
<td>End of year</td>
<td>$176,000</td>
<td>$160,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

**Observation:** If notes are included for the historical (actual) financial statements, there is no need to include any information on the budgeted financial information. Meaning, the summary of significant assumptions and policies typically required for budget information in SSAE No. 10, would not be included because they apply only to prospective financial statements. Once the prospective period expires, the information is no longer prospective and, instead, is supplementary information just like any other supplementary information (e.g., schedule of operating expenses, etc.).

The information on the income statement should be labeled “budgeted” and “actual” or other labels that differentiate the supplementary information from the actual information. Moreover, the term “actual” is suggested by the author; however, some commentators suggest that the label “historical” be used in lieu of “actual.” The author suggests that the reader choose any label that clearly differentiates the budgeted information from the historical/actual information.
Prospective information presented for an unexpired period

If an accountant is asked to report on prospective financial information for an unexpired period, SSAE No. 10, Attestation Standards, would apply. The unexpired budgeted information is not supplementary information because it has not yet expired.

However, if budgeted financial information for an unexpired period is presented along with historical financial statements, there is a special provision found in the AICPA Audit and Accounting Guide entitled, Prospective Financial Information. The provision applies to compilation reports but not review reports.44

1. Under this provision:
   - The accountant may report on the historical statements under SSARS No. 21, and
   - Disclaim on the prospective budgeted financial information.

2. The accountant is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:
   a. Is labeled as budgeted,
   b. Does not extend beyond the current fiscal year, and
   c. Is presented with interim historical financial statements for the current year.

3. If the above criteria are met, the accountant is not required to:
   a. Apply procedures to the prospective budgeted financial information, even if the information is intended for third parties.
   b. Disclose significant assumptions or accounting policies that would ordinarily be required for prospective budgeted information, provided the omission of this information is not, to the accountant's knowledge, undertaken with the intention of misleading those who might use it.

4. The accountant issues a report indicating that he or she did not compile the budgeted information, and disclaiming an opinion or any other form of assurance on the budget.

Example: Harry Callahan, CPA prepares a twelve-month budget for the year ended December 31, 20X1. After six months, Harry compiles a six-month historical statement for the six-month period ended June 30, 20X1.

Conclusion: Harry may present the six-month June 30, 20X1 interim historical statements along with comparatively presenting the twelve-month unexpired budget for the year ended December 31, 20X1 provided:

As of early 2016, the ARSC has exposed a statement that would move the compilation of prospective financial information from SSAE No. 10 to SSARS No. 21.
The budgeted information is labeled "budgeted."

The budgeted information does not extend beyond the year ended December 31, 20X1, and

The six-month interim statement ended June 30, 20X1 is presented along with the budgeted information.

**Change the facts:** Harry's client requests that the six-month historical statements be presented along with a five-year budget.

**Conclusion:** Because the budgeted information extends beyond the current year, the special disclaimer exception is not available. Consequently, the accountant must comply with the provisions of SSAE No. 10 and compile the budgeted information, and issue a compilation report, along with presenting, at a minimum, a summary of significant forecast assumptions.

**L. Communications Between Predecessor and Successor Accountants**

With respect to audits, SAS No. 122, AU-C Section 510, *Opening Balances-Initial Audit Engagements Including Reaudit Engagements* (formerly SAS No. 84), requires that a successor auditor communicate with a predecessor auditor prior to accepting an audit engagement.

For compilation and review engagements, guidance was previously found in SSARS No. 4, *Communications Between Predecessor and Successor Accountants*. With the issuance of SSARS No. 21, the guidance found in SSARS No. 4 is officially eliminated leaving no authoritative guidance as to how to handle communications between predecessor and successor accountings in a SSARS engagement.

Even though SSARS No. 4 has been superseded, the author believes that the guidance previously found in that SSARS is still valid and should be followed until the ARSC issues new guidance to follow in conjunction with SSARS No. 21.

This section addresses communications between accountants when the successor accountant decides to communicate with the predecessor accountant regarding the acceptance of an engagement.

Unlike an audit engagement, in a compilation or review engagement, a successor accountant is not required to communicate with the predecessor accountant and/or obtain access to working papers of predecessor accountant in accepting a compilation or review engagement. However, nothing prevents an accountant from making a communication and, in certain circumstances, it may be helpful.

The following information previously found in SSARS No. 19 provides additional guidance on the successor-predecessor accountant communication process as follows:

**1. Definitions of predecessor and successor accountant**

*Successor accountant:* An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted the engagement.
**Predecessor accountant:** An accountant who:

- Has reported on the most recent compiled or reviewed financial statements or was engaged to perform, but did not complete, a compilation or review of the financial statements, and

- Has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

2. A successor accountant *is not required* to communicate with a predecessor accountant in connection with acceptance of a compilation or review engagement. But, he or she may believe it is beneficial to obtain information that will assist in determining whether to accept the engagement.

3. The successor accountant may consider making inquiries of the predecessor accountant when circumstances exist as follows:

   - The information obtained about the prospective client and its management and principals is limited or appears to require special attention

   - The change in accountants takes place substantially after the end of the accounting period for which statements are to be compiled or reviewed, or

   - There have been frequent changes in accountants.

4. The successor accountant should be aware that the predecessor accountant and the client may have disagreed about accounting principles, procedures applied by the predecessor accountant, or similarly significant matters.

5. The successor accountant should request permission from the prospective client to make any inquiries of the predecessor accountant.

   - Except as allowed by the AICPA Code of Professional Conduct, the predecessor accountant is precluded from disclosing any confidential information obtained in the course of the engagement unless the client specifically consents.

6. If the successor accountant decides to communicate with the predecessor, the successor accountant should request the client to:

   - Permit the successor accountant to make inquiries of the predecessor accountant, and

   - Authorize the predecessor accountant to respond fully to those inquiries.

7. If the prospective client refuses to permit the predecessor accountant to respond or limits the response, the successor accountant should inquire about the reasons and consider the implications of that refusal in determining whether to accept the engagement.
8. If the successor accountant decides to communicate with the predecessor accountant, the inquiries should be specific and reasonable regarding matters that will assist the successor in determining whether to accept the engagement. Examples of such matters include:

- Information that might bear on the integrity of management or the owners
- Disagreements with management or the owners about accounting principles or the necessity for the performance of certain procedures or similarly significant matters
- The cooperation of management or the owners in providing additional or revised information
- The predecessor’s knowledge of any fraud or noncompliance with laws and regulations perpetrated within the client, and
- The predecessor’s understanding of the reason for the change of accountants.

9. The predecessor is required to respond promptly and fully to the inquiries on the basis of known facts.

- If the predecessor decides, due to unusual circumstances, such as impending, threatened, or potential litigation, disciplinary proceedings, or other circumstances, not to respond fully to the inquiries, the predecessor should indicate that the response is limited. The successor should consider the effect of such limited responses on his or her decision to accept the engagement.

  **Note:** Unpaid fees are not considered to be an unusual circumstance for which the predecessor refuses to respond to inquiries.

10. If the successor wishes to review the predecessor’s working papers, the successor should request the client to authorize the predecessor to allow access.

- The predecessor should determine which working papers are to be made available for review and which may be copied.
- Usually, the predecessor should provide the successor with access to certain working papers related to matters of continuing accounting significance and contingencies.
- Valid business reasons, including, but not limited to unpaid fees, may lead the predecessor to decide not to allow access to the working papers.
- The predecessor may wish to reach an agreement with the successor as to the use of the working papers. Such an agreement may be in writing in the form of a “Successor Accountant Acknowledgement Letter.”
- The predecessor should not be expected to make the working papers available until the client has designated an accountant as a successor.

  **Note:** The SSARSs do not address the form and content of working papers for a review or compilation.
11. The successor is not permitted to reference the predecessor’s report or work in his or her own report, except if financial statements for the prior year are presented comparatively and those statements were compiled or reviewed by the predecessor.

In such a case, the successor should include the following language in his report for the current period:

**Review report for 20X3 would include language related to 20X2 as follows:**

*The 20X2 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 20X3, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.*

**Compilation report for 20X3 would include language related to 20X2 as follows:**

*The 20X2 financial statements of XYZ Company were compiled by other accountants whose report dated March 1, 20X3, stated that they did not express an opinion or any other form of assurance on those statements.*

12. If, during the engagement, the successor becomes aware of information that leads him or her to believe that the financial statements reported on by the predecessor may require revision, the successor should request the client to communicate this information to the predecessor.

**Note:** If the client refuses to communicate with the predecessor or if the successor is not satisfied with the predecessor’s course of action, the successor should evaluate possible implications for the current engagement and whether to resign. Also, the accountant may wish to consult with legal counsel about the appropriate course of action.

**What if the previous year’s financial statements were audited and the current year will be compiled or reviewed?**

There is no requirement for a successor accountant to communicate with a predecessor auditor if the previous year was audited and the current year will be compiled or reviewed.

And, from the auditing side, SAS No. 122, AU-C Section 510, *Opening Balances- Initial Audit Engagements, Including Reaudit Engagements* (formerly SAS No. 84) applies only when both the previous and current year statements involve an audit. The same answer would apply if the opposite were true with the prior year statements compiled or reviewed with an upgrade to a current-year audit.

The following is a sample letter to be signed by the successor accountant before having access to the predecessor’s working papers.
Sample Successor Accountant Acknowledgment Letter

Harry Callahan and Company, CPA (Successor Accountant)
51 Make My Day Lane
Nowhere, Massachusetts 02165

We have previously [reviewed or compiled], in accordance with Statements on Standards for Accounting and Review Services the December 31, 20X2, financial statements of XYZ Corporation (XYZ). In connection with your [review or compilation] of XYZ’s 20X3 financial statements, you have requested access to our working papers prepared in connection with that engagement. XYZ has authorized our firm to allow you to review those working papers.

Our [review or compilation] engagement and the working papers prepared in connection therewith, of XYZ’s financial statements were not planned or conducted in contemplation of your [review or compilation]. Therefore, items of possible interest to you may not have been specifically addressed. Our use of professional judgment for the purpose of this engagement means that matters may have existed that would have been assessed differently by you. We make no representation about the sufficiency or appropriateness of the information in our working papers for your purposes.

We understand that the purpose of your review is to obtain information about XYZ and our 20X2 results to assist you in your 20X3 engagement of XYZ. For that purpose only, we will provide you access to our working papers that relate to that objective.

Upon request, we will provide copies of those working papers that provide factual information about XYZ. You agree to subject any such copies or information otherwise derived from our working papers to your normal policy for retention of working papers and protection of confidential client information. Furthermore, in the event of a third-party request for access to your working papers prepared in connection with your [reviews or compilations] of XYZ Corporation, you agree to obtain our permission before voluntarily allowing any such access to your working papers or information otherwise derived from our working papers, and to obtain on our behalf any releases that you obtain from such third party. You agree to advise us promptly and provide us a copy of any subpoenas, summons, or other court order for access to your working papers that include copies of our working papers or information otherwise derived therefrom.

Additional optional language:
Because your [review] of our working papers is undertaken solely for the purpose described above and may not entail a review of all of our working papers, you agree that (1) the information obtained from the review will not be used by you for any other purpose, (2) you will not comment, orally or in writing, to anyone as a result of that review about whether our engagement was performed in accordance with Statements on Standards for Accounting and Review Services, and (3) you will not provide expert testimony or litigation services or otherwise accept an engagement to comment on issues relating to the quality of our engagement.

Please confirm your agreement with the foregoing by signing and dating a copy of this letter and returning it to us.

Very truly yours,

__________________________________________
James J. Fox & Company [Predecessor Accountant]

Accepted by: ______________________________________
Harry Callahan and Company, CPA, [Successor Accountant]
Is a successor accountant permitted to name a predecessor accountant in his or her compilation or review report?

Prior to the issuance of SSARS No. 21, guidance on naming the predecessor accountant was found in Footnote 9 of SSARS No. 2, Reporting on Comparative Financial Statements, as amended, which provided that a successor accountant could name the predecessor accountant if the predecessor’s practice was acquired by, or merged with, that of the successor accountant.

Effective in 2015, all SSARSs are superseded by SSARS No. 21.

Even though the guidance found in SSARS No. 2 has been superseded, the author believes its application is still valid and can be applied until the ARSC issues new authoritative guidance.

Predecessor or successor accountant reporting on changed prior period financial statements

From time to time, a successor accountant must address reporting when the prior year’s financial statements were compiled or reviewed by a predecessor accountant. In such instances, the successor accountant may have to restate the prior year’s financial statements to correct the work of the predecessor accountant.

Prior to the issuance of SSARS No. 21, guidance was found in SSARS No. 2, Reporting on Comparative Financial Statements. SSARS No. 21 has officially superseded all SSARSs, including SSARS No. 2. Therefore, what is a predecessor accountant to do if he or she needs to communicate with a successor accountant?

Although there is no authority in SSARS No. 21 to address this issue, the author believes an accountant should follow the same guidance that was previously found in SSARS No. 2, Reporting on Comparative Financial Statements. as amended.

That is, the successor accountant’s current year compilation or review report would include a separate emphasis-of-matter paragraph stating that:

a. The successor accountant is compiled or reviewed the restatement adjustment, and

b. The predecessor accountant reported on the financial statements of the prior period before the restatement.
Example 1:

Facts:

A successor accountant is hired by XYZ Company to compile financial statements for 20X2. Financial statements for 20X1 were compiled by another (predecessor) accountant. The successor accountant plans to issue compiled financial statements for 20X2 along with the restated 20X1 financial statements.

Sample Compilation Report:

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2 and the related statements of income and retained earnings, and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

We also compiled the adjustments described in Note X, that were applied to restate the 20X1 financial statements. The financial statements of XYZ Company as of December 31, 20X1, before the adjustments that were applied to restate the 20X1 financial statements, were compiled by other accountants whose report dated March 31, 20X2, did not express an opinion or any other form of assurance on those financial statements.

James J. Fox & Company
Burlington, Massachusetts

March 31, 20X3
Example 2: Same facts as Example 1 except it is a review engagement:

Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, (owners’) financial data and making inquiries of company management (owners). A review is and the related statements of income and retained earnings, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter
We also reviewed the adjustments described in Note X, that were applied to restate the 20X1 financial statements. Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Burlington, Massachusetts

March 31, 20X3
M. Selected Information- Substantially All Disclosures Required By Accounting Principles Generally Accepted in the United States of America Are Not Included

Paragraph A31 of AR-C 80, SSARS No. 21 carries over from SSARS No. 19 the practice of disclosing selected information as required by GAAP or another applicable reporting framework.

In some instances, a client may wish to include only selected disclosures in compiled financial statements. For example, the bank may accept compiled financial statements that include only long-term debt, fixed asset and lease footnotes, thereby excluding the remainder of disclosures required by GAAP (or tax basis).

If this is the case, is the accountant permitted to issue a compilation report indicating that substantially all of the disclosures and the statement of cash flows have been omitted?

Response:

Paragraph A31 of AR-C 80 states:

“When management elects to include disclosures about only a few matters in the notes to the financial statements, such disclosures may be labeled “Selected Information- Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included.”

Paragraph 24 of AR-C 80 further states:

“The accountant should not issue an accountant’s compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework unless the omission of substantially all disclosures is not, to the accountant’s knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.”

What these two paragraphs mean is that an accountant may elect to include a few disclosures in its financial statements and elect to omit the remainder of the disclosures. In doing so the accountant takes the following actions:

a. Includes in the compilation report a separate paragraph “management has elected to omit substantially all disclosures,” and

b. Includes on each page of the notes that include a “few matters” the following:

"Selected Information- Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included"

Example: Jimmy's client, Fred asks Jimmy to compile financial statements. Fred has little need for a statement of cash flows and most of the disclosures required by GAAP except that the local bank wants a disclosure of the long-term debt and operating leases.
Conclusion: Jimmy CPA may issue a compilation report as follows along with the attached notes to financial statements.

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of 20X1 and the related statements of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company
Burlington Massachusetts
March 31, 20X2
Note 1: Long-term debt:
A summary of long-term debt at December 31, 20X1 follows:

No Loan Bank: Term loan with monthly payments of $10,000 plus interest at 9 percent per annum through the year 20X6.
Secured by a first mortgage on certain corporate real estate. $1,000,000

Installment loans: Several installment loans relating to the purchase of certain manufacturing equipment. The terms of these loans require monthly principal payments of $5,000 plus interest at 10% per annum through the year 20X6. 300,000

Less current portion 1,300,000

(100,000)

$1,200,000

Interest expense was $118,000.

A summary of the annual maturities of long-term debt for the five years subsequent to 20X1 follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$100,000</td>
</tr>
<tr>
<td>20X3</td>
<td>120,000</td>
</tr>
<tr>
<td>20X4</td>
<td>140,000</td>
</tr>
<tr>
<td>20X5</td>
<td>160,000</td>
</tr>
<tr>
<td>20X6</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Note 2: Leases:
The Company leases its principal operating facility under a five-year, non-cancelable operating lease. The terms of the lease require monthly payments of $15,000 with periodic increases through June 20X5. The company has a five-year option for renewal for the years 20X6 to 20X9 at an increased monthly rental rate.

The following consists of the future minimum rental payments due under this operating lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$180,000</td>
</tr>
<tr>
<td>20X3</td>
<td>190,000</td>
</tr>
<tr>
<td>20X4</td>
<td>200,000</td>
</tr>
<tr>
<td>20X5</td>
<td>205,000</td>
</tr>
<tr>
<td>20X6</td>
<td>0</td>
</tr>
</tbody>
</table>

$775,000
**How many disclosures may be included in the notes under the “selected information- substantially all disclosures are omitted” provision?**

**Response:** Paragraph A31 of AR-C 80 states:

> “When management elects to include disclosures about only a few matters in the notes to the financial statements, such disclosures may be labeled “Selected Information- Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included.”

Although the term “few” is not defined within the SSARSs, the definition of “few” generally means “two or three” items, which means that including two or three disclosures would be only a few matters.

**Question:** Is the accountant permitted to label notes to the financial statements “Selected Information- Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included” when the client includes more than a few required disclosures?

**Response:** No. When the financial statements include more than a few disclosures, this guidance is not appropriate. The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from GAAP, and the nature of the departure and its effects, if known, should be disclosed.

Specifically, Paragraph 26 of AR-C 80, SSARS No. 21 states:

> “The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the applicable financial reporting framework, and the nature of the departure and its affects, if known, should be disclosed...”

The label “Selected Information- Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America” should not be used in situations where substantially all disclosures are included.

The label “Selected Information- Substantially All Disclosures Required by accounting principles generally accepted in the United States of America Are Not Included,” is not intended to be used for the omission of (intentionally or unintentionally) one or more disclosures. In determining whether use of the label is appropriate, the accountant should apply his or her judgment to all the facts and circumstances.

**Example:** A client wishes to include all notes to financial statements except a disclosure of risks and uncertainties as required by ASC 275 (formerly SOP 94-6).

**Conclusion:** Because all but one of the required disclosures are included in the notes, the use of “Selected Information- Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America” is not appropriate. Instead, the missing disclosure should be treated as a GAAP departure, as follows:
Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholder’s equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

As disclosed in Note X, accounting principles generally accepted in the United States of America require that a company disclose certain information about risks and uncertainties. Management has informed us that the company has not disclosed such information.

James J. Fox & Company
Burlington Massachusetts
March 31, 20X2

Question: Is the “Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America” exception available for a review engagement?

Response: No. The exception only applies when financial statements have been compiled, not reviewed. Therefore, generally, an accountant would not accept an engagement to review financial statements that omit substantially all of the GAAP disclosures.

N. Gathering Review Evidence Under SSARS No. 21

SSARS No. 21 requires an accountant to obtain review evidence in a review engagement which is defined as:

“Information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.”

In a review engagement, an accountant is required to accumulate review evidence consisting of completing performance procedures and review procedures as follows:

1. Performance procedures:
   a. Understand the industry in which the client operates, including accounting principles
   b. Obtain knowledge of the client including its business and accounting principles and practices
   c. Be aware of the risk of financial statement misstatement

2. Design and perform review procedures:
   a. Analytical procedures
   b. Inquiries
   c. Other procedures including:
• Read the financial statements
• Using the work of other accountants
• Reconcile the financial statements to the underlying accounting records
• Obtain a written representation letter

In accumulating review evidence, first, the accountant is required to understand the industry in which the client operates and obtain knowledge of the client’s business and accounting principles and practices. In obtaining this understanding and knowledge, the accountant should be aware of the risk that the accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated.

Based on that understanding of the industry and knowledge of the client’s business, the accountant is required to design and perform review procedures consisting primarily of analytical procedures and inquiries. Other procedures include reading the financial statements and, if applicable, obtaining the reports from other accountants or auditors of financial statements of significant components of the reporting entity, such as other subsidiaries or investees.

**Does SSARS No. 21 require an accountant to perform a risk assessment like an audit engagement requires?**

No. Even though the concept of risk permeates through a review engagement, it does not require the accountant to perform a risk assessment.

**Does the accountant really gather evidence in a review engagement?**

No. The concept of review evidence is misleading as it suggests that an accountant is required to gather evidence similar to that in performing an audit engagement such as examining documents, etc. Arguably, SSARS No. 21, like its predecessor SSARS No. 19, should have used a different term than “review evidence” to differentiate from procedures performed in an audit engagement.

Review evidence consists of understanding and obtaining knowledge of the industry and client’s business, and designing and performing analytical procedures and inquiries. No further procedures are required unless the results of those procedures result in incomplete, incorrect or unsatisfactory information.

**Dealing with analytical procedures in SSARS No. 21**

During a review engagement, SSARS No. 21 requires that an accountant develop and document expectations of analytical procedures and compare those expected amounts to actual results.

The SSARS No. 21 requirement is nothing new in that since its issuance in 1979, the originally issued SSARS No. 1, included the requirement to develop expectations in performing analytical procedures. Yet, many, if not most, accountants have not complied with the requirement to perform analytical procedures using *expected amounts*.

**What are expected amounts?**
An expected amount represents an accountant’s prediction of a recorded amount used in ratios developed of that amount. The accountant should:

- Develop expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant’s understanding of the industry in which it operates and knowledge of the client.

- Use statistical techniques as trend analysis or regression analysis, performed either manually or with the use of computer-assisted techniques.

In developing expectations, an accountant may use various sources including, but not limited to:

- Prior period information
- Anticipated results such as management budgets and forecasts
- Relationships among elements within the period
- Information from the industry such as gross margin, and
- Relationship of financial information with nonfinancial information such as payroll costs to number of employees.

Analytical procedures may be performed at the financial statement level or at the detailed account level. Further, if analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected amounts by a significant amount, the accountant should investigate the differences by inquiring of management and performing other procedures needed.

**Should expectations be developed for each analytical procedure or in the aggregate?**

The accountant has flexibility in using expectations in analytical procedures.

The AICPA Guide provides several examples of the application of expectations.

Although SSARS No. 21 does not state so, it would appear that expectations can be developed using a range (e.g., expected gross profit is 20-23 percent), rather than using one absolute amount.

For example, an accountant can develop an expectation that the gross profit will decline by 2 to 5 percent.

Following is an example extracted from the AICPA Guide, as modified by the author:

**Example 1:**

**Facts:**
An accountant is performing a review engagement on a company that manufactures components for the United States Military.

Facts used to develop expectations include the following:

- The accountant expects sales to increase by 10 to 15 percent due to the overall world situation.
• The number of day’s sales in accounts receivable should also increase by 10 to 15 percent due to the increase in sales.

• Interest expense and the related loans payable should increase by 10 to 15 percent due to carrying a larger amount of receivables and inventories to accommodate additional sales.

• No significant change in either days supply in inventory or inventory turnover is expected as most of the sales increase is expected to occur at or near year end. Any increase in inventory of more than 5 percent will be unexpected and will be subject to additional procedures.

Specific data follows:

<table>
<thead>
<tr>
<th></th>
<th>Current year</th>
<th>Prior year</th>
<th>Change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,500,000</td>
<td>$2,175,000</td>
<td>$325,000</td>
<td>14.94%</td>
</tr>
<tr>
<td>CGS</td>
<td>1,780,000</td>
<td>1,566,000</td>
<td>214,000</td>
<td>13.67%</td>
</tr>
<tr>
<td>Gross profit</td>
<td>720,000</td>
<td>609,000</td>
<td>111,000</td>
<td>18.23%</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>230,000</td>
<td>184,000</td>
<td>46,000</td>
<td>25.00%</td>
</tr>
<tr>
<td>Interest expense</td>
<td>48,000</td>
<td>42,000</td>
<td>6,000</td>
<td>14.29%</td>
</tr>
<tr>
<td>AR</td>
<td>1,625,000</td>
<td>843,000</td>
<td>782,000</td>
<td>NA</td>
</tr>
<tr>
<td>Inventories</td>
<td>1,100,000</td>
<td>832,000</td>
<td>268,000</td>
<td>NA</td>
</tr>
<tr>
<td>Loans payable</td>
<td>498,000</td>
<td>437,000</td>
<td>61,000</td>
<td>13.96%</td>
</tr>
</tbody>
</table>

Results of analytical procedures:

Sales and cost of sales: Sales and cost of sales increased by 14.94% and 13.67%, respectively, which are within the expected range of 10 to 15%. No additional procedures are required.

Interest expense and debt: Interest expense increased by 14.29% which is within the expected range of 10 to 15%. The increase in the loans payable was 14% ($61,000/$437,000) which is within the expected range of 10 to 15% consistent with the expected increase in interest expense.

Number of days sales in AR:

\[
\begin{align*}
\text{Current year:} & \\
\frac{\text{AR}}{\text{Net sales}} &= \frac{1,625,000}{2,500,000} = 65\% \times 365 \text{ days} & = 237 \text{ days} \\
\text{Prior year (given):} & \\
\% \text{ change} &= 141 \text{ days} & 68\%
\end{align*}
\]

Conclusion: Because the increase in the number of days is greater than the expected increase of 10 to 15%, the accountant should perform additional procedures including inquiries and documentation of the reason for the unexpected increase.
Number of days supply in inventory:
Current year:
  Inventory \( \frac{1,100,000}{1,780,000} = 62\% \times 365 \text{ days} \) \( \approx 226 \text{ days} \)

Prior year (given):
  194 days

% change
  16%

Inventory turnover:
Current year:
  \( \frac{1,780,000}{1,100,000} = 1.84 \text{ times} \)

Prior year: (given):
  2.05 times

% change
  (10)\%

Conclusion: No significant change in either days supply in inventory or inventory turnover was expected. Any increase in inventory of more than 5 percent was to be unexpected and subject to additional procedures.

The results of the procedures demonstrate that in both the number of sales supply in inventory (an increase of 16 percent) and the inventory turnover (a decrease of 10 percent) changed by an unexpected amount of more than 5 percent. Thus, the accountant should perform additional procedures including making an inquiry of the client and documenting the reason(s) for the unexpected changes.

Other analytical procedures:

Selling expenses increased by 25 percent which is unexpected due to an increase in sales of only 14.94 percent. The accountant should perform additional procedures including making an inquiry of the client and documenting the reason(s) for the unexpected change.
Review Questions

1. According to SSARS No. 21, which of the following is correct:
   a. All companies are permitted to issue tax-basis accrual financial statements
   b. An entity must use the basis of accounting that it uses to prepare its tax return
   c. SSARS No. 21 authorizes companies that file their income tax return on a cash basis to prepare tax-basis financial statements on an accrual basis
   d. An entity cannot issue tax-basis accrual financial statements

2. In which of the following situations may it not be prudent to use tax-basis financial statements:
   a. When it may be perceived to be intentionally misleading to a third party
   b. When the accountant has extra time to complete the engagement
   c. When a client is interested in cash flows
   d. When the company has a strong financial position

3. According to the author, which of the following is the engagement of choice when profitability is the goal:
   a. Audit – GAAP
   b. Audit – Tax Basis
   c. Review – GAAP
   d. Review – Tax Basis

4. Although not authoritative, the author suggests that an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity:
   a. Under any circumstances
   b. Unless the accountant has neither compiled nor reviewed the financial statements
   c. Unless the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them
   d. Unless the accountant has audited, but not reviewed nor compiled the financial statements

5. ASC 220, as amended by ASU 2011-05, requires that comprehensive income be presented in a format. Which of the following is one of the format options available:
   a. Disclose comprehensive income only
   b. Present a single continuous statement of income and comprehensive income
   c. Combine the statement of comprehensive income with the balance sheet
   d. Present comprehensive income as a section within the statement of stockholders’ equity

6. In reporting on supplementary information, which of the following is a correct option:
   a. If a compilation report is issued for the financial statements, the supplementary information may be compiled
   b. If a compilation report is issued for the financial statements, the supplementary information may be reviewed
   c. If a review report is issued for the financial statements, the supplementary information may not be disclaimed
   d. If a review report is issued for the financial statements, the supplementary information may not be compiled
7. Which of the following is an example of supplementary information:
   a. Percentages that are presented next to the numbers on an income statement
   b. Aging analysis of receivables
   c. Unexpired budgeted numbers presented next to historical numbers on an income statements
   d. Legend on each page of the financial statements

8. An accountant is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:
   a. Extends beyond the current fiscal year
   b. Is not presented with interim historical financial statements for the current year
   c. Is expired information
   d. Is labeled as budgeted

9. A successor accountant may wish to consider making inquiries of the predecessor accountant when:
   a. The information obtained about the prospective client is unlimited
   b. The information obtained about the prospective client requires special attention
   c. The change in accountants takes place substantially before the end of the accounting period
   d. There have been infrequent changes in accountants

10. Which of the following is correct regarding a successor accountant naming the predecessor accountant in his or her report:
    a. The successor accountant should identify that there is a predecessor accountant in his report
    b. The successor accountant must specifically name the predecessor accountant in his report
    c. Prior to SSARS No. 21, the SSARSs allowed the successor accountant to identify the existence of a predecessor accountant if the predecessor accountant’s practice was acquired by, or merged with, that of the successor accountant
    d. SSARS No. 21 does not permit a successor accountant to name a predecessor accountant in any circumstances

11. According to SSARS No. 21, which of the following is correct regarding disclosing selected information as required by GAAP:
    a. An accountant is permitted to review financial statements that omit substantially all of the disclosures required by GAAP
    b. An accountant is not permitted to compile financial statements that omit substantially all of the disclosures required by GAAP
    c. An accountant is permitted to compile financial statements that omit substantially all of the disclosures required by GAAP provided the omission of substantially all disclosures is clearly indicated and is not intended to be misleading
    d. SSARS No. 21 is silent regarding this issue

12. In which of the following situations may an accountant label notes to financial statements:
    “Selected Information-Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included:”
    a. No disclosures are included in the notes
    b. Two disclosures are included in the notes
    c. 50 percent of the ten required disclosures are included in the notes
    d. All disclosures, but one, are included in the notes
13. Which of the following is correct regarding SSARS No. 21 as it relates to development of expectations in analytical procedures:
   a. The SSARS No. 21 requirement of developing expectations in performing analytical procedures is new
   b. Most accountants have complied with the requirement to develop expectations in performing analytical procedures
   c. SSARS No. 21 provides extensive guidance as to how to develop expectations
   d. The accountant has flexibility in applying SSARS No. 21
O. Responsibility for Materiality in a Compilation and Review Engagement

Question: Is an accountant who performs a compilation or review engagement required to plan materiality?

Response: No. Unlike an audit engagement, SSARS No. 21 does not require an accountant to plan and document materiality in performing a compilation or review engagement. However, the accountant must consider, but not necessarily document, materiality, in performing a compilation or review engagement.

The review report does reference materiality as follows:

“Based on our review, we are not aware of any materiality modifications that should be made to the accompanying financial statements ……..”

The compilation report does not reference materiality.

For either a compilation or review engagement, the accountant should consider materiality in the context of the applicable financial reporting framework (GAAP, tax basis, etc.) which provides a frame of reference to the accountant in determining whether there are any material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

SSARS No. 21 states that although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements,

- Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both, and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the accountant with such a frame of reference.

The accountant’s determination of materiality is a matter of professional judgment and is affected by the accountant’s perception of the financial information needs of users of the financial statements.

Observation: In an audit engagement, an auditor is required to define materiality using qualitative and quantitative factors, such as a percentage of revenue, assets or net income. SSARS No. 21 does not require that a similar approach be used in a compilation or review engagement, although nothing prevents an accountant from measuring materiality.
P. Restricting the Use of an Accountant’s Compilation or Review Report

*Are there instances in which an accountant is required to restrict the use of his or her compilation or review report?*

The answer is “yes.”

Typically, accountants are not concerned about third-party liability in connection with compilation, review or even audit reports that are issued to third parties. In most cases, the client financial statements are being distributed to the client, and to a few third parties, such as banks and vendors.

In some situations where the accountant considers the client to be high-risk or may be engaging in a high-risk transaction, such as the sale of a business or raising of capital, the accountant may wish to restrict the use of the report.

Although an accountant may have a strong engagement letter, that letter is a contract between the accountant and the client, and does not necessarily protect the accountant from claims made by known third parties who rely on the accountant’s report on the financial statements.

*Background:*

SSARS No. 21 provides guidance to accountants on restricting the use of reports issued under SSARS No. 21 as follows:

- **Compilation report:** Permits but does not require restricted use
- **Review report:** Requires restricted use in certain instances

In general, the following terms are used in this section:

*Restricted use:* Applies to reports intended only for one or more specified third parties. The need to restrict use may result from a number of circumstances including, but not limited to:

- The purpose of the report, and
- Potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

*General use:* Applies to reports that are not restricted to specified parties including reports on financial statements prepared in conformity with an applicable financial reporting framework that are ordinarily not restricted to use, such as GAAP or a special purpose framework.

Reports on GAAP and tax-basis financial statements ordinarily are not restricted regarding use although nothing precludes an accountant from restricting the use of any report.
**Restricted use review report**

SSARS No. 21 states that in certain instances, an accountant’s review report should include an alert (restriction), in a *separate other-matter paragraph*, that restricts its use.

1. Situations in which the review report should include an alert (restriction) is when:
   a. There are measurement or disclosure criteria that are determined by the accountant to be *suitable only for a limited number of users* who can be presumed to have an adequate understanding of the criteria, or
   b. There are measurement or disclosure criteria that are available only to the specified parties.

2. The language that restricts the use of the accountant’s review report should:
   a. State that the accountant’s review report is intended solely for the information and use of the specified parties
   b. Identify the specified parties for whom use is intended, and
   c. State that the accountant’s review report is not intended to be and should not be used by anyone other than the specified parties.

   **Note:** The language that restricts the use of the accountant’s review report may list the specified parties or refer to the specified parties listed elsewhere in the accountant’s review report. Moreover, the restricted use report is *not used for nonspecified parties*.

   **Illustrative language:**

   The following illustrates language would be included in a review report as an other-matter paragraph:

   **Restricted Use**
   
   *This report is intended solely for the information and use of [list or refer to the specified parties] and is not intended to be and should not be used by anyone other than these specified parties.*

3. When the accountant includes an alert that restricts the use of the accountant’s review report to certain specified parties and the accountant is requested to add other parties as specified parties, the accountant should determine whether to agree to add the other parties as specified parties.

   a. If the other parties are added after the release of the accountant’s review report, the accountant should take one of the following actions:

      • Amend the accountant’s review report to add the other parties. In such circumstances, the accountant should not change the original date of the accountant’s review report.
• Provide a written acknowledgment to management and the other parties that such parties have been added as specified parties. The accountant should state in the acknowledgment that no procedures were performed subsequent to the original date of the accountant’s review report.

4. When the accountant is requested to add other parties as specified parties, the accountant may agree to add other parties as specified parties based on the accountant’s consideration of factors such as the identity of the other parties and the intended use of the accountant’s review report.

Note: In addition, the accountant should include language in the engagement letter restricting use and distribution of the financial statements to parties outside the list of specified parties.

**Restricted use compilation report**

Unlike a review report, SSARS No. 21 does not provide any instances in which an accountant must restrict the use of a compilation report.

However, nothing precludes an accountant from restricting the use of a compilation report by inserting the same language in an other-matter paragraph, as used in a review report.

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

In particular, a restricted use paragraph might be warranted in a compilation report in situations in which:

• There are measurement or disclosure criteria that are determined by the accountant to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria, or

• There are measurement or disclosure criteria that are available only to the specified parties.

**What if the client does distribute a restricted use report and financial statements to parties outside the identified list?**

If the client distributes the financial statements and accountant’s report to a third party that is not one of the authorized parties identified in the report and engagement letter, the accountant would have a breach of contract claim against the client if the accountant were sued by the unauthorized party.

Is it prudent for an accountant to voluntarily restrict the use of his or her compilation or review report even if not otherwise required to be restricted?

Yes. As previously noted, an accountant is required to restrict use of a review report in certain instances in which there are measurement or disclosure criteria that are determined by the accountant to be suitable only for a limited number of users.

No such requirement applies to a compilation report.
Regardless of the SSARS No. 21 requirement, an accountant may choose to restrict use of his or her compilation or review report for other reasons. One reason might be where the accountant wants to limit the specified third parties that receive the financial statements, such as certain identified banks. Nothing in SSARS No. 21 prevents an accountant from restricting the use of the report for any reason. If such a restriction is included in the compilation or review report, there should be similar language included in the engagement letter.

Q. Reporting of Specified Elements, Accounts, or Items of a Financial Statement

There are instances in which an accountant may wish to prepare, compile or review a specified element, account or item of a financial statement in lieu of a full set of financial statements.

Prior to the issuance of SSARS No. 21, the guidance was found in SSARS No. 13, Compilation of Specified Elements, Accounts, or Items of a Financial Statement (AR 110). SSARS No. 21 has replaced SSARS No. 13 and provides little specific guidance as to how to report on specified elements.

Although SSARS No. 13 no longer applies, there is important information that was previously found that still should be followed if an accountant wishes to report on a specified element, account or an item of a financial statement:

1. Rules:
   a. SSARS No. 21 permits an accountant to perform a preparation of financial statements, compilation or review engagement on a specified elements, accounts, or items of a financial statement.

      Examples of specified elements, accounts or items of a financial statement that an accountant may compile include schedules of:
      - Rentals
      - Royalties
      - Profit participation
      - Receivables or inventory
      - Provision for income taxes

   b. The engagement may be undertaken as a separate engagement or in conjunction with another engagement.

2. Performance and reporting requirements: An accountant who compiles specified elements, accounts, or items of a financial statement should follow:

   a. The preconditions of Paragraphs .34 and .25 of AR-C 60, and

   b. The specific preconditions of the preparation, compilation or review engagement.

   Example: An accountant is asked to perform a compilation engagement on a schedule of sales.
**Conclusion:** Following is a sample of a report and related schedule to be issued under SSARS No. 21.

**Sample Compilation Report- Specified Element**

Management is responsible for the accompanying *schedule of gross sales* of XYZ Restaurant Inc. for the year ended December 31, 20X1 in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the *schedule of gross sales* nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on the *schedule of gross sales*.

James J. Fox & Company  
Burlington, Massachusetts  
March 31, 20X1

<table>
<thead>
<tr>
<th>Gross sales:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restaurant food</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Restaurant bar</td>
<td>800,000</td>
</tr>
<tr>
<td>Catering</td>
<td>400,000</td>
</tr>
<tr>
<td>On-line sales</td>
<td>600,000</td>
</tr>
<tr>
<td>Special events</td>
<td>300,000</td>
</tr>
<tr>
<td>Sundry other sales</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,700,000</strong></td>
</tr>
</tbody>
</table>

**Note:** The legend “See Accountant’s Compilation Report” or similar language may be placed on the schedule although such language is not required under SSARS No. 21.

**What about a review report on a specified element, account or financial statement item?**

Prior to the issuance of SSARS No. 21, the authority for issuing a review report on a specified element, accountant or other item of a financial statement was found in SSE No. 10, *Attestation Standards*.

With the issuance of SSARS No. 21, the authority for performing a review engagement on a specified element, account or item of a financial statement is moved from SSAE No. 10 to SSARS No. 21.

In particular, paragraphs 1 and 2 of AR-C 90 establish the scope for the application of AR-C 90 to review engagements and states that review engagements apply to:
a. Engagements to review financial statements

b. Engagements to review other historical financial information such as:

- Specified elements, accounts, or items of a financial statement such as schedules of rentals, royalties, profit participation, or provision for income taxes
- Supplementary information
- Required supplementary information, and
- Financial information contained in a tax return.

In addition to performing a preparation of financial statements, compilation or review engagement on a specified element, account or item, an accountant may also perform an audit or agreed-upon procedures engagement on a specified element, accountant or element.

Following is a summary of the authoritative guidance that is available for each particular type of engagement:

<table>
<thead>
<tr>
<th>Reporting on Specified Elements, Accounts or Items of Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Engagement</strong></td>
</tr>
<tr>
<td>------------------------</td>
</tr>
<tr>
<td>Audit</td>
</tr>
<tr>
<td>Preparation</td>
</tr>
<tr>
<td>Compilation</td>
</tr>
<tr>
<td>Review</td>
</tr>
<tr>
<td>Agreed-Upon Procedures</td>
</tr>
</tbody>
</table>
EXAMPLE 1: Review Report Issued on Specified Element, Account or Item of a Financial Statement:

Facts: An accountant is asked to perform a review engagement on a schedule of accounts receivable.

Conclusion: The accountant would perform a review engagement and issue a report under SSARS No. 21 as follows:

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**Independent Accountant’s Review Report**

Board of Directors  
XYZ Company  
Nowhere, Massachusetts

I (we) have reviewed the accompanying schedule of accounts receivable of XYZ Corporation as of December 31, 20XX, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

**Management's Responsibility for the Financial Statements**

Management (owners) is (are) responsible for the preparation and fair presentation of the schedule in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule that are free from material misstatement whether due to fraud or error.

**Accountant’s Responsibility**

My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the schedule for it to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

**Accountant’s Conclusion**

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying schedule in order for it to be in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company  
Burlington, Massachusetts

March 31, 20X3
XYZ Corporation  
Schedule of Accounts Receivable  
December 31, 20XX

Accounts receivable:
Current $300,000
31-60 days 200,000
61-90 days 100,000
More than 90 days 50,000
Allowance for uncollectible accounts (30,000)
$620,000

XYZ Corporation  
Notes to Schedule of Accounts Receivable  
December 31, 20XX

1. Nature of Operations and Certain Concentrations:
The Company is a distributor of doors and windows with office and distribution facilities located in Boston, Massachusetts. The majority of sales are made to home construction contractors and retail home improvement centers in the Northeast United States.

Approximately 50% of the company's 20XX sales were made to contractors located in Boston, Massachusetts. As a matter of normal practice, the Company grants credit to contractors and does not have a policy for requiring collateral for accounts receivable. At December 31, 20X1, $400,000 of accounts receivable were due from contractors.

2. Summary of Significant Accounting Policies:
Revenue recognition:
The Company uses the accrual basis of accounting whereby revenue is recognized when earned.

Trade receivables:
Trade receivables are recorded at net realizable value consisting of the carrying amount less the allowance for uncollectible accounts.

The Company uses the allowance method to account for uncollectible trade receivable balances. Under the allowance method, an estimate of uncollectible customer balances is made based on weighted-average percentages of balances that exceed 60 days old using factors such as the credit quality of the customer and the economic conditions in the market. Accounts are considered past due once the unpaid balance is 90 days or more outstanding, unless payment terms are extended by contract. When an account balance is past due and attempts have been made to collect the receivable through legal or other means, the amount is considered uncollectible and is written off against the allowance balance.

Use of estimates:
The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reporting amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.
Note: The schedule and note pages do not include a legend such as “See Independent Accountant’s Review Report.” Such a legend is no longer required by SSARS No. 21 although it is highly recommended by the author that it be included on each page.

As for the disclosures, they should be limited to those that are relevant to the subject matter, in this case, the accounts receivable. In deciding which disclosures are relevant, the accountant should look not only at the subject matter, but also to all related accounts and elements. For example, footnotes that are relevant to accounts receivable also include those relating to sales.

The author’s selection of the above notes is based on the following reasoning:

1. **Nature of operations and certain concentrations**: This is an overlap of disclosures required by ASC 275 (SOP 94-6) related to nature of operations, and ASC 815 (formerly FASB No. 133/107) related to concentrations of credit risk associated with accounts receivable.

2. **Revenue recognition**: This disclosure relates to sales.

3. **Trade receivables and allowance account**: Disclosures of trade receivables and the allowance account are required by ASC 942 (formerly SOP 01-6).

4. **Use of estimates**: The use of estimates note is required by ASC 942 (formerly SOP 94-6) and relates to both receivables and sales. There is an estimate involved in the computation of allowance for uncollectible accounts and, presumably, an estimate may be used in the computation of sales returns and allowances.

References to other notes such as those related to long-term debt, tangible assets, etc. are not required because they have no relevance to the subject matter (accounts receivable).

Are disclosures required when reporting on a specified element, account or item of a financial statement?

Response: The technical answer is “no”. Disclosures are not required. However, recent developments created by the Auditing Standards Board, and not the FASB, have resulted in current confusion on the issue of disclosures in connection with specified elements, accounts or items of a financial statement.

First, let’s look at the authority.

In GAAP, the requirement to include disclosures applies to financial statements and not to a specified element, account or item of a financial statement, regardless of whether the report on such an element, account or item is a compilation, review or audit report.

ASC 235-10-50-3, Notes to Financial Statements, Overall Disclosure, What to Disclose, states:

“Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations.”
ASC 235-10-50, Notes to Financial Statements, Overall Disclosure, further states:

“In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with GAAP, statements so presented also shall include disclosure of the pertinent accounting policies.”

If there is a presentation of a specified element, account or item, such a presentation does not pertain to the determination of financial position (balance sheet), cash flows, or results of operations. Thus, the GAAP requirement for disclosure does not apply.

In 2011, the Auditing Standards Board (ASB) added some confusion to the mix with the issuance of AU-C Section 805, Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement. In AU-C 805, the ASB states that:

“a specific element of a financial statement includes the related notes.”

Contrary to the GAAP codification, the ASB has taken the position that GAAP requires notes to be included when there is a presentation of a specific element, account or item of a financial statement. The problem is that the FASB, not the ASB, provides authority for GAAP disclosures and there is no GAAP requirement for disclosures to be presented when there is a presentation of an element, account or item. There is authority in ASC 235 that requires disclosures when presenting a single financial statement, but not an element, account or item of a financial statement.

**Should an accountant who issues a compilation report on a specified element, account or item of a financial statement include a paragraph “management has elected to omit substantially all disclosures….” if disclosures are not included?**

Some accountants believe that if they issue a compilation report on a specified element, account or item of a financial statement (such as a schedule of sales), and do not include disclosures, they should include the typical additional paragraph “management has elected to omit substantially all disclosures required by accounting principles generally accepted in the United States of America….”

Is this approach appropriate? No. Because GAAP does not require disclosures when there is a presentation of an element, account or item, the author believes such an additional paragraph is inappropriate and incorrect even though some commentators take the erroneous position that such a paragraph should be included in the report.

Although GAAP does not require disclosures when there is a presentation of an element, account or item of a financial statement, the author suggests that it would be meaningful for such disclosures to be included to enhance the overall presentation to the user.

**Are disclosures required if a single financial statement (such as a balance sheet) is presented and not the other financial statements?**

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45 The ASB uses the term “specific” while SSARS No. 21 uses the term “specified.”
Response: Yes. If a single financial statement is presented, and not a specified element, account or item of a financial statement, disclosures pertaining to that single financial statement are required.

In fact, ASC 235-10-50-3, Notes to Financial Statements, Overall Disclosure, states:

“In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with GAAP, statements so presented also shall include disclosure of the pertinent accounting policies.”

Example: An accountant issues a compilation report on a schedule of accounts receivable.

Conclusion: Although the company may choose to include disclosures (notes) related to the schedule of accounts receivable, such disclosures are not required to accompany the schedule because the schedule is not a financial statement.

Example: An accountant issues a compilation report on a single balance sheet without presenting the other financial statements.

Conclusion: Disclosures related to the balance sheet are required.

Example: An accountant issues a review report on a schedule of accounts receivable.

Conclusion: Notes are not required. If disclosures are included, they should be limited to those disclosures related to the schedule of accounts receivable. For example, a disclosure of revenue recognition may be supplied, yet one relating to long-term debt would not be useful as it does not relate to accounts receivable.

Present the specified element, account or financial statement item in supplementary information: an alternative to issuing a separate review or compilation report

One alternative to issuing a separate review or compilation report is to include the specified element, account or financial statement item as supplementary information which accompanies the financial statements. By doing so, the accountant avoids having to issue a separate report.

Example: A client asks the accountant to report on the schedule of accounts receivable.

Conclusion: Although the accountant can issue a review or compilation report on the schedule of accounts receivable, an effective alternative would be to include the schedule as supplementary information as part of the full set of financial statements.

The following reports illustrate the report language that would be changed to reflect the supplementary information.
EXAMPLE 1: Compilation Report on Financial Statements: Specified Element, Account or Item Presented as Supplementary Information

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2 and the related statements of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

The schedule of accounts receivable is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have performed a compilation engagement on the information. I (We) have not audited or reviewed the information and, accordingly, do not express an opinion, a conclusion, or provide any assurance on such information.

James J. Fox & Company
Burlington, Massachusetts

March 31, 20X3
**EXAMPLE 2: Review Report on Financial Statements: Specified Element, Account or Item Presented as Supplementary Information**

**Independent Accountant’s Review Report**

Board of Directors  
XYZ Company  
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, and the related statements of income and retained earnings, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

**Management’s Responsibility for the Financial Statements**  
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

**Accountant’s Responsibility**  
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

**Accountant’s Conclusion**  
Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

**Other Matter**  
The schedule of accounts receivable is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have *not audited, reviewed or compiled* such information and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

James J. Fox & Company  
Burlington, Massachusetts

March 31, 20X3
Note: The last paragraph in the previous compilation and review Reports (Examples 1 and 2) can also be presented as a separate report. The sample review report found in Example 2 assumes that the supplementary information was subjected to review procedures.

If the supplementary information is disclaimed, instead of reviewed, the last paragraph should be changed as follows:

Disclaimer on supplementary information:

Other Matter
The schedule of accounts receivable is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. I (We) have not audited, reviewed [or compiled] such information and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

Are there any limitations to presenting the specified element, account or item of a financial statement as supplementary information?

Yes. Although including the element, account or financial statement item as supplementary information may be beneficial, in many cases it is quite limiting as to distribution to third parties. The reason is because the supplementary information cannot be segregated from the core financial statements. Thus, if the supplementary information must be presented to a third party, the entire financial statement package must also be presented, resulting in more information than needed being submitted to the third party.

For example, if a lessor requires a client to submit a schedule of sales, your client wants only to give the landlord that schedule, and not the full set of financial statements. By reporting on the schedule as supplementary information to the audit, you prevent your client from being able to submit only that schedule to the landlord with an attached report.

R. Management Representation Letter- Review Engagement

SSARS No. 21 amends the illustrative management representation letter for a review engagement that was previously found in SSARS No. 19.

Below is a sample representation letter found in Exhibit B of AR-C 90, SSARS No. 21.
Illustative Management Representation Letter
Review Engagement

(Enterprise Letterhead)

Date

To [Accountant]

This representation letter is provided in connection with your review of the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity and cash flows for the years then ended, and the related notes to the financial statements, for the purpose of obtaining limited assurance as a basis for reporting whether you are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve 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 be changed or influenced by the omission or misstatement.

We represent that [, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves] [as of (date of accountant’s review report)]:

Financial Statements

- We acknowledge our responsibility and have fulfilled our responsibilities for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America.
- We acknowledge our responsibility and have fulfilled our responsibilities for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Guarantees, whether written or oral, under which the company is contingently liable have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America.
- Significant estimates and material concentrations known to management that are required to be

46 The date should be the date the client presents and signs the representation letter. The letter should not be presented and signed prior to the date of the accountant’s review report.
disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, Risks and Uncertainties, have been properly accounted for and disclosed in accordance with the requirements of accounting principles generally accepted in the United States of America. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

- All events subsequent to the date of the financial statements and for which accounting principles generally accepted in the United States of America requires adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. [A summary of uncorrected misstatements is attached to this letter.] (2)
- The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with accounting principles generally accepted in the United States of America.
- [Any other matters that the accountant may consider appropriate.]

Information Provided

- We have responded fully and truthfully to all inquiries made to us by you during your review.
- We have provided you with
  - access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation and other matters;
  - minutes of meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared;
  - additional information that you have requested from us for the purpose of the review; and
  - unrestricted access to persons within the entity from whom you determined it necessary to obtain review evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have [no knowledge of any] [disclosed to you all information that we are aware of regarding] fraud or suspected fraud that affects the entity and involves
  - management,
  - employees who have significant roles in internal control, or
  - others when the fraud could have a material effect on the financial statements.
- We have [no knowledge of any] [disclosed to you all information that we are aware of regarding] allegations of fraud, or suspected fraud, affecting the entity’s financial statements as a whole communicated by employees, former employees, analysts, regulators or others.
- We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
- We have disclosed to you all known instances of noncompliance or suspected noncompliance with law or regulation whose effects should be considered when preparing financial statements.
- We [have disclosed to you all known actual or possible] [are not aware of any pending or threatened] litigation and claims whose effects should be considered when preparing the financial statements [and we have not consulted legal counsel concerning litigation or claims]
- We have disclosed to you any other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450, Contingencies.
- We have disclosed to you the identity of the entity’s related parties and all the related party relationships and transactions of which we are aware.
- No material losses exist (such as from obsolete inventory or purchase or sale commitments) that have not been properly accrued or disclosed in the financial statements.
The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.

We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

We are in agreement with the adjusting journal entries [and account classifications] that you have recommended, and they have been posted to the company’s accounts (if applicable).

[Any other matters that the auditor may consider necessary.]

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

Note: Representation letters ordinarily are tailored to include additional appropriate representations from management relating to matters specific to the entity’s business or industry.

ABC Company (2)
Schedule of Uncorrected Misstatements
December 31, 20X2 and 20X1

None.
Observations:

(1): In accordance with AICPA Professional Standards, ET 1.295, *Nonattest Services*, if an accountant performs nonattest services for an attest client, the accountant is precluded from taking management responsibility for the nonattest work. If the nonattest service involves bookkeeping services, management must approve all adjusting entries and accountant classifications. One way in which an accountant might want to have his or her client sign off on the bookkeeping service is to include a statement in the management representation letter stating that management is in agreement with the adjusting entries and account classifications that the accountant has recommended.

(2): SSARS No. 21 requires that the accountant attach to his or her management representation letter a schedule of uncorrected misstatements. The Illustrative Management Representation Letter includes a schedule of uncorrected misstatements that shows no misstatements. Even though there is no requirement to include a schedule if there are no uncorrected misstatements, the author suggests including the schedule to demonstrate that the accountant is aware of the requirement particularly when he or she is the subject of a peer review.

Observation: In designing an effective representation letter, an accountant may wish to consider the following:

1. Avoid the use of technical terms and, instead, use terms that are understandable to the client.

2. It is good practice to review the representation letter with the client before the letter is signed. By reviewing the letter in person, it may act as a “memory jogger” for the client concerning additional matters that may affect the financial statements. Discussions may make the client feel more comfortable about signing the letter.

   Note: In litigation, a more thorough explanation in person has helped some firms defend against management’s claim that they did not understand the level of service being performed.

3. Written representations should be obtained for *all financial statements and periods covered* by the accountant’s review report:

   - A representation letter is *required for a review engagement* but not required for a compilation or preparation of financial statements engagement, although nothing precludes an accountant from obtaining a representation letter for a compilation or preparation of financial statements engagement.

   - If comparative financial statements are reported on, the representations at the completion of the most recent review *should address all periods being reported on*.

4. For a review of financial statements, specific representations should relate to the following matters:

   - Management’s acknowledgement of its responsibility for the fair presentation in the financial statements in conformity with GAAP (or a special purpose framework, such as a tax basis, if applicable)
- Management’s belief that the financial statements are fairly presented in conformity with GAAP (or a special purpose framework, such as tax basis, if applicable)
- Management’s full and truthful response to all inquiries
- Completeness of information
- Information concerning subsequent events
- Other information on matters specific to the entity’s business or industry.

5. The representation letter should be addressed to the accountant.

6. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the letter.

Examples: CEO, CFO, or others with equivalent positions

- If the current management was not present during all periods covered by the accountant’s report, the accountant should nevertheless obtain written representations from the current management on all such periods.

7. **Date of letter:** The date of the letter should be the date that the letter is presented and signed by the client. In no event should the letter be presented prior to the date of the accountant’s review report.

8. **Date of representations included in the letter:** The representations should be made as of the date of the accountant’s review report.

Obtaining Representation Letters for All Periods Reported:

SSARS No. 21 requires that an accountant obtain a representation letter for all periods covered by the accountant’s report.

Paragraph A56 of AR-C 90, SSARS No. 21 states:

“The written representations cover all periods referred by in the account’s review report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.”

But what happens when current management was not present in the previous period?

SSARS No. 21 does not provide an exception when current management was not present in a prior year. In fact, management might reasonably be reluctant to sign a letter for a period during which it was not present.

Paragraph A58 of AR-C 90, SSARS No. 21 states:
“Situations may arise in which current management was not present during all periods referred to in the accountant’s review report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period.

This fact, however, does not diminish such person’s responsibilities for the financial statements as a whole. Accordingly, the requirement for the accountant to request from them written representations that cover the whole of the relevant periods still applies.”

Example: In 20X2, Harry purchases the common stock of Company X. The accountant is planning to issue comparative reviewed financial statements for 20X2 and 20X1. Harry was not involved in the operations in 20X1.

Conclusion: The accountant must obtain a representation letter for both 20X2 and 20X1. However, Harry might be reluctant to sign the representation letter for 20X1 since it was before he was involved in the company.

Question: Assuming the accountant received a representation letter from the previous owner for 20X1, doesn’t that satisfy the need to obtain a representation letter for the 20X1 financial statements?

Conclusion: No. Even though a representation letter was obtained in 20X1 from the previous owner, a new representation letter covering both 20X2 and 20X1 must be obtained because the 20X1 financial statements are presented along with the 20X2 statements.

One solution is to present reviewed financial statements for 20X2 only without 20X1 information. By doing so, the new owner must only sign a representation letter for 20X2.

Observation: One way to convince management to sign a representation letter for a previous period during which management was not involved with the company is by pointing out the degree of representation. Additional language can be inserted into the letter to protect an absent management concerning representations that relate to a period during which it was not present such as:

“To the best of my knowledge or belief”

If the current owner/manager refuses to sign a representation letter, a review report may not be issued.

Question: If management refuses to sign a representation letter that covers a period of time during which management was not present, may the accountant step down the engagement to a compilation to solve the issue?

Response: No. Stepping down to a compilation engagement is not appropriate if management refuses to sign the representation letter.

In fact, AR-C 90 states that if management does not provide the required representations or the accountant doubts management’s integrity such that any written representations provided may not be reliable, the accountant should withdraw from the engagement.

Question: Who should sign the management representation letter?
Response: Paragraph 33 of AR-C 90 states that the accountant should request written representations from “members of management who have appropriate responsibilities for the financial statements and knowledge of the matters concerned.”

SSARS No. 21 further states that:

a. The individuals who would sign the letter may vary depending on the governance structure of the entity.

b. Written representations may be requested from the CEO and CFO or other equivalent persons that do not use such titles.

c. Typically, management, rather than those charged with governance, are responsible parties who are responsible for and knowledgeable about, matters covered by the representations.

d. For owner-managed entities, usually the owner would be the person who signs the letter.

Question: If an accountant issues a review report for interim periods (e.g., three- or six-month statements), must he or she obtain a representation letter for each interim financial statement?

Response: Yes. The accountant must obtain a representation letter for each interim period.

Example: An accountant prepares monthly reviewed financial statements for a client.

Conclusion: The accountant must obtain twelve representation letters, one for each monthly financial statement issued.

Observation: Usually most firms prepare monthly compiled statements rather than reviewed statements. Therefore, the issue of obtaining interim representation letters is not applicable.

Question: Must the accountant have in his or her possession the signed management representation letter at the time the report and financial statements are issued?

Response: Yes. Par 1.148 of the AICPA Guide states that the accountant does not have to be in physical receipt of the management representation letter as of the date of the review report, provided that management has reviewed the representation letter and will sign the letter without modification as of the date of the accountant’s review report.

However, the Guide further states that possession of the signed management representation letter prior to the release of the accountant’s review report is necessary.
**Additional Illustrative Representations:**

The following are examples of additional illustrative disclosures that may be added into the basic management representation letter. Some of these representations are recommended by the AICPA Guide to SSARS No. 21, while the remainder are disclosures that the author believes are relevant to review engagements.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Example of Additional Representation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The effect of a new accounting principle is not known.</td>
<td>We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board FASB ASC XXX, as discussed in Note X. The company is therefore unable to disclose the impact that adopting FASB ASC XXX will have on the financial statements and the results of operations when such Statement is adopted.</td>
</tr>
<tr>
<td>Change in accounting principle is made and management has justification making the change.</td>
<td>We believe that [description of the newly adopted accounting principle] is preferable to [description of the former accounting principle] because [description of management’s justification for the change in accounting principle].</td>
</tr>
<tr>
<td>Financial circumstances are strained, with disclosure of management’s intentions and the entity’s ability to continue as a going concern.</td>
<td>Note X to the financial statements discloses all of the matters of which we are aware that are relevant to the company’s ability to continue as a going concern, including significant conditions and events, and management’s plans.</td>
</tr>
<tr>
<td>The entity has used the work of a specialist.</td>
<td>We agree with the findings of the specialist in evaluating the [description of the assertion] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to the specialist with respect to the values or amounts derived in an attempt to bias his or her work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialist.</td>
</tr>
<tr>
<td>Disclosure has been made regarding an entity’s ability to continue as a going concern.</td>
<td>The financial statements disclose all of the matters of which we are aware that are relevant to the company’s ability to continue as a going concern, including significant conditions and events, and our plans.</td>
</tr>
<tr>
<td>Financial statement misstatements in the current period related to the prior periods.</td>
<td>We believe the effects of the uncorrected financial statement misstatements detected in the current year that relate to the prior year presented, when combined with those misstatements aggregated by you during the prior year review engagement and pertaining to the prior year presented, are immaterial, both individually and in the aggregate, to the financial statements for the year ended taken as a whole.</td>
</tr>
<tr>
<td>Supplementary information is required</td>
<td>We are responsible for the fair presentation of the additional information accompanying the basic financial statements that is presented for the purpose of additional analysis of the basic financial statements.</td>
</tr>
<tr>
<td>Management has used accounting conventions.</td>
<td>We have disclosed to you the accounting conventions used when preparing our financial statements. The effect of applying these accounting conventions and the use of such applications is immaterial to the financial statements.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>CASH</strong></td>
<td>Arrangements with financial institutions involving compensating balances or other arrangements involving restricted balances, lines of credit, or similar arrangements have been properly disclosed.</td>
</tr>
<tr>
<td>Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements.</td>
<td>---</td>
</tr>
<tr>
<td><strong>TRADE AND OTHER RECEIVABLES</strong></td>
<td>---</td>
</tr>
<tr>
<td>General</td>
<td>Receivables recorded in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance-sheet date and have been appropriately reduced to their estimated net realizable value.</td>
</tr>
<tr>
<td>No allowance for uncollectible accounts has been used.</td>
<td>No allowance for uncollectible accounts has been established for trade receivables because the amount of estimated uncollectible accounts is not material.</td>
</tr>
<tr>
<td><strong>INVENTORIES</strong></td>
<td>---</td>
</tr>
<tr>
<td>Excess or obsolete inventories exist.</td>
<td>A provision in the amount of $XX has been made to reduce excess or obsolete inventories to their estimated net realizable value.</td>
</tr>
<tr>
<td>The year-end inventory has been valued by the company.</td>
<td>Inventories, valued at LIFO, lower of cost or market value were $XX at December 31, 20X2 and $XX at December 31, 20X1.</td>
</tr>
<tr>
<td><strong>INVESTMENT SECURITIES</strong></td>
<td>---</td>
</tr>
<tr>
<td>The entity has investment securities which have been placed into three (3) categories: held to maturity, trading, and available for sale.</td>
<td>Debt securities [with an amortized cost of $XX and $XX at December 31, 20X2 and 20X1, respectively], that have been classified as held-to-maturity have been so classified due to our intent to hold such securities to maturity and our ability to do so. All other debt securities have been classified as available-for-sale or trading.</td>
</tr>
<tr>
<td></td>
<td>Certain equity securities with a market value of $XX and $XX at December 31, 20X2 and 20X1, respectively, have been classified as trading securities as the company intends to sell such securities within the next operating cycle.</td>
</tr>
<tr>
<td></td>
<td>Certain debt and equity securities with a market value of $XX and $XX at December 31, 20X2 and 20X1, respectively, have been classified as available for sale as the company does not intend to hold such securities to maturity or does not have a plan to sell such securities within the next operating cycle.</td>
</tr>
<tr>
<td>Management considers the decline in value of debt or equity securities to be temporary.</td>
<td>We consider the decline in value of debt or equity securities as either available-for-sale or held-to-maturity to be temporary.</td>
</tr>
<tr>
<td><strong>INVESTMENTS- NON SECURITIES (NOT PUBLICLY TRADED)</strong></td>
<td>---</td>
</tr>
<tr>
<td>General</td>
<td>The cost method is used to account for the company’s investment in the common stock of [investee] because the company does not have the ability to exercise significant influence over the investee’s operating and financial policies.</td>
</tr>
</tbody>
</table>
### INVESTMENTS ACCOUNTED FOR USING EQUITY METHOD

| General | The equity method is used to account for the company’s investment in the common stock of [investee] because the company does have the ability to exercise significant influence over the investee’s operating and financial policies. |

### FINANCIAL INSTRUMENTS (INCLUDING INVESTMENTS)

| Management has determined the fair value of significant financial instruments that do not have readily determinable market values. | The methods and significant assumptions used to determine fair values of financial instruments are as follows: [describe methods and significant assumptions used to determine fair values of financial instruments]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes. |

### FINANCIAL INSTRUMENTS (INCLUDING INVESTMENTS)

| There are financial instruments with off-balance-sheet risk. | The following information about financial instruments with off-balance sheet risk has been properly disclosed in the financial statements:  
 a) The extent, nature, and terms of financial instruments with off-balance-sheet risk.  
 b) The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments.  
 c) Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments. |

| The entity has the following financial instruments with concentrations of credit risk:  
 a) The majority of the entity’s trade receivables are due from customers concentrated within one geographic area.  
 b) The majority of the entity’s cash is deposited in one commercial bank with balances that, from time to time, exceed FDIC insurable limits. | The entity has disclosed all significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments. |

### DEFERRED CHARGES

| Material expenditures have been deferred. | We believe that all significant expenditures that have been deferred to future periods will be recoverable. |
## FIXED ASSETS AND INTANGIBLE ASSETS

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is the possibility that the value of specific significant long-lived assets or certain identifiable intangibles may be impaired.</td>
<td>We have reviewed long-lived assets and certain identifiable intangible assets to be held and used for impairment in accordance with FASB ASC 360, Property, <em>Plant and Equipment</em>, whenever events or changes in circumstances have indicated that the carrying value of its assets might not be recoverable, and have appropriately recorded the adjustment.</td>
</tr>
<tr>
<td>The company has goodwill or intangibles with indefinite lives.</td>
<td>We have tested goodwill and indefinite-lived intangibles for impairment in accordance with FASB ASC 350, <em>Intangibles-Goodwill and Other</em>, when an asset has been impaired, we have appropriately recorded the adjustment to the carrying value of the impaired asset.</td>
</tr>
</tbody>
</table>

## ALL ASSETS

### General

We believe that the carrying amounts of all material assets will be recoverable.

## VARIABLE INTEREST ENTITIES

### The entity has a variable interest in another entity.

We have made and continue to make exhaustive efforts to obtain information about entities in which the Company has an implicit or explicit interest but that were excluded from complete analysis under FASB ASC 810, Consolidation, due to lack of essential information to determine one or more of the following: whether the entity is a VIE, whether the Company is the primary beneficiary, or the accounting required to consolidate the entity.

### The entity has a variable interest in another entity.

Variable interest entities (VIEs) and potential VIEs and transactions with VIEs and potential VIEs have been properly recorded and disclosed in the financial statements in accordance with GAAP.

- We have considered both implicit and explicit variable interests in (a) determining whether potential VIEs should be considered VIEs, (b) calculating expected losses and residual returns, and (c) determining which party, if any, is the primary beneficiary.
- We have provided you with lists of all identified variable interests in (a) VIEs, (b) potential VIEs that we considered, but judged not to be VIEs, and (c) entities that were afforded the scope exceptions of FASB ASC 810, *Consolidation*.
- We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FASB ASC 810.
- We have made available all relevant information about financial interests and contractual arrangements with related parties, de facto agents, and other entities, including but not limited to their governing documents, equity and debt instruments, contracts, leases, guarantee arrangements, and other financial contracts and arrangements.

The information we provided about financial interests and contractual arrangements with related parties, de facto agents,
and other entities includes information about all transactions, unwritten understandings, agreement modifications, and written and oral side agreements.

Our computations of expected losses and expected residual returns of entities that are VIEs and potential VIEs are based on the best information available and include all reasonably possible outcomes.

Regarding entities in which the Company has variable interests (implicit and explicit), we have provided all information about events and changes in circumstances that could potentially cause reconsideration about whether the entities are VIEs or whether the Company is the primary beneficiary or has a significant variable interest in the entity.

### Deferred Tax Asset

A deferred tax asset exists at the balance sheet date. A valuation allowance in the amount of $XXX at December 31, 20X2, has been determined pursuant to the provisions of FASB ASC 740, Income Taxes, including the company’s estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will more likely than not be realized. [Fill in with appropriate wording detailing how the entity determined the valuation allowance against the deferred tax asset.]

A valuation allowance against deferred tax assets at the balance-sheet date is not considered necessary because it is more likely than not the deferred tax asset will be fully realized.

### Debt

Short-term debt could be refinanced on a long-term basis and management intends to do so. The Company has excluded short-term obligations totaling $XX from current liabilities because it intends to refinance the obligations on a long-term basis.

- The Company has issued a long-term obligation [debt security] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis.

- The Company has the ability to consummate the refinancing by using the financing agreement referred to in Note X to the financial statements.

### Taxes

The Company is an S Corporation. At year-end, the Company has retained its S corporation tax status for federal and state tax purposes. The Company has met all of the eligibility requirements, and the election remains in effect through [end of the review period].

The Company is an LLC and elects to be taxed as a partnership. At year-end, the Company has retained its election to be taxed as a partnership and not a corporation for federal and state tax purposes.

Tax-exempt bonds have been issued. Tax-exempt bonds issued have retained their tax-exempt status.

Management intends to reinvest undistributed earnings of a foreign entity. We intend to reinvest the undistributed earnings of [name of foreign subsidiary].
<table>
<thead>
<tr>
<th>Subsidiary.</th>
<th>The entity does not have income tax contingencies. We do not have a) asserted or unsettled income tax contingencies or b) unasserted income tax contingencies cause by uncertain tax positions taken in our income tax returns filed with the Internal Revenue Service and state, and [local and foreign] tax authorities that are probable of assertion by such tax authorities under the provisions of FASB ASC 450, Contingencies. Furthermore, we have not received either written or oral tax opinions that are contrary to our assessment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONTINGENCIES</td>
<td>Estimates and disclosures have been made of environmental remediation liabilities and related loss contingencies. We have recorded a provision for any material loss in connection with environmental remediation where it is probable that a loss has been incurred and we can reasonably estimate the amount. In particular, we have recorded a provision for loss in connection with Site X. We believe that such estimate is reasonable based on available information and that the liability and related loss contingency and the expected outcome of uncertainties have been adequately described in the company’s financial statements.</td>
</tr>
<tr>
<td>There are no known environmental liabilities. We are not aware of any asserted or unasserted claims remediation presented against the company by the EPA, governmental agencies or other third parties related to any environmental issues [ASC 410].</td>
<td></td>
</tr>
<tr>
<td>AGREEMENT TO REPURCHASE ASSETS</td>
<td>There is an agreement that may exist to repurchase assets previously sold. An agreement to repurchase assets previously sold has been properly disclosed.</td>
</tr>
<tr>
<td>PENSION AND POSTRETIREMENT BENEFITS</td>
<td>An actuary has been used to measure pension liabilities and costs. We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.</td>
</tr>
<tr>
<td>There is involvement with a multi-employer plan. We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan, or We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $XX.</td>
<td></td>
</tr>
<tr>
<td>Postretirement benefits have been eliminated. We do not intend to compensate for the elimination of post-retirement benefits by granting an increase in pension benefits, or We plan to compensate for the elimination of post-retirement benefits by granting an increase in pension benefits in the amount of $XX.</td>
<td></td>
</tr>
<tr>
<td>Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary. Current employee layoffs are intended to be temporary.</td>
<td></td>
</tr>
<tr>
<td>PENSION AND POSTRETIREMENT BENEFITS</td>
<td>Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive We plan to continue to make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost or We do not plan to make frequent amendments to its pension or other postretirement benefit plans.</td>
</tr>
</tbody>
</table>
commitment to increase benefit obligations.

### EQUITY

| There are capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements. | Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed. |

### INCOME STATEMENT

| There may be a loss from sales commitments. | We have made provisions for losses to be sustained in the fulfillment of or from inability to fulfill sales commitments. |
| There may be losses from purchase commitments. | Provisions have been made for losses to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices. |
| Nature of the product or industry indicates the possibility of undisclosed sales terms. | We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions. |

**Updated Management Representation Letter:**

There are circumstances in which an accountant should consider obtaining an updated representation letter from management. Examples of such situations include:

- There is a significant amount of time between obtaining a representation letter and issuing the review report.
- A material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original management representation letter, but before the issuance of the report.
- A predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period.

If an updated management representation letter is obtained, it should state:

- Whether any information has come to management’s attention that would cause management to believe that any of the previous representations should be modified, and
- Whether any events have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.

Following is a sample of an updated management representation letter:
Sample Updated Management Representation Letter
Review Engagement

Date  (close to the issuance date)

To [Accountant]

In connection with your review of the [identify the financial statements] of [name of entity] as of [dates] and for the [periods of review] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the accountant or date of previous representation letter] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

Name of Owner or Chief Executive Officer and Title

Name of Chief Financial Officer And Title
[where applicable]

Observation: To avoid having to obtain an updated representation letter, the author suggests that an accountant withhold the management representation letter until the financial statements are ready to be issued. Only at that time should a letter be distributed to the client for signature.

S. Applicability of Auditing Standards to the SSARSs

Effective in 2012, SAS No. 122, AU-C Section 930, Interim Financial Information, establishes standards and provide guidance when an accountant reviews interim financial information of a non-issuer, including companies offering securities under the SEC Rule 144A or participating in private equity exchanges.

In instances where AU-C 930 applies, there must be authority to clarify that the SSARSs do not apply. Otherwise, there could be a situation in which both a review under AU-C 930 and a review under the SSARSs could simultaneously apply to the same engagement.

SSARS No. 21 states that in a situation in which the provisions of AU-C 930, Interim Financial Information, apply, SSARS No. 21 does not apply.

In particular, SSARS No. 21 states that the SSARS review engagement rules found in AR-C 90 do not apply when the accountant is engaged to review interim financial information in accordance with AU-C 930, Interim Financial Information. AU-C 930 applies when:
a. the entity's latest annual financial statements have been audited by the accountant or a predecessor

b. the accountant either:
   
   - has been engaged to audit the entity's current year financial statements, or
   
   - audited the entity's latest annual financial statements and, in situations in which it is expected that the current year financial statements will be audited, the engagement of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review, and

c. the entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

T. Reconciling the Financial Statements to the Underlying Accounting Records

AR-C 90 adds a new requirement in a review engagement where the accountant should obtain evidence that the financial statements agree or reconcile with the accounting records.

To obtain evidence that the financial statements agree or reconcile with the accounting records, the accountant may compare the financial statements to:

   a. The accounting records, such as the general ledger or trial balance
   b. A consolidating schedule derived from the accounting records, or
   c. Other supporting data in the entity’s records.

For those accountants who also prepare the financial statements as part of the review engagement, it would appear that the requirement to reconcile the financial statements to the records would be redundant and moot. Nevertheless, SSARS No. 21 does, in fact, explicitly include the requirement to demonstrate that the financial statements “agree” with the accounting records. The author believes that the best way in which an accountant can satisfy this requirement is to print a copy of the financial statement grouping schedule and include that document in the accountant’s workpapers. That grouping schedule, by itself, clearly demonstrates that the financial statements reconcile to the trial balance from which the financial statements were prepared.
Review Questions

1. In which of the following types of engagements must an accountant plan materiality:
   a. Audit engagement
   b. Review engagement
   c. Compilation engagement
   d. Agreed-upon procedures engagement

2. A restricted-use report should contain a separate other-matter paragraph that includes all of the following except:
   a. A statement indicating that the report is intended solely for the information and use of the specified parties
   b. An explanation for how to use the statements for nonspecified parties
   c. An identification of the specified parties to whom use is restricted
   d. A statement that the report is not intended to be and should not be used by anyone other than the specified parties

3. SSARS No. 21 permits an accountant to perform a compilation engagement related to a specified _______ of a financial statement.
   a. Component
   b. Account
   c. Position
   d. Type

4. Which of the following is correct regarding a review of a specified element, account or item after the effective date of SSARS No. 21:
   a. A review engagement of a specified element, account or item is authorized by SSARS No. 21
   b. A review engagement is authorized by SSAE No. 10
   c. The review report provides positive assurance similar to an audit report
   d. A review of a specified element, account or item is not permitted

5. Ivan the CPA is asked to perform a compilation on a schedule of accounts receivable. Which of the following is correct.
   a. A full set of GAAP (or a special purpose framework) disclosures is required
   b. No disclosures are required
   c. Disclosures pertaining to the schedule of accounts receivable only are required
   d. Selected disclosures limited to the summary of significant accounting policies are required

6. Sarah CPA is issuing a review report on a single financial statement, a balance sheet on a GAAP basis. Sarah is determining whether there should be disclosures. Which of the following is correct.
   a. No disclosures are required
   b. A full set of GAAP (or a special purpose framework) disclosures is required
   c. Disclosures pertaining to the balance sheet only are required
   d. Selected disclosures limited to the summary of significant accounting policies are required

7. Which of the following should be the date of a management representation letter for a review engagement:
a. The last day of the related fiscal year being reviewed
b. The date that the letter is presented and signed by the client
c. The date of the accountant’s review report
d. The last date that the accountant and the client had contact

8. If a current owner/manager refuses to sign a representation letter for a period of time during which management was not present:
   a. A review report may not be issued
   b. The accountant is permitted to step down the engagement to a compilation engagement
   c. The accountant should notify all shareholders of the owner/manager’s refusal
   d. The accountant may step up the engagement to an audit

9. Which of the following is not an example of a circumstance when an accountant should consider obtaining an updated representation letter from management for a review engagement:
   a. The review report is not issued for a significant period of time after the original management representation letter was obtained
   b. A material subsequent event occurs after obtaining the original management representation letter, but before the issuance of the report
   c. A predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period
   d. There is a change in the format of the letter due to an issuance of a new SSARS

10. Ralphie CPA is performing a review on the financial statements of XYZ Company. Under AR-C 90, Ralphie must obtain evidence that:
    a. The general ledger reconciles to the trial balance
    b. The financial statements agree with the accounting records
    c. The notes agree with the financial statements
    d. Supplementary information reconciles with the financial statements
II. Practice Issues- Part 2

A. Personal Financial Statements and Prescribed Forms

CPAs are frequently asked to compile or review the personal financial statements of individuals or families applying for credit; perform income tax, retirement, gift, or estate planning; or provide public disclosure about their financial affairs (for example, individuals seeking public office).

1. Authority for Personal Financial Statements

GAAP for personal financial statements is found in ASC 274, *Personal Financial Statements* (formerly SOP 82-1). ASC 274 establishes accounting standards for GAAP-basis personal financial statements.

ASC 274 requires the following:

a. Personal financial statement assets must be stated at their estimated current values, and liabilities at their estimated current amounts. The costs of disposal of assets, if material, should be deducted in computing current values.

b. A statement of net worth (financial condition) is required while a statement of changes in net worth is optional.

c. A hypothetical estimated income tax liability must be calculated and presented in the liability section of the statement of net worth as follows:

<table>
<thead>
<tr>
<th>Estimated current value of net assets</th>
<th>$XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax basis of net assets</td>
<td>XX</td>
</tr>
<tr>
<td>Hypothetical gain</td>
<td>XX</td>
</tr>
<tr>
<td>Tax rate (s)</td>
<td>XX%</td>
</tr>
</tbody>
</table>

Estimated income tax liability on difference between value and tax basis of net assets

* Present as liability on the statement of financial condition

d. ASC 274 requires disclosures.

In most cases, personal financial statements are prepared using a bank’s prescribed form, instead of the borrower creating his or her own personal financial statement. In completing a prescribed form, there are logistical issues as to how SSARS No. 21 applies to the completion of that prescribed form.

A prescribed form is a standard preprinted form designed or adopted by the body to which it is to be submitted.
Examples of prescribed forms include:

- A personal financial statement on a bank’s preprinted form
- Industry trade association form
- Governmental or regulatory body form

Under the SSARS No. 21 standards, an accountant who is asked to perform an engagement on the prescribed form may perform either a:

- Preparation engagement on the prescribed form,
- Compilation engagement on the prescribed form, or
- Review engagement on the prescribed form.

Rarely will an accountant be called upon to perform a review engagement on a prescribed form.

2. Preparation Engagement- Personal Financial Statements

Is an accountant permitted to perform a preparation of financial statements engagement under AR-C 70 on a prescribed form?

Prior to the effective date of SSARS No. 21, the guidance for the rules for reporting on a prescribed form was found in SSARS No. 3, Compilation Reports on Financial Statements Included in Certain Prescribed Forms. SSARS No. 3 permitted an accountant to issue a compilation report on a prescribed form financial statement such as a bank's preprinted personal financial statement. SSARS No. 3 offered a specific compilation report format for reporting on a prescribed form. SSARS No. 21 supersedes SSARS No. 3 so that there is no longer any formal guidance for reporting on a prescribed form, other than limited reference found in the AICPA Guide.

The question is whether an accountant is permitted to perform a preparation of financial statements engagement on a bank's prescribed form personal financial statement.

The answer is that nothing within SSARS No. 21 precludes an accountant from performing a preparation of financial statements engagement on a bank's prescribed form personal financial statement or, for that matter, a GAAP personal financial statement.

Paragraph 3.44 of the AICPA Guide offers guidance on performing a preparation engagement on a prescribed form.

1. In a prescribed form, there is a *presumption* that the information required by the prescribed form is *sufficient* to meet the needs of the body (such as a bank) that designated or adopted the form.

2. Because the form is deemed to be sufficient for the body’s (bank’s) needs, there is no need to advise the body (bank) of any departures from the applicable framework that are required by the form, including inadequacy of disclosures.

3. If there is a departure from the applicable framework other than departures that are called for by the prescribed form, that departure should be treated as a departure from the framework.
Note: Under the AR-C 70 preparation rules, if there is a departure from a framework, that departure should be disclosed either on the face of each page of the financial statements or in a related note.

Example: A bank personal financial statement (a prescribed form) has a statement of financial condition that uses GAAP as its framework. GAAP requires assets to be presented at estimated current values and liabilities at estimated current amounts. GAAP also requires that an estimated tax liability be recorded.

However, the form does not call for (require) that the statement of financial condition present an estimated tax liability which is required by GAAP.

Conclusion: There is a presumption that the information on the bank’s prescribed form is sufficient to meet the needs of the bank. Thus, even though the form has a departure from GAAP (missing estimated tax liability), that difference is not treated as a GAAP departure because the form calls for departure from the GAAP framework. The disclosures on the prescribed form are deemed to be sufficient for that bank’s prescribed form framework.

Change the facts: Assume that in addition to the missing tax liability, the personal financial statement is prepared by recording the borrower’s home at cost, instead of estimated current value required by the form.

Conclusion: The fact that the home is recorded at cost is a departure from the prescribed form which calls for recording the home at estimated current value. Thus, recording the home at cost is a departure from the framework in the prescribed form. That departure should be handled by disclosing the departure either on the face of each page of the prescribed form or in a related note to the form.

4. In a preparation engagement of a prescribed form, the following rules should be followed consistent with AR-C 70:

   a. Each page of the prescribed form personal financial statement must state, "no assurance is provided on these financial statements" or similar language.

      Note: If the client does not wish to add the "no assurance" legend, the accountant must attach a disclaimer report.

   b. The accountant must follow the preconditions found in AR-C 60 general conditions, as well as the overall performance requirements found in AR-C 70.

Example 1: Mary Jones, CPA performs a preparation of financial statements engagement on John Smith's prescribed form personal financial statement for the year ended December 31, 2015. A compilation, review or audit engagement is not performed.

The only GAAP departure in the prescribed form personal financial statement is that the personal financial statement does not include an "estimated tax liability" that is required under GAAP for personal financial statements. Substantially all GAAP disclosures are omitted.
Conclusion: Mary should follow the rules for a preparation of financial statements engagement under AR-C 70 as follows:

a. Mary must follow the preconditions found in AR-C 60 general conditions, as well as the overall performance requirements found in AR-C 70.

b. Each page of the prescribed form personal financial statement must state:

"No assurance is provided on these financial statements."

c. If the client does not wish to add the "no assurance" legend, Mary must attach a disclaimer report.

d. There is no requirement to disclose the GAAP departure (missing estimated tax liability) because it is presumed that the information on the prescribed form is sufficient for the bank’s needs.

e. There is no requirement to include on each page a legend stating that substantially all disclosures required by GAAP are not included. It is presumed that all disclosures on the form are sufficient for the needs of the bank.

On the following pages, the author provides sample personal financial statements on a prescribed bank form based on the Example 1 information. The prescribed form is prepared under the AR-C 70 rules.
**PERSONAL FINANCIAL STATEMENT**

As of: 12-31-15

Name: John Smith
Address: 112 Jones Blvd
City/Town: Boston State: MA
Employer/position: Big Dog Manufacturing
Date of birth: 04-04-52
Social security number: 023-33-4435

**IMPORTANT: INSTRUCTIONS TO APPLICANT**

Read directions before completing Financial Statement.
Please check appropriate box

- Individual credit—If relying on your own income and assets and not the income and assets of a spouse or another person as a basis for Extension or repayment or credit, complete the Financial Statement below.
- Joint Credit
  - If applying for joint credit or for individual credit relying on income or assets of a spouse or another person for extension and repayment of credit requested,
  - Individuals relying upon income or assets of the spouse or other person. Both Applicant and Spouse or Co-Applicant sign this statement.

Please do not leave any questions unanswered. Use “no” or “none” where necessary.

**FINANCIAL CONDITION AS OF December 31, 2015**

<table>
<thead>
<tr>
<th>Assets</th>
<th>In Even Dollars</th>
<th>Liabilities and Net Worth</th>
<th>In Even Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand and in Banks—See Schedule A</td>
<td>$ 200,000</td>
<td>Notes Payable: This Bank—See Schedule A</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Government Securities—See Schedule B</td>
<td></td>
<td>Notes Payable: Other Institutions—See Schedule A</td>
<td></td>
</tr>
<tr>
<td>Listed Securities—See Schedule B</td>
<td>3,800,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unlisted Securities—See Schedule B</td>
<td></td>
<td>Notes Payable: Relatives</td>
<td></td>
</tr>
<tr>
<td>Other Equity Interests—See Schedule B</td>
<td></td>
<td>Notes Payable: Others</td>
<td></td>
</tr>
<tr>
<td>Accounts and Notes Receivable</td>
<td></td>
<td>Accounts and Bills Due</td>
<td>25,000</td>
</tr>
<tr>
<td>Real Estate Owned—See Schedule C</td>
<td>4,000,000</td>
<td>Unpaid Taxes</td>
<td></td>
</tr>
<tr>
<td>Mortgages and Land Contracts Receivable—See Schedule D</td>
<td></td>
<td>Real Estate Mortgages Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Cash Value Life Insurance—See Schedule E</td>
<td></td>
<td>Land Contracts Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Other Assets: Itemize</td>
<td>150,000</td>
<td>Life Insurance Loans—See Schedule E</td>
<td></td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>50,000</td>
<td>Other Liabilities: Itemize</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous payables</td>
<td></td>
<td></td>
<td>75,000</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>$8,200,000</strong></td>
<td><strong>TOTAL LIABILITIES</strong></td>
<td><strong>$2,400,000</strong></td>
</tr>
<tr>
<td><strong>NET WORTH</strong></td>
<td><strong>$5,800,000</strong></td>
<td><strong>TOTAL LIABILITIES AND NET WORTH</strong></td>
<td><strong>$8,200,000</strong></td>
</tr>
</tbody>
</table>

*No assurance is provided on these financial statements.*
## Sources of Income

<table>
<thead>
<tr>
<th>Sources of Income</th>
<th>In Even Dollars</th>
<th>General Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td></td>
<td>Employer: Smith, Smith and Alfonzo, Attorneys at Law</td>
</tr>
<tr>
<td>Bonus and Commissions</td>
<td></td>
<td>Position or Profession: Partner</td>
</tr>
<tr>
<td>Dividends</td>
<td>200,000</td>
<td>Employer’s Address: 10 State St., Boston, MA</td>
</tr>
<tr>
<td>Real Estate Income</td>
<td>170,000</td>
<td>Phone No.: 617-628-4400</td>
</tr>
<tr>
<td>*Other Income: Itemize</td>
<td></td>
<td>Partner, officer or owner in any other venture? No</td>
</tr>
<tr>
<td></td>
<td></td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Partnership income K-1</td>
<td>250,000</td>
<td>TOTAL: $620,000</td>
</tr>
</tbody>
</table>

### General Information (continued)

- Are any assets pledged? No
- Are assets pledged? Detail in Schedule A and C
- Income taxes settled through (Date): 2011

## Contingent Liabilities

<table>
<thead>
<tr>
<th>Contingent Liabilities</th>
<th>In Even Dollars</th>
<th>General Information (continued)</th>
</tr>
</thead>
<tbody>
<tr>
<td>As endorser, co-maker or guarantor</td>
<td></td>
<td>Are you a defendant in any suits or legal action? No</td>
</tr>
<tr>
<td>On leases</td>
<td></td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Legal claims</td>
<td></td>
<td>Have you ever taken bankruptcy? Yes</td>
</tr>
<tr>
<td>Provision for federal income taxes</td>
<td>100,000</td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Other special debt, e.g., recourse or repurchase liability</td>
<td></td>
<td>Do you have a will? Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Do you have a trust? Yes</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$100,000</td>
<td>Number of dependents: 2 Ages: 16 and 19</td>
</tr>
</tbody>
</table>

## Schedule A: Banks, Brokers, Savings & Loan Association, Finance Companies or Credit Unions

<table>
<thead>
<tr>
<th>Name of Institution</th>
<th>Name on Account</th>
<th>Balance on Deposit</th>
<th>High Credit</th>
<th>Amount Owing</th>
<th>Monthly Payment</th>
<th>Secured by What Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>John Smith</td>
<td>$150,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>TD Bank</td>
<td>John Smith</td>
<td>50,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>No Loan Bank</td>
<td>John Smith</td>
<td>1,000,000</td>
<td>4,500</td>
<td>4,500</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>$200,000</td>
<td></td>
<td></td>
<td>$4,500</td>
<td>$0</td>
</tr>
</tbody>
</table>

## Schedule B: U.S. Governments, Stocks (Listed & Unlisted), Bonds (Gov't & Comm.), and Partnership Interests

<table>
<thead>
<tr>
<th>Shares, Face Value (Bonds), or % of Ownership</th>
<th>In Name of</th>
<th>*Market Value</th>
<th>Pledged</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Agency or name of company issuing security or name of partnership</td>
<td>John Smith</td>
<td>400,000</td>
<td>X</td>
</tr>
<tr>
<td>2. Type of investment or equity classification</td>
<td>John Smith</td>
<td>1,800,000</td>
<td>X</td>
</tr>
<tr>
<td>3. Number of shares, bonds or % of ownership held</td>
<td>John Smith</td>
<td>1,000,000</td>
<td>X</td>
</tr>
<tr>
<td>4. Basis of valuation*</td>
<td>John Smith</td>
<td>600,000</td>
<td>X</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3,800,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*If unlisted security or partnership interest, provide current financial statements to support basis for valuation.

---

No assurance is provided on these financial statements.
## Schedule C: Real Estate Owned (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Cost + Improvements</th>
<th>Present Mkt. Value</th>
<th>Mortgage or Land Contract Payable Bal. Owing</th>
<th>Mo. Payt.</th>
<th>Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td>130 Reginald St, Boston, MA</td>
<td>John Smith</td>
<td>2005</td>
<td>$1,500,000</td>
<td>$3,000,000</td>
<td>$1,000,000</td>
<td>$5,000</td>
<td>BOA</td>
</tr>
<tr>
<td>Residence- 112 Jones Blvd, Boston, MA</td>
<td>John and Mary Smith</td>
<td>1990</td>
<td>130,000</td>
<td>1,000,000</td>
<td>300,000</td>
<td>1,500</td>
<td>BOA</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td>$4,000,000</td>
<td>$1,300,000</td>
<td>$6,500</td>
<td></td>
</tr>
</tbody>
</table>

## Schedule D: Real Estate: Mortgages & Land Contracts Receivable (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Balance Receivable</th>
<th>Monthly Payment</th>
<th>Mortgage or Land Contract Payable Bal. Owing</th>
<th>Mo. Payt.</th>
<th>Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Schedule E: Life Insurance Carried

<table>
<thead>
<tr>
<th>Name of Company</th>
<th>Face Amount</th>
<th>Cash Surrender Value</th>
<th>Loans</th>
<th>Beneficiary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

I/we have carefully read and submitted the foregoing information provided on all three pages of this statement to the Bank named above. The information is presented as a true and accurate statement of my/our financial condition on the date indicated. This statement is provided for the purpose of obtaining and maintaining credit with said Bank. I/we agree that if any material change(s) occur(s) in my/our financial condition that I/we will immediately notify said Bank of said change(s) and unless said Bank is so notified it may continue to rely upon this financial statement and the representations made herein as a true and accurate statement of my/our financial condition.

I/we authorize the Bank to make whatever credit inquiries it deems necessary in connection with this financial statement. I/we authorize and instruct any person or consumer reporting agency to furnish to the Bank any information that it may have or obtain in response to such credit inquiries.

I/we also hereby certify that no payment requirements listed herein are delinquent or in default except as follows; if “NONE” so state.

I/we fully understand that it is a federal crime punishable by fine or imprisonment or both to knowingly make any false statements concerning any of the above facts.

Applicant’s Signature ___________________________ Date ________
Signed __________

Spouse’s or Co-Applicant’s Signature ___________________________ Date ________
Signed __________

No assurance is provided on these financial statements.

**Example 2:** Same facts as Example 1 except that the client does not wish to place a "no assurance" legend on each page of the personal financial statements.
Conclusion: In accordance with SSARS No. 21, Mary must attach a disclaimer report.

John Smith

The accompanying financial statements of John Smith as of and for the year ended December 31, 2015, were not subjected to an audit, review, or compilation engagement by me. Accordingly, I do not express an opinion, a conclusion, nor provide any assurance on them.

Mary Jones, CPA
Boston, Massachusetts
PERSONAL FINANCIAL STATEMENT

As of: 12-31-15

Name: John Smith
Address: 112 Jones Blvd
City/Town: Boston State: MA
Employer/position: Big Dog Manufacturing
Date of birth: 04-04-52
Social security number: 023-33-4435

Spouse name: 
Address: 
City/Town: State: 
Employer/position: 
Date of birth: 
Social security number: 

Please do not leave any questions unanswered. Use “no” or “none” where necessary.

FINANCIAL CONDITION AS OF December 31, 2015

<table>
<thead>
<tr>
<th>Assets</th>
<th>In Even Dollars</th>
<th>Liabilities and Net Worth</th>
<th>In Even Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand and in Banks—See Schedule A</td>
<td>$200,000</td>
<td>Notes Payable: This Bank—See Schedule A</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Government Securities—See Schedule B</td>
<td>3,800,000</td>
<td>Notes Payable: Other Institutions—See Schedule A</td>
<td></td>
</tr>
<tr>
<td>Listed Securities—See Schedule B</td>
<td>4,000,000</td>
<td>Notes Payable—Relatives</td>
<td></td>
</tr>
<tr>
<td>Unlisted Securities—See Schedule B</td>
<td></td>
<td>Notes Payable—Others</td>
<td></td>
</tr>
<tr>
<td>Other Equity Interests—See Schedule B</td>
<td></td>
<td>Accounts and Bills Due</td>
<td></td>
</tr>
<tr>
<td>Accounts and Notes Receivable</td>
<td>25,000</td>
<td>Unpaid Taxes</td>
<td></td>
</tr>
<tr>
<td>Real Estate Owned—See Schedule C</td>
<td></td>
<td>Real Estate Mortgages Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Mortgages and Land Contracts Receivable—See Schedule D</td>
<td></td>
<td>Land Contracts Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Cash Value Life Insurance—See Schedule E</td>
<td>150,000</td>
<td>Life Insurance Loans—See Schedule E</td>
<td></td>
</tr>
<tr>
<td>Other Assets: Itemize</td>
<td>50,000</td>
<td>Other Liabilities: Itemize</td>
<td></td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td></td>
<td>Miscellaneous payables</td>
<td></td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>$8,200,000</td>
<td>TOTAL LIABILITIES</td>
<td>$2,400,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>NET WORTH</td>
<td>$5,800,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TOTAL LIABILITIES AND NET WORTH</td>
<td>$8,200,000</td>
</tr>
</tbody>
</table>
Sources of Income

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
<th>Employer</th>
<th>Address</th>
<th>Phone No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$</td>
<td>Smith, Smith and Alfonzo, Attorneys at Law</td>
<td>10 State St., Boston, MA</td>
<td>617-628-4400</td>
</tr>
<tr>
<td>Bonus and Commissions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate Income</td>
<td>170,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>*Other Income: Itemize</td>
<td></td>
<td>Partner, officer or owner in any other venture?</td>
<td>X No Yes If so, explain:</td>
<td></td>
</tr>
<tr>
<td>Partnership income K-1</td>
<td>250,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$620,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Alimony, child support or separate maintenance payments need not be disclosed unless relied upon as a basis for extension of credit. If disclosed, payments received under □ court order □ written agreement □ oral understanding.

Contingent Liabilities

<table>
<thead>
<tr>
<th>Liability Description</th>
<th>Amount</th>
<th>Employer</th>
<th>Address</th>
<th>Phone No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>As endorser, co-maker or guarantor</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal claims</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for federal income taxes</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other special debt, e.g., recourse or repurchase liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$100,000</td>
<td>Number of dependents 2 Ages 16 and 19</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Schedule A: Banks, Brokers, Savings & Loan Association, Finance Companies or Credit Unions.

<table>
<thead>
<tr>
<th>Name of Institution</th>
<th>Name on Account</th>
<th>Balance on Deposit</th>
<th>High Credit</th>
<th>Amount Owing</th>
<th>Monthly Payment</th>
<th>Secured by What Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>John Smith</td>
<td>$150,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>TD Bank</td>
<td>John Smith</td>
<td>50,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>No Loan Bank</td>
<td>John Smith</td>
<td>1,000,000</td>
<td>4,500</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>$200,000</td>
<td></td>
<td>$1,000,000</td>
<td>$4,500</td>
<td>$0</td>
</tr>
</tbody>
</table>

Schedule B: U.S. Governments, Stocks (Listed & Unlisted), Bonds (Gov't & Comm.), and Partnership Interests (General & Ltd.)

<table>
<thead>
<tr>
<th>Shares, Face Value (Bonds), or % of Ownership</th>
<th>Number of Shares</th>
<th>In Name of</th>
<th>*Market Value</th>
<th>Pledged</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Agency or name of company issuing security or name of partnership</td>
<td>10,300 IBM</td>
<td>John Smith</td>
<td>400,000</td>
<td>X</td>
</tr>
<tr>
<td>2. Type of investment or equity classification</td>
<td>18,000 Microsoft</td>
<td>John Smith</td>
<td>1,800,000</td>
<td>X</td>
</tr>
<tr>
<td>3. Number of shares, bonds or % of ownership held</td>
<td>20,000 Ford</td>
<td>John Smith</td>
<td>1,000,000</td>
<td>X</td>
</tr>
<tr>
<td>4. Basis of valuation*</td>
<td>10,000 General Electric</td>
<td>John Smith</td>
<td>600,000</td>
<td>X</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3,800,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*If unlisted security or partnership interest, provide current financial statements to support basis for valuation.
### Schedule C: Real Estate Owned (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Cost + Improvements</th>
<th>Present Mkt. Value</th>
<th>Mortgage or Land Contract Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>130 Reginald St, Boston, MA</td>
<td>John Smith</td>
<td>2005</td>
<td>$1,500,000</td>
<td>$3,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Residence- 112 Jones Blvd, Boston, MA</td>
<td>John and Mary Smith</td>
<td>1990</td>
<td>130,000</td>
<td>1,000,000</td>
<td>300,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td>$4,000,000</td>
<td>$1,300,000</td>
</tr>
</tbody>
</table>

### Schedule D: Real Estate: Mortgages & Land Contracts Receivable (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Balance Receivable</th>
<th>Monthly Payment</th>
<th>Mortgage or Land Contract Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Schedule E: Life Insurance Carried

<table>
<thead>
<tr>
<th>Name of Company</th>
<th>Face Amount</th>
<th>Cash Surrender Value</th>
<th>Loans</th>
<th>Beneficiary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

I/we have carefully read and submitted the foregoing information provided on all three pages of this statement to the Bank named above. The information is presented as a true and accurate statement of my/our financial condition on the date indicated. This statement is provided for the purpose of obtaining and maintaining credit with said Bank. I/we agree that if any material change(s) occur(s) in my/our financial condition that I/we will immediately notify said Bank of said change(s) and unless said Bank is so notified it may continue to rely upon this financial statement and the representations made herein as a true and accurate statement of my/our financial condition.

I/we authorize the Bank to make whatever credit inquiries it deems necessary in connection with this financial statement. I/we authorize and instruct any person or consumer reporting agency to furnish to the Bank any information that it may have or obtain in response to such credit inquiries.

I/we also hereby certify that no payment requirements listed herein are delinquent or in default except as follows; if “NONE” so state.

I/we fully understand that it is a federal crime punishable by fine or imprisonment or both to knowingly make any false statements concerning any of the above facts.

Applicant's Signature ______________________ Date ________ Signed ________
Spouse's or Co-Applicant's Signature ______________________ Date ________ Signed ________

**Observation:** Notice that Example 2 does not include a "no assurance" legend on each page of the financial statements. AR-C 70 of SSARS No. 21 states that if a "no assurance" legend is not included on each page of the financial statements, the accountant must include a disclaimer report.
2. Compilation of Personal Financial Statements

Examples of a preparation engagement on a prescribed form are presented within the presentation of financial statements of this course.

As previously noted in this section of the course, prior to the effective date of SSARS No. 21, the guidance for the rules for reporting on a prescribed form has been found in SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*.

SSARS No. 21 supersedes SSARS No. 3 so that there is no longer any formal guidance for reporting on a prescribed form, other than limited reference found in the AICPA Guide.

The question is whether an accountant is permitted to perform a compilation of financial statements engagement on a bank's prescribed form personal financial statement.

Paragraph 2.81 of the AICPA Guide offers guidance on performing a compilation engagement on a prescribed form.

   a. In a prescribed form, there is a *presumption* that the information required by the prescribed form is *sufficient* to meet the needs of the body (such as a bank) that designated or adopted the form.

   b. Because the form is deemed to be sufficient for the body’s (bank’s) needs, there is no need to advise the body (bank) of any departures from the applicable framework that are required by the form, including inadequacy of disclosures.

   c. If there is a departure from the applicable framework other than departures that are called for by the prescribed form, that departure should be treated as a departure from the framework.

The AICPA Guide offers an example of a compilation report on a prescribed form. The author has modified the Guide’s report to create the following example:

**Facts:**

- Accountant is asked to issue a compilation report on a prescribed form personal financial statement of Never Loan Bank.
- The prescribed form has one financial statement which is the statement of financial condition which is prepared using GAAP.
- The prescribed form has one departure from U.S. GAAP in that an estimated liability for taxes is not included in the prescribed form.

**Conclusion:**

The report and prescribed form are issued in the following format:
Management is responsible for the statement of financial condition of John Smith as of December 31, 2015 included in the accompanying prescribed form in accordance with accounting principles generally accepted in the United States of America. We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statement included in the accompanying prescribed form, nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on the financial statements included in the accompanying prescribed form.

The financial statements included in the accompanying prescribed form are presented in accordance with the requirements of Never Loan Bank, and are not intended to be a presentation in accordance with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of Never Loan Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of accounting firm or accountant, as appropriate]
[Accountant’s city and state]
[Date of the accountant’s report]
As of: 12-31-15

Name: John Smith
Address: 112 Jones Blvd
City/Town: Boston State: MA
Employer/position: Big Dog Manufacturing
Date of birth: 04-04-52
Social security number: 023-33-4435

**IMPORTANT: INSTRUCTIONS TO APPLICANT**

Read directions before completing Financial Statement.
Please check appropriate box

- Individual credit—if relying on your own income and assets and not the income and assets of a spouse or another person as a basis for Extension or repayment of credit, complete the Financial Statement below

- Joint Credit
  - If applying for joint credit or for individual credit relying on income or assets of a spouse or another person for extension and repayment of credit requested,
  - Complete the Financial Statement below. Include Information about income, assets and liabilities of the spouse or other person. Both Applicant and Spouse or Co-Applicant sign this statement.

Please do not leave any questions unanswered. Use "no" or "none" where necessary.

### FINANCIAL CONDITION AS OF December 31, 2015

<table>
<thead>
<tr>
<th>Assets</th>
<th>In Even Dollars</th>
<th>Liabilities and Net Worth</th>
<th>In Even Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand and in Banks—See Schedule A</td>
<td>$200,000</td>
<td>Notes Payable: This Bank—See Schedule A</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Government Securities—See Schedule B</td>
<td>3,800,000</td>
<td>Notes Payable: Other Institutions—See Schedule A</td>
<td></td>
</tr>
<tr>
<td>Listed Securities—See Schedule B</td>
<td>3,800,000</td>
<td>Notes Payable—Relatives</td>
<td></td>
</tr>
<tr>
<td>Unlisted Securities—See Schedule B</td>
<td></td>
<td>Notes Payable—Others</td>
<td></td>
</tr>
<tr>
<td>Other Equity Interests—See Schedule B</td>
<td></td>
<td>Accounts and Bills Due</td>
<td></td>
</tr>
<tr>
<td>Accounts and Notes Receivable</td>
<td></td>
<td>Unpaid Taxes</td>
<td></td>
</tr>
<tr>
<td>Real Estate Owned—See Schedule C</td>
<td>4,000,000</td>
<td>Real Estate Mortgages Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Mortgages and Land Contracts Receivable—</td>
<td></td>
<td>$1,300,000</td>
<td></td>
</tr>
<tr>
<td>See Schedule D</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Value Life Insurance—See Schedule E</td>
<td></td>
<td>Land Contracts Payable—See Schedule C or D</td>
<td></td>
</tr>
<tr>
<td>Other Assets: Itemize</td>
<td>150,000</td>
<td>Life Insurance Loans—See Schedule E</td>
<td></td>
</tr>
<tr>
<td>Furniture and fixtures</td>
<td>50,000</td>
<td>Other Liabilities: Itemize</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Miscellaneous payables</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>TOTAL LIABILITIES</td>
<td></td>
<td>$2,400,000</td>
<td></td>
</tr>
<tr>
<td>NET WORTH</td>
<td></td>
<td>$5,800,000</td>
<td></td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>$8,200,000</td>
<td>TOTAL LIABILITIES AND NET WORTH</td>
<td>$8,200,000</td>
</tr>
</tbody>
</table>

See Accountant’s Compilation Report (1)
### Sources of Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>General Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$</td>
<td>Employer: Smith, Smith and Alfonzo, Attorneys at Law</td>
</tr>
<tr>
<td>Bonus and Commissions</td>
<td></td>
<td>Position or Profession: Partner, No. Years: 25</td>
</tr>
<tr>
<td>Dividends</td>
<td>200,000</td>
<td>Employer’s Address: 10 State St., Boston, MA</td>
</tr>
<tr>
<td>Real Estate Income</td>
<td>170,000</td>
<td>Phone No.: 617-628-4400</td>
</tr>
<tr>
<td>*Other Income: Itemize</td>
<td></td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Partnership income K-1</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$620,000</td>
<td></td>
</tr>
</tbody>
</table>

*Alimony, child support or separate maintenance payments need not be disclosed unless relied upon as a basis for extension of credit. If disclosed, payments received under a court order or written agreement or oral understanding.

### Contingent Liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>General Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>As endorser, co-maker or guarantor</td>
<td>$</td>
<td>Are you a defendant in any suits or legal action? X No</td>
</tr>
<tr>
<td>On leases</td>
<td></td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Legal claims</td>
<td></td>
<td>Have you ever taken bankruptcy? X No</td>
</tr>
<tr>
<td>Provision for federal income taxes</td>
<td>100,000</td>
<td>If so, explain:</td>
</tr>
<tr>
<td>Other special debt, e.g., recourse</td>
<td></td>
<td>Do you have a will? X Yes</td>
</tr>
<tr>
<td>liability</td>
<td></td>
<td>Do you have a trust? X Yes</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

### Schedule A: Banks, Brokers, Savings & Loan Association, Finance Companies or Credit Unions

<table>
<thead>
<tr>
<th>Name of Institution</th>
<th>Name on Account</th>
<th>Balance on Deposit</th>
<th>High Credit</th>
<th>Amount Owing</th>
<th>Monthly Payment</th>
<th>Secured by What Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>John Smith</td>
<td>$150,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>TD Bank</td>
<td>John Smith</td>
<td>50,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>No Loan Bank</td>
<td>John Smith</td>
<td>1,000,000</td>
<td>4,500</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$200,000</td>
<td>$1,000,000</td>
<td>$4,500</td>
<td>$0</td>
<td></td>
<td>$0</td>
</tr>
</tbody>
</table>

### Schedule B: U.S. Governments, Stocks (Listed & Unlisted), Bonds (Gov’t & Comm.), and Partnership Interests (General & Ltd.)

<table>
<thead>
<tr>
<th>Number of Shares, Face Value (Bonds), or % of Ownership</th>
<th>Indicate:</th>
<th>Pledged</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Agency or name of company issuing security or name of partnership</td>
<td>In Name of</td>
<td></td>
</tr>
<tr>
<td>2. Type of investment or equity classification</td>
<td>*Market Value</td>
<td></td>
</tr>
<tr>
<td>3. Number of shares, bonds or % of ownership held</td>
<td>Yes (Ⅲ)</td>
<td></td>
</tr>
<tr>
<td>4. Basis of valuation*</td>
<td>No (Ⅲ)</td>
<td></td>
</tr>
<tr>
<td>10,300 IBM</td>
<td>John Smith</td>
<td>400,000</td>
</tr>
<tr>
<td>18,000 Microsoft</td>
<td>John Smith</td>
<td>1,800,000</td>
</tr>
<tr>
<td>20,000 Ford</td>
<td>John Smith</td>
<td>1,000,000</td>
</tr>
<tr>
<td>10,000 General Electric</td>
<td>John Smith</td>
<td>600,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>3,800,000</td>
<td></td>
</tr>
</tbody>
</table>

*If unlisted security or partnership interest, provide current financial statements to support basis for valuation.

See Accountant's Compilation Report (1)
Schedule C: Real Estate Owned (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Cost + Improvements</th>
<th>Present Market Value</th>
<th>Mortgage or Land Contract Payable</th>
<th>Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td>130 Reginald St, Boston, MA</td>
<td>John Smith</td>
<td>2005</td>
<td>$1,500,000</td>
<td>$3,000,000</td>
<td>$1,000,000</td>
<td>BOA</td>
</tr>
<tr>
<td>Residence- 112 Jones Blvd, Boston, MA</td>
<td>John and Mary Smith</td>
<td>1990</td>
<td>130,000</td>
<td>1,000,000</td>
<td>300,000</td>
<td>1,500</td>
</tr>
</tbody>
</table>

**TOTAL**

$4,000,000 $1,300,000 $6,500

Schedule D: Real Estate: Mortgages & Land Contracts Receivable (and related debt, if applicable)

<table>
<thead>
<tr>
<th>Description of Property or Address</th>
<th>Title in Name Of</th>
<th>Date Acq.</th>
<th>Balance Receivable</th>
<th>Monthly Payment</th>
<th>Mortgage or Land Contract Payable</th>
<th>Holder</th>
</tr>
</thead>
</table>

**TOTAL**

Schedule E: Life Insurance Carried

<table>
<thead>
<tr>
<th>Name of Company</th>
<th>Face Amount</th>
<th>Cash Surrender Value</th>
<th>Loans</th>
<th>Beneficiary</th>
</tr>
</thead>
</table>

**TOTAL**

I/we have carefully read and submitted the foregoing information provided on all three pages of this statement to the Bank named above. The information is presented as a true and accurate statement of my/our financial condition on the date indicated. This statement is provided for the purpose of obtaining and maintaining credit with said Bank. I/we agree that if any material change(s) occur(s) in my/our financial condition that I/we will immediately notify said Bank of said change(s) and unless said Bank is so notified it may continue to rely upon this financial statement and the representations made herein as a true and accurate statement of my/our financial condition.

I/we authorize the Bank to make whatever credit inquiries it deems necessary in connection with this financial statement. I/we authorize and instruct any person or consumer reporting agency to furnish to the Bank any information that it may have or obtain in response to such credit inquiries.

I/we also hereby certify that no payment requirements listed herein are delinquent or in default except as follows; if “NONE” so state.

I/we fully understand that it is a federal crime punishable by fine or imprisonment or both to knowingly make any false statements concerning any of the above facts.

Applicant’s Signature ___________________________ Date ______________
Signed __________

Spouse’s or Co-Applicant’s Signature ___________________________ Date ______________
Signed __________

See Accountant’s Compilation Report (1)

Observation:

(1) Notice that the prescribed form includes a legend, “See Accountant’s Compilation Report.” SSARS No. 21 no longer requires such a legend for a compilation engagement even though it is permitted. The author has included the legend on each page of the prescribed form to emphasize that he recommends that a practitioner include the legend even though not required.
4. Tax-Basis Personal Financial Statements:

A client may present personal financial statements using the tax-basis of accounting provided the financial statements or the report discloses the basis of accounting and how it differs from GAAP.

a. If this is the case, a tax basis title must be used such as:

   Statement of Financial Condition- Tax Basis

b. Under SSARS No. 21, if tax-basis financial statements are issued, the title should describe the framework (tax basis) and differentiate the title from a GAAP title.

c. If tax-basis personal financial statements are issued, the statement of financial condition would be measured at tax cost, and not estimated current values.

5. Obtaining a Management Representation Letter for a Preparation or Compilation of Personal Financial Statements:

If the accountant performs a preparation or compilation engagement on personal financial statements, SSARS No. 21 does not require that an accountant obtain a management representation letter.

However, because the accountant is relying on the client’s estimated values of assets and liabilities:

a. The accountant may wish to obtain a management representation letter.

b. In that letter, the accountant would probably want to include representations of values assigned to various assets and liabilities on the statement of financial condition.

B. Financial Statements Submitted Electronically

Regulatory bodies or other users of financial statements may request that financial statements that have been compiled or reviewed be submitted on a computer disk (e.g.; CD or USB disk, flash drive, etc.) or electronically as an email attachments.

a. SSARS No. 21 states that financial statements may be issued in a hard copy format or electronic medium:

   • The accountant's report may be included on the disk or transmitted electronically as part of the financial statements.

   • A hard copy of the financial statements and accountant's report does not have to be submitted.

When financial statements are submitted electronically, should they be sent in a Word®, PDF or other format, or password protected to avoid changes being made?
**Response:** If financial statements are sent in a Word®, PDF or other format with the report presumably scanned onto the accounting firm's letterhead, there is the risk that the client could change the financial statements and report prior to submitting them to a third party. If, instead, the financial statements and report are scanned into a PDF format (using Adobe® Acrobat), and then sent electronically to the client, it is less likely that the client is going to override the financial statements that are in a PDF format. Nevertheless, a client can override a PDF format or “cut and paste” a password-protected file so that it can be changed.

There is no authority as to which format is appropriate. The author believes that a practical approach should be applied toward sending information electronically. If a client's goal is to change the accountant's financial statements, that goal can be easily achieved regardless of the format in which they are received. This is the case whether the financial statements are in an electronic or paper format. Yes, it would be more prudent to send the financial statements in a PDF format; however, there is no requirement to do so.

**How should the financial statements be signed if sent in an electronic version?**

**Response:** SSARS No. 21 allows an accountant’s report signature to be either manual or printed. Therefore, an accountant may use a scanned or printed electronic signature in a report that is sent electronically. Most firms scan the firm's signature into the Word® or PDF file.

**Should the report include the firm's letterhead?**

**Response:** Although professional standards do not require that the accountant’s report (or financial statement pages) be printed on the firm’s letterhead, most firms print paper financial statements on their letterhead to add a level of formality to the presentation.

SSARS No. 21 requires that the city and state where the accountant practices be included on the report page. The city and state can either be included somewhere at the bottom of the body of the report or it can be part of the letterhead.
Review Questions

1. Which of the following is correct regarding ASC 274, *Personal Financial Statements*:
   a. ASC 274 requires that assets be stated at their fair value
   b. ASC 274 requires that liabilities be stated at their liquidation value
   c. The costs of disposal of assets, if material, should not be deducted in computing the values of assets
   d. The Statement of Changes in Net Worth is required

2. Which of the following is a prescribed form if it is submitted to a bank:
   a. A standard financial statement issued in accordance with GAAP
   b. A tax return
   c. A bank’s preprinted form
   d. A comprehensive set of instructions directing a particular form

3. Harry CPA is performing a compilation engagement on personal financial statements in a bank’s prescribed form. The prescribed form does not include an estimated tax liability which is required by GAAP. Which of the following is correct:
   a. The accountant should reference the GAAP departure in his compilation report
   b. The accountant should reference the GAAP departure in the disclosures but not the report
   c. No reference to the departure should be made in the report or disclosures
   d. There is no guidance to address the departure

4. Harold Brown CPA is asked to prepare a personal financial statement for Angie Jolie on the tax-basis of accounting. Which of the following is a title that Harold may use for one of the financial statements.
   a. Balance Sheet- Fair Value Basis
   b. Statement of Financial Condition- Tax Basis
   c. Statement of Cash Flows
   d. Statement of Financial Condition

5. Which of the following is correct regarding financial statements submitted electronically:
   a. SSARS No. 21 is not applicable to financial statements submitted electronically
   b. If financial statements are submitted to a client electronically, they must be sent in a PDF format only
   c. A hard copy of the financial statements and accountant’s report must also be submitted
   d. The report may be signed manually or electronically.
C. Peer Review Standards

The current peer review model has as key objectives the promotion of consistency and efficiency, and improved transparency.

The current model has two *types* of peer reviews:

**System Review** – This type of review is for firms that perform engagements under the SASs (audits) and/or examinations of prospective financial information under the SSAEs (attestation standards).

A system review focuses on a firm’s accounting and auditing practice system of quality control design, policies and procedures in accordance with the quality control standards.

**Engagement Review** – This type of review is for firms that are not required to have a system review (e.g., do not perform any audits (governmental or otherwise), or non-examination engagements under the SSAEs).

The objective of an engagement review is to evaluate whether engagements submitted for review are performed and reported on in conformity with professional standards including whether *the reviewed firm's working paper documentation conforms with the requirements of the SSARSs applicable to those engagements in all material respects*.

a. There is no opinion on the reviewed firm's system of quality control and, therefore, the reviewer is not opining on the firm’s compliance with its own quality control policies and procedures or with quality control standards, just conformity with SSARS and the SSAEs.

**Note:** Some examples of the documentation referred to above on a review engagement include the management representation letter, the documentation of the matters covered in the accountant's inquiry and analytical procedures, etc.

b. Engagement reviews include compilations that omit substantially all disclosures.

The following table summarizes the current peer review structure:
<table>
<thead>
<tr>
<th>Highest Level of Service Conducted by Firm</th>
<th>Type of Peer Review Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audits and/or examinations of prospective information (attestation engagements).</td>
<td><strong>System review:</strong></td>
</tr>
<tr>
<td></td>
<td>- An opinion given on the firm's system of quality control.</td>
</tr>
<tr>
<td>Firms that are not required to have a system review.</td>
<td><strong>Engagement review:</strong></td>
</tr>
<tr>
<td></td>
<td>- Committee acceptance and monitoring.</td>
</tr>
<tr>
<td>Example:</td>
<td>- Additional requirements: workpaper documentation is in conformity with the SSARSs and/or SSAEs. Examples include management representation letter, documentation of matters covered in the accountant's inquiry and analytical procedures, etc.</td>
</tr>
<tr>
<td>- Reviews</td>
<td></td>
</tr>
<tr>
<td>- Compilations with or without disclosures</td>
<td></td>
</tr>
</tbody>
</table>

**Current measurement standards:**

The current peer review program includes terms to measure the quality of the peer review engagement:

- Matter
- Finding
- Deficiency, and
- Significant deficiency

A peer reviewer identifies a matter as a result of his or her evaluation of the firm’s system of quality control. A matter warrants further consideration by the reviewer and is documented on a Matter for Further Consideration (MFC) form.

**System review:**

A finding is one or more related matters that result from a condition in the firm’s system of quality control or compliance with that system that provides more than a remote possibility that the firm would not perform and/or report in conformity with professional standards.

a. If there is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

b. A finding that does not rise to the level of deficiency or significant deficiency is documented on a Finding for Further Consideration (FFC) form and is not included in the final peer review report.
A *deficiency* is one or more findings that the peer reviewer concludes that taken as whole, *could create a situation* in which the firm would not have reasonable assurance of performing and/or reporting in conformity with professional standards on one or more important respects.

A *significant deficiency* is one or more deficiencies that the peer reviewer concludes results from a condition in the reviewed firm’s system of quality control or compliance such that as a whole, does not provide the firm with reasonable assurance of performing and/or reporting in conformity with professional standards in all material respects.

**Engagement review:**

A *finding* is one or more related matters that the reviewer concludes result in financial statements or information, accountant’s report, or procedures performed, not being performed and/or reported on in conformity with the professional standards.

a. If there is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

A *deficiency* is one or more findings that the peer reviewer concludes that taken as whole, are material to the understanding of the financial statements or information and/or related accountant’s reports or that represent omission of a critical procedure, including documentation, required by professional standards.

A *significant deficiency* exists when the peer reviewer concludes that deficiencies are evident on all of the engagements submitted for review. The exception is when more than one engagement has been submitted for review, the exact same deficiency occurs on each of those engagements, and there are no other deficiencies, which ordinarily would result in a report with a peer review rating of pass with deficiencies.

There are three (3) types of final reviewer reports that can be issued:

**Pass:** There were no deficiencies or significant deficiencies.

**Pass with deficiency:** There was one or more deficiencies but no significant deficiencies.

**Fail:** There was one or more significant deficiencies.

**Other changes:**

There are several other important requirements under the current peer review program:

a. The initial selection of engagements to be reviewed should be provided by the peer reviewer to the reviewed firm *no earlier* than three weeks prior to the commencement of the peer review procedures.

• At least one engagement from the initial selection should be provided to the firm once the peer review begins and not provided in advance. The selection should be an audit or the next highest level of service.

b. The reviewed firm must provide a representation letter to the peer reviewer.
The representation regarding compliance is stipulated as negative assurance.

A firm’s refusal to furnish a written representation letter to the reviewer constitutes a limitation of the peer review.

The letter must state that the accountant has submitted all engagements to the reviewer.

c. A firm’s due date for its initial peer review is 18 months from the date it enrolled in the program. Subsequent peer reviews have a due date of three years and six months from the year end of the previous peer review.

*Developments in peer review*

In the past few years, there were several changes made to peer reviews that practitioners should understand.

**Development 1: Changes in Peer Review Documentation for a Compilation Engagement:**

In performing a peer review under an engagement review, peer reviewers were required to look at documentation for a review engagement but had *the option to look at such documentation for a compilation engagement*. Thus, prior to 2011, if a compilation engagement was selected for peer review, the peer reviewer would generally look at the compiled financial statements and report, but not necessarily ask for any compilation engagement documents.

In May 2011, the AICPA published a peer review standard entitled, *Performing and Reporting on Peer Reviews of Compilations Performed Under SSARS No. 19*.

In the peer review standard, with respect to peer reviews for which the peer reviewer selects a compilation engagement, the following rules apply:

1. For each engagement selected (compilation or review engagement), the reviewed firm should submit not only the appropriate financial statements and accountant’s report, masking the client identity, if it desires, along with specified background information, but also the firm’s documentation required for each of these engagements.

2. The documentation requirement now applies to both compilation and review engagements, and not just review engagements.

That means, for new peer reviews, the reviewed firm must submit the following documentation for each compilation engagement selected:

1. Compiled financial statements (including notes, if applicable), and compilation report.

2. Documentation that includes:

   a. An engagement letter documenting the understanding with the client
b. Any findings or issues that, in the accountant’s judgment, are significant.

c. Communications (oral or written), to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention, if any.

**Development 2: Reports on Service Organizations Now Included under a System Review:**

Firms that perform engagements under the SASs or examinations of prospective financial statements under the Statements on Standards for Attestation Engagements (SSAEs) must undergo a system review.

SSAE No. 16, *Reporting on Controls at a Service Organization*, was issued and superseded SAS No. 70 dealing with an examination of the controls of a service organization.

Under SAS No. 70, service organization engagements were subject to a system review, and not an engagement review. As currently written, SSAE No. 16 is an SSAE engagement that is not the examination of prospective financial statements, and therefore is subject to an engagement review, not a system review.

With the transformation from SAS No. 70 to SSAE No. 16, the Peer Review Committee sought to update the standards need to be updated for inclusion to include examinations of a service organization’s controls likely to be relevant to user entities‘ internal control over financial reporting under SSAEs in a System Review. Therefore, under the change, reports of a service organization’s controls issued under SSAE No. 16 are now subject to a system review, and not an engagement review.

**Development 3: Carrying Broker-Dealer Engagements are now Must-Select Engagements:**

The Peer Review Committee now requires that if there is an audit involving carrying broker-dealers, the peer reviewer must treat that engagement as a must-select engagement in a system review.

1. Regulatory and legislative developments have made it clear that there is a significant public interest in, and a higher risk associated with, audits of broker-dealers. The type of broker-dealer with the highest risk is a carrying broker-dealer.

2. If a firm performs an audit of one or more carrying broker-dealers, at least one such carrying broker-dealer audit engagement should be selected for review.

3. If a firm’s audits of broker-dealers include only non-carrying broker-dealers, the team captain should be aware of and give special consideration to the risks associated with such broker-dealer audits in making engagement selections.

**Peer Reviews: Recurring Deficiencies Noted in Compilation and Review Engagements**

From time to time, the peer review committee of the AICPA published *Common Deficiencies Noted During Peer Reviews*.

Following are the deficiencies noted in peer reviews as published by the AICPA’s peer review committee in its report entitled “*Common Deficiencies Noted During Peer Reviews.*” Although this
course is limited to compilation and review engagements, the author has included the entire list of deficiencies including those related to audit engagements.

<table>
<thead>
<tr>
<th>Significant Engagement Deficiencies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Failure to:</strong></td>
</tr>
<tr>
<td>• Appropriately modify an auditor’s report</td>
</tr>
<tr>
<td>for a scope limitation or departure from</td>
</tr>
<tr>
<td>the basis of accounting used for the</td>
</tr>
<tr>
<td>financial statements.</td>
</tr>
<tr>
<td>• Issue a report on compliance and internal</td>
</tr>
<tr>
<td>controls for audits subject to Government</td>
</tr>
<tr>
<td>Auditing Standards.</td>
</tr>
<tr>
<td>• Disclose the lack of independence in a</td>
</tr>
<tr>
<td>compilation report.</td>
</tr>
<tr>
<td>• Disclose the omission of substantially all</td>
</tr>
<tr>
<td>disclosures in a compilation that omits</td>
</tr>
<tr>
<td>disclosures.</td>
</tr>
<tr>
<td>• Disclose the omission of the statement of</td>
</tr>
<tr>
<td>cash flows in financial statements</td>
</tr>
<tr>
<td>prepared in accordance with GAAP.</td>
</tr>
<tr>
<td>• Disclose an other comprehensive basis of</td>
</tr>
<tr>
<td>accounting (OCBOA) for financial statements compiled without disclosures, where the basis of accounting is not readily determinable from reading the report.47</td>
</tr>
<tr>
<td>• Disclose, in the accountant’s or auditor’s</td>
</tr>
<tr>
<td>report, a material departure from</td>
</tr>
<tr>
<td>professional standards such as the</td>
</tr>
<tr>
<td>omission of significant income tax</td>
</tr>
<tr>
<td>provision on interim financial statements,</td>
</tr>
<tr>
<td>significant disclosures related to defined</td>
</tr>
<tr>
<td>employee benefit plans, etc.</td>
</tr>
<tr>
<td>• Include a material amount or balance</td>
</tr>
<tr>
<td>necessary for the basis of accounting</td>
</tr>
<tr>
<td>used (examples include omission of material</td>
</tr>
<tr>
<td>accruals, failure to amortize a significant</td>
</tr>
<tr>
<td>intangible asset, provide for material</td>
</tr>
<tr>
<td>losses or doubtful accounts, or to provide</td>
</tr>
<tr>
<td>for material deferred income taxes.)</td>
</tr>
<tr>
<td>• Departures from standard wording where the</td>
</tr>
<tr>
<td>report does not contain the critical</td>
</tr>
<tr>
<td>elements of applicable standards.</td>
</tr>
<tr>
<td>• Issuance of an audit or review report</td>
</tr>
<tr>
<td>when the accountant is not independent.</td>
</tr>
<tr>
<td>• Inclusion of material balances that are</td>
</tr>
<tr>
<td>not appropriate for the basis of</td>
</tr>
<tr>
<td>accounting used.</td>
</tr>
<tr>
<td>• Significant departures from the financial</td>
</tr>
<tr>
<td>statement formats prescribed by industry</td>
</tr>
<tr>
<td>accounting and auditing guides.</td>
</tr>
<tr>
<td>• Omission of the disclosures related to</td>
</tr>
<tr>
<td>significant accounting policies applied</td>
</tr>
<tr>
<td>(GAAP or OCBOA).</td>
</tr>
<tr>
<td>• Omission of significant matters related to</td>
</tr>
<tr>
<td>the understanding of the financial</td>
</tr>
<tr>
<td>statements, such as the cumulative</td>
</tr>
<tr>
<td>material effect of a number of deficiencies.</td>
</tr>
<tr>
<td>• Improper accounting for a material</td>
</tr>
<tr>
<td>transaction such as recording a capital</td>
</tr>
<tr>
<td>lease as an operating lease.</td>
</tr>
<tr>
<td>• Misclassification of a material</td>
</tr>
<tr>
<td>transaction or balance.</td>
</tr>
<tr>
<td>• Failure to include a summary of significant</td>
</tr>
<tr>
<td>assumptions in a forecast or projection.</td>
</tr>
<tr>
<td>• Failure to segregate the statement of</td>
</tr>
<tr>
<td>cash flows into the categories of</td>
</tr>
<tr>
<td>investing, operating and financing.</td>
</tr>
<tr>
<td>• Omission of significant required disclosures</td>
</tr>
<tr>
<td>related to material financial statement</td>
</tr>
<tr>
<td>balances or transactions.</td>
</tr>
<tr>
<td>• Failure to disclose the cumulative</td>
</tr>
<tr>
<td>effect of a change in accounting principle.</td>
</tr>
<tr>
<td>• Omission of the statement of income and</td>
</tr>
<tr>
<td>retained earnings when referred to in the</td>
</tr>
<tr>
<td>report.</td>
</tr>
</tbody>
</table>

47 The term “OCBOA” is superseded by “special purpose framework.” The identified deficiencies do not reflect periods during which the change to special purpose framework was made.
### Minor Engagement Deficiencies

#### Supplementary information:
- Failure to report on supplementary information.
- Supplementary information was not clearly segregated or marked.
- Titles of supplementary information did not coincide with the descriptions and titles presented in the financial statements.

#### Reports:
- Minor departures from standard report language.
- Report did not cover all periods presented.
- Minor report dating departures.

#### Other:
- Failure to accrue income taxes where the accrual is not material.
- Inclusion of the reference about the omission of the statement of cash flows for financial statements prepared under OCBOA.
- Failure to reference the accountant’s report on each page of the financial statements.
- Failure to identify within the audit report the country of origin.

#### Disclosures:
- Omitted or inadequate disclosures related to minor account balances or transactions such as inventory, valuation allowances, long-term debt, related-party transactions, and concentrations of credit risk.

#### Financial statement display:
- Minor departures from the financial statement formats recommended by industry accounting guides.
- Use of financial statement titles that are not appropriate for the basis of accounting used.
- Failure to include the title “Selected Information—Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Omitted” as appropriate for the presentation of certain selected disclosures.
- Presentation of treasury stock in the financial statements of a company that is incorporated in a state that does not recognize treasury stock.

### Audit Procedures and Documentation:

#### Failure to:
- Use a written audit program.
- Tailor audit programs for specialized industries or for a specific type of engagement, such as significant areas of inventory and receivable balances.
- Request a legal representation letter, if an attorney was consulted.
- Obtain a client management representation letter.

#### Failure to:
- Perform essential audit procedures required by an industry audit guide.
- Perform adequate tests in key audit areas.
- Confirm significant receivables or document appropriateness and utilization of other audit techniques.
- Assess the level of materiality and control risk.
- Document the nature and extent of analytical
- Include several components of a client management representation letter within the letter.
- Document the auditor’s consideration of the internal control structure.
- Document key audit areas.
- Document tests of controls and compliance for engagements subject to OMB Circular A-133.
- Assess or document fraud risk.

- Review loan covenants.
- Perform audit cut-off procedures.
- Document communications between predecessor and successor auditors.
- Perform a review of subsequent events.
- Test for unrecorded liabilities.
- Observe inventory when the amount is material to the balance sheet.

**Compilation and Review (SSARS) Procedures and Documentation:**

| Failure to: |
| --- | --- |
| - Perform analytical and inquiry procedures for a review engagement. | - Obtain a client management representation letter for a review engagement. |
| - Document the matters covered in the accountant’s inquiry and analytical procedures on a review engagement. | - Include the required language in an engagement letter for a management-use only engagement to communicate the understanding of the engagement for financial statements that are prepared for management use only, except for the failure to refer to the level of responsibility on supplementary information, which is not a significant deficiency. |

**Attestation Procedures and Documentation (SSAEs):**

<table>
<thead>
<tr>
<th>Failure to:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Obtain a client management representation letter for an examination of internal control or regarding managements’ assumptions for a pro forma financial statement.</td>
<td></td>
</tr>
<tr>
<td>- Appropriately label pro forma financial information to distinguish it from historical financial information.</td>
<td></td>
</tr>
</tbody>
</table>

**Specific Common Financial Statement Deficiencies:**

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Improper classifications between current and long-term assets.</td>
<td>- Improper classifications between current and long-term debt.</td>
</tr>
<tr>
<td>- Investments in majority owned or controlled subsidiary not consolidated.</td>
<td>- Demand liabilities classified as long-term.</td>
</tr>
<tr>
<td>- Cash overdrafts shown as a negative balance in the current asset section.</td>
<td>- Non-recognition of liability for compensated balances (e.g., vacation pay).</td>
</tr>
<tr>
<td>- Accounts receivable shown on cash-basis financial statements.</td>
<td>- Non-recognition of capital leases.</td>
</tr>
<tr>
<td></td>
<td>- Improper recognition of deferred revenue.</td>
</tr>
</tbody>
</table>
- Investments in debt and equity securities not classified or measured correctly.

**Statement of Income:**
- Income tax provisions not recorded on interim financial statements.
- Reporting period not clearly identified.
- Significant components of income tax expense not disclosed.

**Statement of Cash Flows:**
- Cash flow statement not categorized by operating, investing and financing activities.
- Misclassification of activities, especially between investing and financing activities.
- No disclosure of non-cash investing and financing activities.
- No disclosure of interest and taxes paid for indirect method.
- No reconciliation between net income and net cash flow from operations.
- Certain amounts in the statement of cash flows did not agree with amounts calculated from the comparative balance sheets.
- Cash flow statement not presented for each period that statement of income is presented.

**Incomplete and Missing Disclosures:**

<table>
<thead>
<tr>
<th>Significant accounting policies, such as revenue recognition.</th>
<th>Information about concentrations of products, services, customers, and suppliers.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of accounting other than GAAP.</td>
<td>Inadequate subsequent event disclosure of significant unrealized stock market losses.</td>
</tr>
<tr>
<td>Concentrations of credit risk.</td>
<td>Interest expense.</td>
</tr>
<tr>
<td>Disclosures about fair value of financial instruments.</td>
<td>Rent expense.</td>
</tr>
<tr>
<td>Disclosures about risks and uncertainties.</td>
<td>Investments.</td>
</tr>
<tr>
<td>Components of receivables.</td>
<td>Intangible assets.</td>
</tr>
</tbody>
</table>
- Components of inventory.
- Disclosure of five-year debt maturities.
- Related party transactions.
- Leases.
- Inadequate employee benefit plan disclosures.
- Inadequate disclosure about deferred taxes.
- Missing caption “Selected Information—Substantially All Disclosures Omitted”, where applicable.
- Modifications to cash-basis of accounting.
- Use of estimates.
- Accounting policy on bad debts.
- Nature of operations.

**Details related to long-term debt.**
- Preferred stock redemption requirements.
- Details related to the components of capital stock.
- Details related to components of retained earnings.
- Restricted loan covenants.
- Depreciation and amortization.
- Cash equivalents.
- Accrued compensation expense.
- Advertising expense.
- Income tax expense.
- Terms and conditions of a commitment.
- Details relating to pension plans.

**Common Functional Area Deficiencies- Engagement**

**Engagement performance:**

**Failure to:**
- Perform an adequate review of working papers and/or the accountant’s/auditor’s report and accompanying financial statements by the practitioner-in-charge of the engagement prior to the issuance of the auditor’s/accountant’s report.
- Perform pre-issuance review of engagement working papers and/or reports and accompanying financial statements by an independent party not associated with the engagement as required by firm policy.
- Utilize a disclosure and reporting checklist as required by firm policy.

**Consult professional literature or with a source outside the firm on reporting for a specialized industry, which resulted in the issuance of an incorrect audit report, and/or financial statement disclosure or presentation.**

**Use accounting/auditing practice aids developed by third party providers as required by firm policy, which resulted in engagement deficiencies.**

**Use engagement letters for accounting/auditing engagements as required by firm policy.**
**Personnel management:**
- Failure of professional staff to take adequate CPE in accounting and auditing related subjects or specialized industries, which resulted in disclosure, reporting, and documentation deficiencies on engagements selected for review.

**Monitoring:**
- Failure to:
  - Adequately implement the firm’s monitoring policies and procedures.
  - Document the firm’s compliance with policies and procedures for its system of quality control as required by AICPA Quality Control Standards.
  - Perform an annual inspection, including the functional elements of quality control, as required by firm policy.
  - Extend monitoring policies and procedures to non-audit services such as compilation and/or review engagements.

<table>
<thead>
<tr>
<th>Common Deficiencies Unique to Specialized Industries</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Engagements subject to government auditing standards</strong></td>
<td></td>
</tr>
<tr>
<td>• Missing reports for internal control or compliance.</td>
<td>• Report on financial statements does not refer to reports on controls and compliance.</td>
</tr>
<tr>
<td>• Missing proper A-133 reports.</td>
<td>• Yellow Book CPE requirements not met.</td>
</tr>
<tr>
<td>• Required compliance testing not performed.</td>
<td>• Improper accounting for a certain fund.</td>
</tr>
<tr>
<td>• Compliance and control tests not adequately designed.</td>
<td>• Failure to restrict the use of the accountant’s report to the proper governmental agency.</td>
</tr>
<tr>
<td>• Inadequate or outdated reference materials used.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Not-for-profit organizations</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to:</td>
<td></td>
</tr>
<tr>
<td>• Identify a voluntary health and welfare organization.</td>
<td>• Incorrect classification of contributions as unrestricted, temporarily restricted, or permanently restricted.</td>
</tr>
<tr>
<td>• Present a statement of cash flows.</td>
<td>• Inadequate audit procedures to support the statement of functional expenses.</td>
</tr>
<tr>
<td>• Inadequate format, titles and presentation of financial statements.</td>
<td>• Improper accounting for restricted funds.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Employee benefit plans</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Inadequate testing of participant data and investments.</td>
<td>• Incomplete description of the plan and its provisions.</td>
</tr>
<tr>
<td>• Inadequate or missing disclosures related to participant directed investment programs, investments and participant data.</td>
<td>• Failure to properly report on a DOL limited-scope audit.</td>
</tr>
<tr>
<td>• Failure to understand testing requirements on a limited-scope engagement.</td>
<td>• Improper use of the limited scope exemption because the financial institution did not qualify for the exemption.</td>
</tr>
<tr>
<td>• Failure to properly report on the supplementary</td>
<td></td>
</tr>
</tbody>
</table>
D. GAAP Hierarchy: Compilation and Review

Although there are different reporting standards for compilation, review and audit engagements, **GAAP is the same for all engagements.**

The GAAP Hierarchy is codified in ASC 105, *Generally Accepted Accounting Principles*, and identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The objective of ASC 105 is to establish the *FASB Accounting Standards Codification™* (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of GAAP financial statements. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

The ASC 105 FASB Codification has the following attributes:

- The Codification simplifies user access to all authoritative GAAP by reorganizing GAAP into approximately 90 accounting topics.
- Relevant portions of SEC and SEC Staff Interpretations have been included for reference only for public companies.
- Updates to the Codification issued after the effective date of ASC 105 will serve only to update the Codification.
- At the effective date of ASC 105, all nongrandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed nonauthoritative and no longer updated.

ASC 105 establishes a new U.S. GAAP which is split into two levels:

- Authoritative GAAP Guidance:
- Non-authoritative GAAP Guidance
The following chart illustrates the items that are included in the authoritative and non-authoritative GAAP guidance:

<table>
<thead>
<tr>
<th>Authoritative GAAP Guidance</th>
<th>Non-authoritative GAAP Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) FASB Accounting Standards Codification (FASB ASC)</td>
<td>1) GAAP that is not included as part of the FASB Accounting Standards Codification (ASC). Sources of non-authoritative accounting guidance and literature include:</td>
</tr>
<tr>
<td></td>
<td>Practices that are widely recognized and prevalent either generally or in the industry (1)</td>
</tr>
<tr>
<td></td>
<td>FASB Concepts Statements (2)</td>
</tr>
<tr>
<td></td>
<td>AICPA Issues Papers (2)</td>
</tr>
<tr>
<td></td>
<td>International Financial Reporting Standards of the International Accounting Standards Board (IASB), (2)</td>
</tr>
<tr>
<td></td>
<td>Pronouncements of professional associations or regulatory agencies, (2)</td>
</tr>
<tr>
<td></td>
<td>Technical Practice Aids (2), and</td>
</tr>
<tr>
<td></td>
<td>Accounting textbooks, handbooks, and articles. (2)</td>
</tr>
<tr>
<td>2) SEC companies: rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority</td>
<td>3) Certain grandfathered guidance having an effective date before March 15, 1992</td>
</tr>
<tr>
<td>(1) Previously part of Category (d) GAAP per FASB No. 162 hierarchy.</td>
<td></td>
</tr>
<tr>
<td>(2) Previously included in the “other accounting literature” category per FASB No. 162 hierarchy.</td>
<td></td>
</tr>
</tbody>
</table>

ASC 105 established a Codification (FASB Accounting Standards Codification (FASB ASC)) as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities.

The FASB ASC contains the authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

The ASC is broken down by topics, rather than by pronouncements, segregated into five areas as follows:

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### FASB Codification (FASB ASC)

<table>
<thead>
<tr>
<th>Area</th>
<th>Description</th>
<th>Topic Codes</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Principles</td>
<td>Relates to conceptual matters and includes GAAP</td>
<td>105-199</td>
</tr>
<tr>
<td>Presentation</td>
<td>Relates to presentation matters</td>
<td>205-299</td>
</tr>
<tr>
<td>Financial Statement</td>
<td>Includes assets, liabilities, equity, revenue and expenses</td>
<td>305-700</td>
</tr>
<tr>
<td>Accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Broad Transactions</td>
<td>Includes business combinations, derivatives and other</td>
<td>805-899</td>
</tr>
<tr>
<td>Industry</td>
<td>Relates to accounting that is unique to an industry or type of activity. Topics include airlines and financial services</td>
<td>905-999</td>
</tr>
</tbody>
</table>

All FASB statements (FASB No. 1-168) and other GAAP in existence as of July 1, 2009 were merged into the current FASB ASC.

**Note:** Previous FASB statement numbers no longer exist. That subject matter is now referenced by the Topic Code and not the original FASB statement number. Example: FASB No. 140 is no longer referenced within the FASB Accounting Standards Codification (ASC).

Although the original FASB reference number was eliminated and replaced with a Topic Code, there is a Cross Reference feature that allows a user to insert a FASB statement number and find the corresponding place within the Topic Codes where that statement information is located.

a. If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider non-authoritative guidance from other sources.

b. An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events when those accounting principles either prohibit the application of the accounting treatment to the particular transaction or indicate that the accounting treatment should not be applied by analogy. The appropriateness of other sources of GAAP depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.
Review Questions

1. Which of the following is one of the two types of peer reviews under the AICPA peer review program:
   a. System review
   b. Document review
   c. Findings review
   d. Report review

2. A system review focuses on which of the following:
   a. Working paper documentation
   b. Management representation letter
   c. The accountant’s inquiry and analytical procedures
   d. The accounting firm’s system of quality control

3. Firms that only perform compilation engagements on financial statements that omit substantially all disclosures________:
   a. Require a system review
   b. Require an engagement review
   c. Require a report review
   d. Are not required to participate in the peer review program

4. Under the AICPA peer review program, which of the following engagements would require an engagement review to be performed assuming no other engagement is performed by the firm:
   a. Review
   b. Governmental audit
   c. Examination under SSAE No. 10
   d. Audit

5. In a peer review, if there is one or more findings, a peer reviewer may conclude that the finding(s) rise to the level of which of the following:
   a. Matter
   b. Deficiency
   c. Violation
   d. Fraud

6. With respect to the AICPA peer review program, which of the following is correct regarding the firm’s representation letter:
   a. There is no requirement for the firm to provide a representation letter
   b. A signed representation letter must include positive assurance that the firm is in compliance with state board or other regulatory requirements
   c. A firm’s refusal to furnish a written representation letter to the reviewer does not constitute a limitation of the peer review
   d. A representation must be made that all client engagements with periods ending during the year under review and attestation engagements with report dates during the year under review were provided to the reviewer
7. The due date of a firm’s initial peer review is:
   a. Three years
   b. 18 months
   c. Three years and six months
   d. Within one year of receiving notice from the state licensing board

8. Specific financial statement deficiencies noted in peer reviews related to the Statement of Income include all of the following except:
   a. Income tax provisions not recorded on interim financial statements
   b. Reporting period not clearly identified
   c. Significant components of income tax expense not disclosed
   d. Errors in calculations of totals

9. Which of the following is not a deficiency listed for engagements subject to government auditing standards:
   a. Missing reports for internal control or compliance
   b. Required compliance testing not performed
   c. Inadequate titles used on reports
   d. Inadequate or outdated reference materials used

10. Which of the following is an example of authoritative GAAP guidance:
    a. An accounting textbook
    b. Rules and interpretive releases of the SEC under federal securities laws
    c. Pronouncements of professional associations or regulatory agencies
    d. Technical Practice Aids
E. Simplifying the Reporting Process

With each passing change to GAAP, accountants are torn by the pressure placed on them to balance enhanced accounting disclosure requirements with the needs of their cost-conscience clients. The fact is that most of the changes required by GAAP have little usefulness to smaller, nonpublic businesses. Yet, accountants still must comply with the changes.

Examples of GAAP changes that are typically not meaningful for nonpublic businesses include:

- **Goodwill and other intangibles amortization**: ASC 350, Intangibles- Goodwill and Other (formerly FASB No. 142), requires that goodwill and indefinite lived intangibles not be amortized. Instead, an annual test for impairment on goodwill and certain other intangible assets must be made. For most smaller businesses, it is preferable to continue to amortize such intangibles and avoid performing the impairment test.

- **Consolidation of real estate leasing entities**: ASC 810, Consolidation, (formerly FIN 46R) requires a lessee operating company to consolidate a real estate lessor company if the real estate lessor is a variable interest entity and the operating company is the primary beneficiary. Most third parties, including lenders, do not find the operating company’s consolidation of the real estate leasing entity meaningful even though, in certain situations, GAAP requires such a consolidation.

- **Depreciation**: Many small businesses do not find the maintenance of two depreciation methods useful. Yet such businesses are precluded from using tax return depreciation (including section 179 and bonus depreciation) as their GAAP depreciation unless the difference is not material.

For many small business owners, the issuance of financial statements is nothing more than a necessity to satisfy the bank or other third party user. Although the small business client may be willing to pay higher fees to accountants for effective tax planning or management consulting, most owners are unwilling to pay for a high-priced compilation or review engagement that is perceived as a commodity rather than a value-added service.

An accountant may wish to consider existing reporting options that offer practitioners a means to reduce the time spent on completing an engagement. Here is a list that may be useful depending on the client’s needs and circumstances:

1. Compile tax-basis financial statements
2. Compile GAAP financial statements with no footnotes and statement of cash flows
3. Issue prepared financial statements in accordance with SSARS No. 21:
   - Prepared financial statements issued without a report
   - Issue prepared financial statements on a monthly basis and issue compiled, reviewed or audited financial statements for the annual financial statements
4. Issue a compilation report with only selected footnotes:
SSARS No. 21 permits an accountant to report on financial statements under which only a few disclosures are included provided the notes are labeled:

“Selected Information-Substantially All Disclosures Required by Accounting Principles Generally Accepted In the United States Are Not Included.”

5. Issue a compilation report for interim periods that list the departures from GAAP.

**Example:** Assume that an accountant prepares monthly financial statements for a client, and these statements consistently have certain GAAP departures such as missing accruals, allowance for bad debts, etc. The accountant may issue a standard compilation report that makes reference to the GAAP departures and can use this report, without modification, from month to month.

At year-end, the accountant may adjust the departures to GAAP and issue a standard compilation or review report.

6. Compile only one financial statement (e.g., balance sheet), and not the full set of financial statements.

7. Apply options that are excluded from SSARS No. 21 for which a compilation or review report is not required:

   • Provide selected monthly information requested by the client such as account balances (e.g., cash or accounts receivable) or operating information (e.g., number of meals served for the month)

   • Provide a client or other third party users with a copy of the client’s tax return. An accountant is not required to report on a tax return.

8. Issue financial statements with one or more GAAP departures.

*What are the best options for a company that wishes to avoid some of the more laborious GAAP changes?*

From the list of options noted above, the author suggests accountants consider one or two options as the means to provide a “little GAAP” for their small business clients.

- Issue GAAP statements with one or more GAAP departures, or
- Issue tax-basis financial statements

Issue GAAP statements with one or more GAAP departures

Perhaps the best approach to simplify reporting for small businesses, and thereby avoid many of the more difficult GAAP pronouncements, is to issue GAAP statements with one or more GAAP departures. Many third parties appear to favor this option when compared with the alternative of
issuing tax-basis financial statements. Moreover, by having one or two departures, the essence of the statements is still GAAP while tax-basis financial statements may have many differences when compared with GAAP.

The most common GAAP departures that may help simplify the effort required to prepare GAAP statements include:

1. **Amortizing goodwill and indefinite lived intangibles:** ASC 350 precludes such goodwill and indefinite-lived intangibles from being amortized and, instead, requires that an annual impairment test be performed.48

2. **Not testing and consolidating a real estate leasing company with the operating company:** Violate FIN 46R (ASC 810) which requires testing and possible consolidation of a real estate leasing company into its operating company lessee.49

3. **Using income tax depreciation:** (including the section 179 deduction and bonus depreciation) instead of GAAP depreciation.

4. **Not recording deferred income taxes:** Violates ASC 740, Income Taxes (formerly FASB No. 109) by not recording deferred income taxes.

Although there are numerous GAAP departures that can simplify engagement time, the above four departures are the most common for mainstream companies.

**Example:**

Company X is a small manufacturing company.

Details regarding X follow:

- X has approximately $1.5 million of goodwill.

- X leases its primary manufacturing facility from Company R, a related party real estate lessor.

X decides that the cost of implementing certain GAAP standards is too costly and decides on the following GAAP departures:

1. **Amortization of goodwill:** X will amortize goodwill over the 15-year tax life, resulting in amortization expense of $100,000, which, net of the tax effect, is $60,000. GAAP (ASC 350 (formerly FASB No. 142)) does not permit goodwill to be amortized and, instead, requires goodwill to be tested annually for impairment.

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48 Effective in 2015, a private company may elect to amortize goodwill over ten years under ASU 2014-02: An Amendment of the FASB Accounting Standards Codification- Intangibles-Goodwill and Other (Topic 350)- Accounting for Goodwill- a consensus of the Private Company Council.  
49 Effective in 2015, a private company may elect to adopt ASU No. 2014-07: Consolidation (Topic 810) Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements. Under this ASU, a private company may be exempt from applying the consolidation of variable interest entity (VIE) rules to a common control leasing arrangement.
2. **Avoid test for consolidation of real estate leasing company:** X will not test Company R to determine whether R is a variable interest entity nor will it consider consolidating R as R’s primary beneficiary. ASC 810 (formerly FIN 46R) requires X to test R to determine whether R is a variable interest entity and whether X is R’s primary beneficiary that should consolidate R.

Following are the reports that would be issued to address the GAAP departures noted in this example:

**Sample Report: Compilation with GAAP Departures: Substantially All Disclosures and Cash Flow Statement Omitted**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX and the related statements of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

**Accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders’ equity would have increased by $60,000, net of the tax effect.**

**Accounting principles generally accepted in the United States of America require that the company test another company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company’s financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.**

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X1
Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and retained earnings, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, except for the issue noted in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Known Departures From Accounting Principles Generally Accepted in the United States of America
As disclosed in Note 2 to the financial statements, accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders’ equity would have increased by $60,000, net of the tax effect.

As disclosed in Note 3 to the financial statements, accounting principles generally accepted in the United States of America require that the company test another company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company’s financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The
How many GAAP departures can you include in a compilation or review report?

In most cases, a report may include one or two GAAP departures such as in the above example where the departures related to goodwill amortization and consolidation of variable interest entities. However, it is not the number of departures but rather the effect of them on the financial statements, that is important. An entity could have five immaterial GAAP departures which, collectively, are not as significant to the financial statements as one large GAAP departure.

Nevertheless, the number of departures is not limitless.

If an audit is being performed, numerous GAAP departures may require the auditor to change his or her opinion to an adverse opinion.

With respect to compilation and review reports, there is no language that is similar to an adverse opinion for an audit.

**Question:** When the financial statements include significant departures from the applicable financial reporting framework (e.g., U.S. GAAP, tax basis, etc.), may the accountant modify his standard compilation or review report in accordance with AR-C 80 and 90 of SSARS No. 21 to include a statement that the financial statements are not in conformity with the applicable financial reporting framework (e.g., U.S. GAAP, tax basis)?

**Response:** No. Including such a statement in the accountant’s compilation or review report would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in a review report would confuse users because it would contradict the expression of limited assurance required by SSARS No. 21.

Paragraph 60 of AR-C 90 states:

“The accountant should not modify the standard report to include a statement that the financial statements are not in accordance with the applicable financial reporting framework.”

SSARS No. 21 states that the accountant is not precluded from including a *separate (other-matter)* paragraph in the compilation or review report which states the limitations of the financial statements.

The decision as to any limitations is based on factors that include:

- The possible dollar magnitude of the effects of the departures
- The significance of the affected items to the entity
- The pervasiveness and overall impact of the misstatements, and
- Whether disclosure has been made of the effects of the departures.

The separate (other-matter) paragraph that would follow the emphasis-of-matter (GAAP departure) paragraph, can read as follows:

Compilation report- Other-Matter Paragraph:

Because the significance and pervasiveness of the matters previously discussed makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company’s financial position, results of operations, and cash flows if they had accesses to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

Review report (Other-Matter Paragraph):

Limitations of the Financial Statements
Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company’s financial position, results of operations, and cash flows if they had accesses to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

Inclusion of a separate paragraph in the accountant’s compilation or review report is not a substitute for disclosure of the specific departures or the effects of such departures when they have been determined by management, or, are known as a result of the accountant’s procedures.

Example:

XYZ Company has four GAAP departures as follows:
- Amortization of goodwill
- Does not test its related party leasing company for consolidation
- Uses MACRS for depreciation
- Does not use the allowance method to record bad debts

The accountant believes that due to the four GAAP departures, he should include a separate paragraph in his report as follows:
Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

I (we) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and retained earnings, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management (owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
My (our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on my (our) reviews, except for the issue noted in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Known Departures From Accounting Principles Generally Accepted in the United States of America
As disclosed in Note 2 to the financial statements, accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders’ equity would have increased by $60,000, net of the tax effect.

As disclosed in Note 3 to the financial statements, accounting principles generally accepted in the United States of America require that the company test another company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company’s financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from
accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

As disclosed in Note 4, accounting principles generally accepted in the United States of America require that fixed assets be depreciated over their estimated useful lives. Management has informed us that the Company has recorded depreciation using the Modified Accelerated Cost Recovery System (MACRS) required for federal income tax purposes, which does not result in an allocation of depreciation to expense over the estimated useful lives of the fixed assets. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

As disclosed in Note 5, accounting principles generally accepted in the United States of America require that an allowance for uncollectible accounts be recorded to reflect an estimate of trade receivables that will not be realized. Management has informed us that uncollectible accounts have been recorded on the direct writeoff method. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

Limitations of the Financial Statements
Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America paragraphs makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had accesses to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X1
Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX and the related statements of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

Accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders’ equity would have increased by $60,000, net of the tax effect.

Accounting principles generally accepted in the United States of America require that the company test another company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company’s financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

Accounting principles generally accepted in the United States of America require that fixed assets be depreciated over their estimated useful lives. Management has informed us that the Company has recorded depreciation using the Modified Accelerated Cost Recovery System (MACRS) required for federal income tax purposes, which does not result in an allocation of depreciation to expense over the estimated useful lives of the fixed assets. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

Accounting principles generally accepted in the United States of America require that an allowance for uncollectible accounts be recorded to reflect an estimate of trade receivables that will not be realized. Management has informed us that uncollectible accounts have been recorded on the direct writeoff method. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

Because the significance and pervasiveness of the matters previously discussed makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company’s financial position, results of operations, and cash flows if they had access to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X1
Observation: The author believes that in most cases, the inclusion of one or two GAAP departures in a report will not be considered so “significant and pervasive” that the additional other-matter paragraph is warranted.

For example, a small business client may choose to amortize goodwill and not test and consolidate a related party leasing company. When the number of GAAP departures is elevated to three, maybe four, the accountant may wish to consider whether the financial statements are so distorted, they are misleading and no longer purport to be GAAP. Of course, the determination as to whether departures are pervasive or not is based on the financial statement impact of the departures and not necessarily the number of individual departures.

Using tax-basis accrual financial statements is another option for avoiding traditional GAAP financial statements, and is discussed separately within this course.

F. Squeezing the Heck Out of a Review Engagement: the 25-Hour Review

There is little question that the CPA profession spends too much time over-auditing, over-reviewing and over-compiling financial statements. The result is that firms are earning an effective hourly rate on engagements that is far too low relative to the amount of risk and effort that is required to maintain CPA status.

Typically, the most profitable type of engagement is a review, although each firm has its share of profitable and unprofitable audits and compilations. In reality, however, a firm can most effectively streamline his or her review engagement for maximum profit with no augmentation of risk, in full compliance with SSARS No. 21.

All it takes is discipline.

Let’s take a look at the overall differences in engagements:
### Procedures by Engagement Type

<table>
<thead>
<tr>
<th>Procedures</th>
<th>Engagement Type</th>
<th>Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Planning</td>
<td>AUDIT</td>
<td>• Engagement letter</td>
</tr>
<tr>
<td>• Risk assessment</td>
<td></td>
<td>• Financial statements</td>
</tr>
<tr>
<td>• Fraud assessment</td>
<td></td>
<td>• Analytical procedures</td>
</tr>
<tr>
<td>• Materiality</td>
<td></td>
<td>• Inquiries</td>
</tr>
<tr>
<td>• Gather evidence</td>
<td></td>
<td>• Planning docs</td>
</tr>
<tr>
<td>• Understand internal control</td>
<td></td>
<td>• Risk assessment and IC docs</td>
</tr>
<tr>
<td>• Confirmation AR</td>
<td></td>
<td>• Fraud assessment docs</td>
</tr>
<tr>
<td>• Observation inventory</td>
<td></td>
<td>• Materiality</td>
</tr>
<tr>
<td>• Materiality</td>
<td>REVIEW</td>
<td>• Evidence</td>
</tr>
<tr>
<td>• Analytical procedures</td>
<td></td>
<td>• Confirmations</td>
</tr>
<tr>
<td>• Inquiries and responses</td>
<td></td>
<td>• Inventory observation and testing</td>
</tr>
<tr>
<td>• Other procedures in response to incorrect, incomplete or unsatisfactory information</td>
<td></td>
<td>• Management representation letter</td>
</tr>
<tr>
<td>• Understand client and industry</td>
<td>COMPILATION</td>
<td>• Engagement letter</td>
</tr>
<tr>
<td>• Read the financial statements</td>
<td></td>
<td>• Financial statements</td>
</tr>
<tr>
<td>• Other procedures in response to incorrect, incomplete or unsatisfactory information</td>
<td></td>
<td>• Analytical procedures</td>
</tr>
<tr>
<td>• Cash reconciled</td>
<td>BOOKKEEPING</td>
<td>• Inquiries</td>
</tr>
<tr>
<td>• AR ties to aging</td>
<td></td>
<td>• Any additional review procedures performed in response to significant unexpected differences arising from analytical procedures</td>
</tr>
<tr>
<td>• AP ties to aging</td>
<td></td>
<td>• Any findings/issues that are significant</td>
</tr>
<tr>
<td>• Any findings/issues that are significant</td>
<td></td>
<td>• Communications regarding fraud or illegal acts</td>
</tr>
<tr>
<td>• Communications regarding fraud or illegal acts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Management representation letter</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Expectation

Part of the reason why accountants continue to perform too much work in their engagements is that their expectations and goals are wrong. Too many accountants want the financial statements to be “perfect” and ignore the concept of materiality. Thus, they perform procedures on accounts and areas that are not material to the financial statements.

Remember what we are reporting on:
Audit: The financial statements present fairly, in all material respects, the financial position, results of operations and cash flows in conformity with GAAP.

Review: We are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with GAAP.

Compilation: We apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with this standard (AR-C 80) without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework.

Consider the following facts:

1. The additional time to perform a review engagement as compared with a compilation engagement, is not significant, while the additional billing is.

2. The additional time to perform an audit as compared with a review is high, while the incremental billing may not be.

   Take a look at the following chart that illustrates the author’s point.
Comparison of Engagements: Time Versus Additional Billing

<table>
<thead>
<tr>
<th>AUDIT</th>
<th>ADDITIONAL PROCEDURES</th>
<th>ADDITIONAL TIME</th>
<th>ADDITIONAL BILLING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional procedures: Audit vs. Review:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Planning</td>
<td></td>
<td>HIGH</td>
<td>MODERATE</td>
</tr>
<tr>
<td>• Risk assessment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Fraud assessment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Materiality</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Gather evidence</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Understand internal control</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Confirmation AR</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Observation inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>REVIEW</th>
<th>ADDITIONAL PROCEDURES</th>
<th>ADDITIONAL TIME</th>
<th>ADDITIONAL BILLING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional procedures: Review vs. Compilation:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Analytical procedures</td>
<td></td>
<td>LOW</td>
<td>HIGH</td>
</tr>
<tr>
<td>• Inquiries and responses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Obtain a management representation letter</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Other procedures in response to incorrect, incomplete or unsatisfactory information</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COMPILATION</th>
<th>ADDITIONAL PROCEDURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Understand client and industry</td>
<td></td>
</tr>
<tr>
<td>• Read the financial statements</td>
<td></td>
</tr>
<tr>
<td>• Other procedures in response to incorrect, incomplete or unsatisfactory information</td>
<td></td>
</tr>
</tbody>
</table>
The incremental time to elevate an engagement from a compilation to a review engagement is not that significant. In general, the key procedures performed in a review engagement as compared with a compilation engagement are inquiries and analytical procedures. Yet, the additional billing from a review engagement can be significant relative to the additional procedures.

However, changing from a review to an audit engagement involves significant additional time including work for planning, risk and fraud assessment, materiality, internal control, as well as accounts receivable confirmations and physical inventory observation. In many cases, the audit fee may not be significantly higher than the review engagement fee, yet the additional audit work is.

**The 25-hour review engagement**

The author believes that in most cases, a CPA firm should be able to complete a standard review engagement, including preparation of the financial statements and review report, in 25 hours or less. Yet, too many firms are spending 40-60 hours on such engagements, wasting time on procedures that are unnecessary and outside the scope of a review engagement.

There is no surprise that CPA firms are not generating the average hourly rate that they deserve given the overall risk.

So, how does one keep time for a review engagement down to 25 hours and still comply with the SSARSs?

Here are a few suggestions:

1. Refrain from performing audit procedures in a review engagement, unless the accountant discovers inaccurate and incomplete information that warrants additional procedures.

   **Do not:**
   
   - Clear outstanding checks in a bank reconciliation
   - Confirm account balances

2. Increase analytical procedures and reduce detailed analyses of account balances.

   **Note:** In performing substantive tests in a review engagement, the accountant should lead with analytical procedures and perform tests of account balances only as a last resort where analytical procedures are not meaningful.
LEAD WITH ANALYTICAL PROCEDURES

3. Test most prepaid and accrued items on an analytical basis, compared from year to year (or current year to expected amount), in conjunction with analytical procedures on the corresponding expense accounts.

4. Set up clients with imprest balances for recurring prepaid and accrued items such as:
   - Prepaid insurance
   - Accrued commissions
   - Accrued payroll
   - Accrued SUTA and FUTA
   - Accrued FICA

5. Eliminate setting up prepaid items such as insurance, if not material.

6. Increase materiality:

   Quantitative threshold: 5% to 10% of pretax income or 5% to 10% of total assets:
   - 5% is used in numerous concentrations throughout GAAP
   - 10% is used for concentrations and segment reporting

   **Note:** 5% is generally a safe harbor on a quantitative basis. 10% is usually acceptable.

   Qualitative threshold: An adjustment that:
   - Converts a loss into a gain or loss to a gain
   - Impacts a loan covenant or other agreement

*What if the client has bookkeeping issues such as unreconciled cash, accounts receivable and payables that do not tie to the agings?*
In performing a review, the author assumes that the client’s cash is reconciled, and accounts receivable and payable balances per general ledger reconcile to the agings. If not, a portion of the engagement is bookkeeping and it may take significantly more than 25 hours to complete the engagement.

**Replace tests of account balances with analytical procedures**

If an accountant really wants to reduce time in a review engagement, he or she must be committed to expanding analytical procedures and reducing tests of account balances.

There are two areas in which an accountant should expand analytical procedures:

1. Expenses
2. Recurring prepaid expenses and accruals

Examples of areas in which analytical procedures can replace typical tests of account balances include any variable operating expense and prepaid expenses and accruals as follows:

- Interest expense as a % of average debt
- Payroll tax expense as a % of gross payroll
- Repairs and maintenance as a % of fixed assets
- Sales returns and allowances as a % of sales
- Other operating expenses from year to year
- Recurring prepaid expenses and accruals

**Avoiding the time trap of prepaid and accrued expenses**

**Do you want to reduce your engagement time?**

One easy way to do so is to make sure you do not get locked into the “time trap” of spending too much time performing detailed analyses of prepaid expenses and accruals. Instead, the accountant should initially test these accounts analytically from year to year or from the current year to expected amounts. Only if there is a significant fluctuation in the prepaid or accrued expense balance from year to year (adjusted for any expected change), should an accountant spend time with detailed analyses of prepaid or accrued accounts.

**Example:** Joe CPA is performing a review engagement on Company X. X has a prepaid insurance asset on the balance sheet as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid insurance</td>
<td>$20,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>40,000</td>
<td>38,000</td>
</tr>
</tbody>
</table>

Joe’s expectation is that 20X2 insurance expense and prepaid insurance should be similar to 20X1 because there is no indication that there has been a significant change in insurance cost or coverage from year to year.
**Conclusion:** Joe can easily test the prepaid insurance and related insurance expense for 20X2 by comparing both the prepaid balance and insurance expense from year to year. Given the fact that both the 20X2 asset and expense are not materially different from 20X1, there is no need for the accountant to perform additional procedures, such as tests of the account balances.

**Change the facts:** Prepaid insurance and related expense are as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid insurance</td>
<td>$5,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>55,000</td>
<td>38,000</td>
</tr>
</tbody>
</table>

**Conclusion:** In performing an analytical procedure on prepaid insurance and insurance expense, there is a difference between the accounts from year to year. In fact, it looks like both the asset might be understated by $18,000 and the expense might be overstated by a similar amount.

**Should Joe perform additional work on the prepaid insurance and expense?**

Whether Joe expands his work to perform tests of the account balances is based on whether any difference (in this case $18,000) might be material to the financial statements. If not, Joe should pass on further work. If it is potentially material, Joe would perform additional procedures which might include: a) inquiry as to why the accounts have changed, and b) a test of the account balances such as a calculation of the prepaid insurance and expense.

**Observation:** The previous example illustrates a typical situation in practice involving a recurring prepaid asset or accrual. An effective way for an accountant to test all prepaid expenses and accruals that are recurring (such as prepaid insurance, accruals for payroll taxes, commissions, interest, etc.) is first to test them analytically without engaging in a test of the detail of the account balance. In performing the analytical procedure, the accountant should test analytically the balance sheet balance (prepaid or accrual balance) and the related expense account. If the prepaid or accrual balance, and the related expense account, are reasonably consistent from year to year, the accountant should refrain from performing additional procedures.

Addressing recurring prepaid and accrual accounts, and the related expenses, by testing the detail of those accounts should be avoided and performed as a last resort only when the results of the analytical procedures indicate that there might be a material variance.

Having the discipline to avoid detailed work in recurring prepaid and accruals items will save the accountant significant time without increasing risk.

**Using the imprest balance technique to reduce time**

One technique an accountant can use to reduce engagement time for a review engagement is to set up the review engagement client with imprest account balances for certain recurring balance sheet accounts. This approach works best for recurring prepaid and accrual accounts, such as:

- Prepaid insurance
- Accrued commissions
• Accrued payroll
• Accrued SUTA and FUTA
• Accrued FICA
• Accrued interest

Most of the above accounts have balances from year to year that are similar. For example, if an insurance policy has a fiscal period from April 1, 20X1 to March 31, 20X2, and the company has a calendar year end, there should be three months prepaid insurance on the balance sheet at the end of each year. Any differences will be due to changes in the insurance premium, which should not be material from year to year.

Similarly, accrued commissions will usually have one month’s commissions due which should not be materially different from year to year unless there is a huge increase in sales between years.

Accrued payroll and payroll taxes will usually consist of one week’s or one month’s unpaid balances and will typically be consistent from year to year.

With that said, an effective approach for an accountant can use to reduce time in a review or compilation engagement is to set up the company with imprest account balances for the above-noted accounts. That is, have the client record an account balance which is rounded and that balance will not change from year to year unless there is a significant reason to do so. Further, the accountant should not test those accounts during the review engagement as they are consistent from year to year. Instead, the accountant will test the expense account that corresponds to the prepaid or accrual account. If that corresponding expense account is consistent from year to year, there would be no need to look at the imprest balance.

Example: At December 31, 20X1, Company X records imprest balances in certain balance sheet accounts. X maintains the same imprest balances at December 31, 20X2, as follows:

<table>
<thead>
<tr>
<th>GL Account</th>
<th>Impreset balance 12-31-X2</th>
<th>Impreset balance 12-31-X1</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid insurance</td>
<td>$10,000</td>
<td>$10,000</td>
<td>Three months prepaid insurance</td>
</tr>
<tr>
<td>Accrued SUTA/FUTA</td>
<td>1,500</td>
<td>1,500</td>
<td>One month SUTA, one year FUTA</td>
</tr>
<tr>
<td>Accrued commissions</td>
<td>(15,000)</td>
<td>(15,000)</td>
<td>One month commissions due</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>(3,000)</td>
<td>(3,000)</td>
<td>One month interest</td>
</tr>
<tr>
<td>Accrued payroll</td>
<td>(12,000)</td>
<td>(12,000)</td>
<td>One week unpaid payroll</td>
</tr>
<tr>
<td>Accrued FICA</td>
<td>(700)</td>
<td>(700)</td>
<td>One week unpaid employer FICA</td>
</tr>
</tbody>
</table>

Conclusion: In conducting the 20X2 review engagement, the accountant’s analytical procedures should not be focused on the imprest account balances. Instead, the accountant should analytically test the corresponding expense account to the above imprest accounts as follows:

• Commission expense as percentage of sales
• Payroll tax expense as percentage of payroll expense
• Interest as a percentage of average debt
- Comparison of insurance expense from 20X2 versus 20X1 (or compared to the expected amount)

If the analytical procedure performed on the corresponding 20X2 expense is consistent with 20X1 (or compared with an expected amount), there is no need for the accountant to perform any procedures on the imprest balance sheet accounts. If, instead, the analytical procedures on the corresponding expenses results in material differences, the accountant may have to perform additional procedures that include testing the imprest account balances.

**Observation:** Use of the imprest balance approach is very effective in reducing an accountant’s time in a review or other engagement. Most businesses have numerous balance sheet accounts that have balances that are recurring and consistent from year to year. By establishing those accounts with imprest balances, the accountant can avoid having to perform any procedures on those accounts from year to year. Instead, as long as the results of analytical procedures on the corresponding expense accounts are reasonable, the accountant should avoid performing any tests on the imprest balance sheet accounts. After all, if the imprest balance sheet account is materially misstated, that misstatement would result in the corresponding expense account being materially misstated.

**G. Designing Effective Engagement Letters**

In order to mitigate the effects of litigation against CPAs and auditors, more and more CPA firms are including protective language in their engagement letters. The engagement letter is the contract between the client and the auditor and should clearly reflect the understanding and responsibilities of both parties. SAS No. 122, AU-C Section 210, *Terms of Engagement*, provides a list of required and recommended language that should be included in an engagement letter for audits. Similar guidance is found in the AICPA Guide.

Strong engagement letters are needed for audit, review, compilation, preparation and write-up engagements, with most of the same safeguards needed for all types of engagements. Of course, the accountant must weigh the benefits of having a strong engagement letter with those of alienating the client with an overreaching engagement letter.

**What are the SSARS requirements for engagement letters for preparation, compilation and review engagements?**

SSARS No. 21 states the following with respect to a preparation, compilation or review engagement:

“The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement...”

Prior to the issuance of SSARS No. 21, the guidance found in SSARS No. 19 required an understanding in writing (engagement letter) with no requirement that the letter had to be signed. The provision that the engagement letter did not have to be signed was also found within auditing standards.
Those rules changed for audits starting in 2012 with the issuance of SAS No. 122, AU-C Section 210, *Terms of Engagement*, (formerly SAS No. 108) which requires that an auditor establish an understanding with the client in the form of a written communication such as an engagement letter. In auditing standards, SAS No. 122 requires that the engagement letter be signed by both the client and auditor.

SSARS No. 21 follows the change made by SAS No. 122. That is, SSARS No. 21 now requires that an accountant engaged to perform a preparation of financial statements, compilation or review engagement, obtain a written communication (engagement letter) that *must be signed by both management and the accountant*. Failure to obtain a signed engagement letter is a violation of SSARS No. 21.

1. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement and should include the following:

   a. The objectives of the engagement
   b. The responsibilities of management
   c. The responsibilities of the accountant
   d. The limitations of the engagement
   e. Identification of the applicable financial reporting framework for the preparation of the financial statements
   f. For compilation and review engagements: The expected form and content of the accountant’s report (for a compilation or review engagement), and a statement that there may be circumstances in which the report may differ from its expected form and content.
   g. For preparation of financial statement engagement only:

      1) The agreement with management that either a) each page of the financial statements will include a statement (legend) indicating that *no assurance* is provided on the financial statements, or b) the accountant will be required to issue a disclaimer report that makes clear that no assurance is provided on the financial statements.
      2) Whether the financial statements are to a) contain a known departure(s) from the applicable framework, or b) omit substantially all disclosures required by the applicable financial reporting framework.

SSARS No. 21 provides an updated sample of an engagement letter for both compilation and review engagements. Although that sample letter includes all of the required minimum elements identified in SSARS No. 21, it does not include several other clauses that the author believes may be important to assist the accountant in clarifying key issues of dispute commonly found in litigation.

Although these elements represent the minimum requirements to satisfy SSARS No. 21, rarely are they sufficient enough to convey the terms and conditions of both parties and to protect the accountant in litigation.

**What clauses should be included in any engagement letter?**

The following chart identifies some of the clauses that should be included in engagement letters beyond the standard provisions found in the SSARS No. 21 engagement letter. The chart is segregated into *three categories* of provisions for engagement letters:
- Required provisions that should be in every engagement letter
- Highly recommended provisions
- Recommended but difficult to obtain

Language to Include in Engagement Letters

<table>
<thead>
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<th>Required- should be in every letter</th>
<th>Highly recommended provisions</th>
<th>Recommended but difficult to obtain</th>
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<tr>
<td>• Ethics 1.295.040 language for performing nonattest services*</td>
<td>• Ownership of records and confidentiality of information</td>
<td>• Use of report by third parties and limits on reproduction of report</td>
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<td>• Record retention policy</td>
<td>• Limit on amount of damages in litigation and time to sue</td>
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<td>• Mediation clause</td>
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<tr>
<td></td>
<td>• Indemnification arising from management misrepresentations</td>
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</tr>
</tbody>
</table>

* ET sec. 1.295.040 (formerly Interpretation 101-3) language is required if the accountant is going to perform nonattest services (such as write-up, tax return preparation, preparation of financial statements, etc.) for an attest client.
ILLUSTRATIVE ENGAGEMENT LETTERS

The following are non-authoritative clauses for engagement letters for preparation, compilation, review and write-up services engagements, most of which are based on the nonauthoritative engagement letters published in SSARS No. 21.

In addition to language required by SSARS No. 21, the author has included several suggested paragraphs that may assist the accountant in protecting himself or herself against potential litigation. Of course, an accountant may wish to consult with his or her malpractice insurance carrier prior to adopting an engagement letter format.

Following are clauses that an accountant may consider inserting into the engagement letter:

Required clauses:

a. ET sec. 1.295.040 (formerly Interpretation 101-3) nonattest services language

Highly recommended clauses:

a. Ownership of records and confidentiality of information  
b. Record retention policy  
c. Mediation clause  
d. Indemnity arising from management misrepresentations

Recommended clauses but difficult to obtain from the client:

a. Use of the report by third parties and limits on reproduction of the report  
b. Limitation on amount of damages in litigation and time to sue

Required clauses:

1. ET sec. 1.295.040- Nonattest Services

ET sec. 1.295.040 requires an accountant who performs nonattest services for an attest client, to document in writing, certain information as to the client’s responsibility with respect to the nonattest services performed.

Examples of such services include:

- Tax return preparation
- Payroll tax preparation
- Bookkeeping/writeup services, and
- Preparation of financial statements.
Sample language to include in an engagement letter:

**Abbreviated version: Nonattest Services**

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services.

**Elaborate version: Nonattest Services**

In addition to the performance of our review engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, preparation of financial statements, and the preparation of the Company’s federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as assuming management responsibilities, including determining general ledger account classifications of certain transactions and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must take all management responsibility with regard to those matters.

You agree that in connection with our performance of any nonattest service, you will:

1. Assume all management responsibilities
2. Oversee the nonattest service, by designating an individual, preferably within senior management, who possesses the skill, knowledge and experience
3. Evaluate the adequacy and results of the services, and
4. Accept responsibility for the results of our services.

ET sec. 1.295.040 (formerly Interpretation 101-3) language requires that an accountant document in writing the client’s responsibility. Such documentation does not have to be included in the engagement letter even though the letter is the most logical place in which to present such documentation.

ET sec. 1.295.040 language is only required if an accountant is performing nonattest services in some form while also performing a compilation or review engagement. For example, it is rare for an accountant not to perform some type of tax services for his or her client, or perform some bookkeeping services that include proposing adjusting entries to the client. The result is that the author believes this ET sec. 1.295.040 language should be included in every compilation or review engagement letter as a standard provision.

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50 The sample engagement letter found in SSARS No. 21 uses this abbreviated language to address the requirement of ET 1.295 of the code of ethics when nonattest services are performed in an attest engagement.
Highly recommended clauses:

a. Ownership of records and confidentiality of information

If a client’s working papers may be subject to inspection by a peer reviewer or a regulatory reviewer, the accountant must have language in the engagement letter that authorizes the accountant to release those papers to the reviewer.

**Sample language: Ownership of Records and Confidentiality of Information**

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.

- We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

b. Record retention policy

If a firm has a record retention policy, most insurance companies recommend that the policy be noted in the engagement letter.

**Sample language: Record Retention Policy**

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

c. Mediation clause

Most insurance carriers believe the inclusion of a mediation clause in the engagement letter assists the accountant. Mediation acts as an intermediate step before litigation during which there is the
possibility that both parties can agree to terms before going the costly route of litigation. Also, mediation is not binding on either party.

**Sample language: Mediation Clause**

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

**What about an arbitration clause?**

Generally, arbitration clauses are dangerous with respect to a professional engagement. Arbitration is legally binding and the process can restrict the accountant from proving his or her case. Arbitrators are known for “splitting the difference” and there are limitations on the extent of discovery that can be presented in the hearing. In a malpractice case, an accountant who has excellent workpapers may be precluded from presenting those papers as evidence.

Most insurance carriers state that an arbitration clause should be avoided and can be included only with respect to fee disputes, and not malpractice cases.

d. **Indemnification for Management Misrepresentations**

The AICPA’s Code of Professional Conduct (ET sec. 1.228.020, *Indemnification of an Attest Client*) restricts the use of indemnification agreements between a client and an accountant. Ethics Ruling 102 deals with the issue from the other side in which an accountant agrees to indemnify a client for damages, losses, or costs arising from lawsuits, claims or settlements that relate, directly or indirectly, to client acts. Nevertheless, it concludes that such an agreement impairs the accountant's independence. It would appear that the same conclusion would be reached if the client agreed to indemnify the accountant for any losses incurred for any reason.

For example, the following clause would not be acceptable:

**Not acceptable under Professional Ethics:**

“If we incur legal fees or other costs as a result of any claims against us by a third party for any reason, you agree to release and indemnify our Firm and its representatives and personnel from all claims, liabilities and expenses, including payment of all of our legal fees and related costs of defense.”

However, Ethics Ruling 94 does permit an indemnification clause that provides for the client to indemnify the accountant for damages arising from known misrepresentations by management. In such a case, the clause is permissible and does not impair independence.
**Sample language-Acceptable indemnification for management misrepresentations:**

“You agree to hold us harmless and to release, indemnify, and defend us from any liability or costs, including attorney’s fees, resulting from management’s knowing misrepresentations to us.”

or

“If we incur legal fees or other costs as a result of our reliance on any false representation made by you, you agree to release and indemnify our Firm and its representatives and personnel from all claims, liabilities and expenses, including payment of all of our legal fees and related costs of defense.”

or

“You agree to indemnify our firm, and the firm's partners, principals, and employees, and hold them harmless from all claims, liabilities, losses, and costs arising in circumstances where there has been a known misrepresentation by a member of the Company's management, regardless of whether such person was acting in the Company's interest.”

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**Observation:** The second sample of acceptable indemnification language above is provided by the author because it has already survived the test of litigation. Specifically, the language was included in an engagement letter and enforced by the State of New York Supreme Court in *Kimber Mfg., Inc. v. Marcum & Kliegman, LLP.*

**Recommended clauses, but difficult to obtain from the client:**

The following clauses are recommended, but may not be acceptable to clients.

**Use of report by third parties and limits on reproduction of the report**

Identifying those third parties to whom the auditor knows the report will be sent may assist the auditor if a claim is made by an unidentified third party. Yet, some attorneys are against including such language in the engagement letter on the grounds that the inclusion may be construed to make the third party a party to the contract, thereby fortifying their direct claim against the accountant. This clause probably should not be used in those states that practice the privity standard where, by its inclusion, a third party could claim it had a contract with the accountant. Opinions on whether known third parties should be named in the engagement letter differ among malpractice insurance companies.

Restricting reproduction of the report is generally considered a vital clause that helps protect the accountant’s privity (contract):

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51 Abbreviated version of the indemnification found in the illustrative engagement letter in SSARS No. 21.

52 In 2009, the Appellate Division of the Supreme Court of the State of New York upheld the enforceability of this language in *Kimber Mfg., Inc. v. Marcum & Kliegman LLP.*
2. **Limitation on amount of damages and time to sue**

The limitations on amount and time of any claim against the auditor may be useful if the client is willing to agree to such a claim. Of course, whatever the client agrees to within the engagement letter does not bind a damaged third party.

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**Sample language: Limitation on Amount of Damages and Time to Sue**

“There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.”

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3. **Other matters**
In addition to the engagement letter provisions outlined above, a firm should be careful not to include any of the following items in any engagement letter:

a. Marketing information about the firm.

b. Absolutes, superlatives, or words that may be perceived as expanding responsibilities.

c. Any representation as to the quality of the firm’s work or its level of expertise. Avoid statements like “We are experts in this area,” or “We are well qualified to perform this work.”

d. Legal and accounting jargon such as the terms GAAP or GAAS.

Following are sample engagement letters that include changes made by SSARS No. 21.
Sample Engagement Letter: Compilation  
Inclusion of Various Additional Clauses

Accountant’s Letterhead

Mr. John Smith  
President  
ABC Company  
100 Main Street  
Nowhere, MA 02110

Dear Mr. Smith:

You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements, and perform a compilation engagement with respect to those financial statements. We are pleased to confirm our acceptance and our understanding of this compilation engagement by means of this letter.

We will also perform the following additional services: preparation of the 20XX federal and state income tax returns, and perform bookkeeping services.

Our Responsibilities  
The objective of our engagement is to:

a. prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you, and

b. apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA’s Code of Professional Conduct, including the ethical principles of integrity, objectivity, professional competence, and due care.

We are not required to and will not verify the accuracy or completeness of the information you will provide to us for the engagement or otherwise gather evidence for the purpose of expressing an opinion or a conclusion. Accordingly, we will not express an opinion or a conclusion, nor provide any assurance on the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

Your Responsibilities  
The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and to assist you in the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America. You have the following overall
responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

i. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of financial statements
j. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
k. The prevention and detection of fraud
l. To ensure that the entity complies with the laws and regulations applicable to its activities
m. To make all financial records and related information available to us
n. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
o. To provide us with:
   • Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
   • Additional information that may be requested management for the purpose of the engagement, and
   • Unrestricted access to persons within the Company of whom we determine necessary to make inquiries.
p. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America.

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services. [AICPA ET 1.295-Nonattest Services]

You are also responsible for including the following reference on each page of the financial statements including supplementary information: "See Accountant's Compilation Report."

Our Report

As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them. There may be circumstances in which the report differs from the expected form and content.

You agree to include the compilation report in any document containing financial statements that indicates that the entity's accountant has performed a compilation engagement on such financial statements and, prior to inclusion of the report, to ask our permission to do so.

Other relevant information
Our fees for these services . . . .

ADDITIONAL PROVISIONS FOR COMPILATION ENGAGEMENT:

Insert additional language if CPA is not independent:

We are not independent with respect to XYZ Company.

We will disclose that we are not independent in our compilation report.

[Insert additional language for omission of substantially all disclosures and the statement of cash flows]

If management elects to omit substantially all disclosures and the statement of cash flows from the financial statements, we will include an additional paragraph that will read as follows:

Management has elected to omit the statement of cash flows and substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.
REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:

[ET sec. 1.295 Language]
You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services.

[HIGHLY RECOMMENDED PROVISIONS]

[Ownership of Records]
All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

1. Our firm, as well as other accounting firms, participates in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]
It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Mediation]
In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]
If we incur legal fees as a result of our reliance on any false representation by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]

[Limit on Amount of Damages and Time to Sue]
There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

[Use of Report by Third Parties and Limits on Reproduction of the Report]
We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a
copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction, or

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a compilation engagement with respect to those same financial statements, and our respective responsibilities.

Sincerely yours,

____________________

James J. Fox & Company, CPA

Acknowledged and agreed on behalf of ABC Company by:

____________________  _____________

President                                Date
Sample Engagement Letter: Review
Inclusion of Various Additional Clauses

Accountant’s Letterhead

Mr. John Smith
President
ABC Company
100 Main Street
Nowhere, MA 02110

Dear Mr. Smith:

You have requested that we prepare the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements and perform a review engagement with respect to those financial statements. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

We will also perform the following additional services: preparation of the 20XX federal and state income tax returns, and perform bookkeeping services.

Our Responsibilities
The objective of our engagement is to:

c. Prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you, and

d. Obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America.

We will conduct our review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs) promulgated by the Accounting and Review Services Committee of the AICPA and comply with the AICPA’s Code of Professional Conduct, including ethical principles of integrity, objectivity, professional competence, and due care.

A review engagement includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review engagement is substantially less in scope that an audit engagement, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review engagement does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement. Accordingly, we will not express an opinion regarding the financial statements.

Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including

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53 The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.
those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our review procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

Your Responsibilities
The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with accounting principles generally accepted in the United States of America. You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

i. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements
j. The preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America
k. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements
l. The prevention and detection of fraud
m. To ensure that the entity complies with the laws and regulations applicable to its activities
n. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement
o. To provide us with:
   • Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters
   • Additional information that may be requested for the purpose of the preparation of the financial statements, and
   • Unrestricted access to persons within ABC Company of whom we determine necessary to make inquiries.
p. To provide us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

You are also responsible for including the following reference on each page of the financial statements including supplementary information: "See Independent Accountant's Review Report."

[Insert appropriate reference to the expected form and content of the accountant’s review report. Example follows:] We will issue a written report upon completion of our review of ABC Company’s financial statements. Our report will be addressed to the board of directors of ABC Company. We cannot provide assurance that an unmodified accountant’s review report will be issued. Circumstances may arise in which it is necessary for us to report known departures from accounting principles generally accepted in the United States of America, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

You agree to include our accountant’s review report in any document containing financial statements that indicates that such financial statements have been reviewed by us and, prior to inclusion of the report, to ask
our permission to do so.

Other relevant information
Our fees for these services . . .

REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:
[ET sec. 1.295 Language]
You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services. [AICPA ET 1.295-Nonattest Services]

[HIGHERLY RECOMMENDED PROVISIONS]
[Ownership of Records]
All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

1. Our firm, as well as other accounting firms, participates in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]
It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Mediation]
In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]
If we incur legal fees as a result of our reliance on any false representations by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]
[Limit on Amount of Damages and Time to Sue]
There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

[Use of Report by Third Parties and Limits on Reproduction of the Report]
We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction, or

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to prepare the financial statements described herein and to perform a review of those same financial statements, and our respective responsibilities.

Sincerely yours,

_____________________________________
James J. Fox & Company, CPA

Acknowledged and agreed on behalf of ABC Company by:

___________________________________  ________________
President                                Date

H. Liability to Accountants Who Perform Bookkeeping Services

The irony is that most accountants believe that their engagement risk is the greatest in performing an audit, and least risky for compilation and write-up/bookkeeping engagements.

Yet, nothing could be further from the truth. The courts have ample cases against accountants who performed compilation or bookkeeping services for their clients.

Specifically:

1. In performing bookkeeping engagements, accountants are being sued by clients who have higher engagement scope expectations than those actually being performed.

2. Accountants who perform bank reconciliations are not adequately communicating the scope and limits of their services to clients.

3. Accountants, in general, are not obtaining engagement letters in bookkeeping engagements.
4. Courts are holding accountants who perform bookkeeping services to a higher level of responsibility when there is employee embezzlement because *clients misunderstand*:

   a. The different levels of accounting services
      
      Example: They believe the accountant is an auditor.

   b. The accountant’s role in performing the service, and

   c. Basic terminology such as “bank reconciliation.”

*Mitigating the risk of liability*

The best way to mitigate the risk associated with performing bookkeeping services is to prepare a well-written engagement letter that outlines the specific procedures that will be performed.

If bank reconciliations are prepared, the engagement letter should include specific language stipulating that the accountant is *not responsible for fraud/embezzlement*.

**Insert in bookkeeping engagement letter:**

```
Each month we will reconcile XYZ Company’s books and records of the following bank accounts with the bank statements for proper account balance, and to identify reconciling items that may require adjustments to your books and records.

    Bank of America       30304044
    Bank of America       54044040

We will not be analyzing cancelled checks to determine whether signatures or payments are authorized or for any other purpose, but we will briefly scan them to confirm the amounts match those recorded by the bank on the statement.

By your signature below, you acknowledge that you understand and agree that our services are limited in scope and *they are not designed to detect employee embezzlement or other fraudulent activities* involving your bank accounts. Should you wish us to expand our procedures to include additional work and investigations, we will arrange this with you in a separate engagement letter.

    Source: Camico Insurance Co. (camico.com)
```

*Bookkeeping and the Tropical Glass Case*

One recent case illustrates the importance of outlining any bookkeeping services to be performed in an engagement letter.
The case is *Tropical Glass & Construction Co. v. Gitlin*.

**Facts:**

a. Tropical Glass retained a CPA firm to perform accounting services as follows:
   - Compilation engagement
   - Tax return preparation
   - Monthly bookkeeping and bank reconciliation preparation

b. The parties executed two engagement letters as follows:

   **First Engagement Letter:** for the *tax return preparation* stated the following:

   “Our engagement will be designed to perform the following services:

   *Prepare the Federal Income Tax Return* (Form 1120), the Florida Corporate Income/Franchise and Emergency Excise Tax Return (Form F-1120). Our work in connection with the *preparation of your income tax returns does not include procedures designed to discover defalcations or other irregularities*, should any exist.

   Our fee for these services will be based upon the *amount of time* required at standard billing rates plus out-of-pocket expenses.”

   **Second Engagement Letter:** pertained to the * compilation engagement* as follows:

   “Our engagement *cannot be relied upon to disclose errors, fraud, or illegal acts that may exist*. For these reasons, you, and any successors, employees or assigns, understand, acknowledge and agree that neither our firm nor any of its employees or agents shall be liable for any act(s), omission(s), negligence (including gross negligence), breach, mistake in judgment, claims or causes of actions, whether legal or equitable, injury or damages of any kind whatsoever, arising from our engagement and that this release will survive the termination of the engagement with you. However, we will inform you of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential.

   Our fee for these services will be based upon the amount of time required at standard billing rates plus out-of-pocket expenses. . . .

   **c.** Neither engagement letter specifically referenced that the CPA firm would perform monthly bank reconciliations. The CPA firm was paid an additional $350 per month for the bank reconciliation work.
d. The CPA firm performed a compilation engagement and prepared tax returns. In addition, the CPA firm performed *monthly bank reconciliations* for Tropical.

e. Tropical’s *bookkeeper embezzled funds and it was not discovered* by the CPA firm or Tropical until several years later.

f. Tropical filed a complaint against the CPA firm alleging that the firm had *negligently performed monthly bank reconciliations* and, as a result, the CPA firm had failed to detect the Tropical bookkeeper’s theft.

g. The CPA firm filed a response in court:
   - Alleging that Tropical failed to pay accounting fees for the firm’s services rendered.
   - Requesting dismissal arguing that the fraud detection was “contractually waived” as follows:
     1) That the monthly bank reconciliations were performed as part of, and incidental to, the preparation of Tropical’s annual tax returns, and
     2) That both engagement letters had specific language disclaiming responsibility to detect fraud.

h. In response, Tropical argued that the monthly bank reconciliations were *not part of the engagement letters because those letters only covered tax return preparation and the compilation engagement*. Therefore, the engagement letters could not relieve the CPA of liability for their alleged negligence because the letter did not apply to the bookkeeping engagement.

i. Through both the CPA firm’s testimony and that of two expert witnesses, there was conflicting testimony as to *whether performing monthly bank reconciliations was necessary to prepare tax returns or to perform a compilation engagement*.

**Conclusions of the court:**

1. The lower court ruled in favor of the CPA firm and dismissed the charges against the CPA firm.

2. The appeals court reversed the dismissal against the CPA firm based on the following facts:
   a. Although the engagement letters did include waiver language for fraud detection, *the clause did not provide a “specific waiver or release for the preparation of monthly bank reconciliations.”*
   b. There was *conflicting evidence as to whether the preparation of monthly bank reconciliations was part of the preparation of tax returns (or compilation engagement)* so as to whether the fraud waiver language found in the engagement letters would apply.
   c. The fact that the CPA firm charged an additional $350 per month fee for services that were not addressed in either engagement letter led to the conclusion that the monthly bank reconciliations were not part of the services identified in the engagement letters.
Observation: The Tropical case emphasizes the importance of a CPA firm clearly outlining the specific services to be rendered, in particular when bookkeeping services are provided in addition to the performance of a compilation, review or audit engagement. If the bookkeeping services are not identified specifically in the engagement letter, there is a strong possibility that the engagement letter related to the compilation, review, audit or tax return preparation services will not cover the bookkeeping services, and the fraud disclaimer language will not protect the CPA firm.

How can accountants protect themselves from embezzlement in a compilation or bookkeeping engagement?

It may be impossible for an accountant to completely insulate himself or herself from liability in a compilation or bookkeeping engagement. If there is a significant embezzlement, there is a strong possibility that the CPA firm would be sued by the client who expects the firm to uncover fraud.

There are a few actions that can be taken to mitigate the risk of being sued if there is an embezzlement of other theft of assets in an engagement:

1. Make sure that if bookkeeping services (including bank reconciliation preparation) are performed in addition to a compilation, review, audit, or tax return engagement, that bookkeeping service should be specifically identified in the engagement letter or in a separate engagement letter:

2. Be careful not to perform additional procedures that are not contracted and not required in accordance with the SSARSs.

Note: If the accountant performs services that are beyond the requirements of the particular engagement, the accountant may be held liable for a negligence claim in connection with that additional service performed.

A general rule is: “Too little work is risky, but too much work is just as risky!”

Observation: Too many accountants perform unnecessary procedures beyond the scope required by SSARS No. 21 and its predecessor. One of them is performing bank reconciliations in a compilation or review engagement or testing the client’s bank reconciliation when there is no indication of any unusual items. What the court cases suggest is that if an accountant performs extended procedures that are beyond what the SSARSs require for a compilation or review procedure, the accountant must ensure that the engagement letter is modified to identify those specific additional procedures (such as bookkeeping services). Otherwise, the accountant’s engagement letter and its related protective language, might not protect the accountant in litigation.

Should standard disclaimer language be included in all SSARS engagement letters?

There is a strong argument that can be made for including protective language in all SSARS engagement letters, regardless of whether bookkeeping services are performed.

Below is modified language that could be inserted in a preparation of financial statements, compilation or review engagement letter:
Standard language: Preparation of financial statements, compilation and review engagement letters:

a. Restrictions of service:

Preparation of financial statements engagement letter:

“As part of our preparation of financial statements engagement, we will not be performing any bookkeeping function including, but not limited to reconciling bank accounts, analyzing deposits, or analyzing cancelled checks to determine whether signatures or payments are authorized, for comparison of payee and endorsement, or for any other purpose.”

By your signature below, you acknowledge that you understand and agree that our services are limited in scope and they are not designed to detect employee embezzlement or other fraudulent activities. Should you wish us to expand our procedures to include additional work and investigations, we will arrange this with you in a separate engagement letter.”

Compilation engagement letter:

“As part of our compilation engagement, we will not be performing any bookkeeping function including, but not limited to reconciling bank accounts, analyzing deposits, or analyzing cancelled checks to determine whether signatures or payments are authorized, for comparison of payee and endorsement, or for any other purpose.”

By your signature below, you acknowledge that you understand and agree that our services are limited in scope and they are not designed to detect employee embezzlement or other fraudulent activities. Should you wish us to expand our procedures to include additional work and investigations, we will arrange this with you in a separate engagement letter.”

Review engagement letter:

“As part of our review engagement, we will not be performing any bookkeeping function including, but not limited to reconciling bank accounts, analyzing deposits, or analyzing cancelled checks to determine whether signatures or payments are authorized, for comparison of payee and endorsement, or for any other purpose.”

By your signature below, you acknowledge that you understand and agree that our services are limited in scope and they are not designed to detect employee embezzlement or other fraudulent activities. Should you wish us to expand our procedures to include additional work and investigations, we will arrange this with you in a separate engagement letter.”

Observation: Some commentators believe that the previous language should not be included in review engagement letters because it negates procedures an accountant may have to perform under SSARS No. 21. Yet, such logic is nonsensical and does not reflect the responsibilities that an accountant has in performing a review engagement. The fact is, SSARS No. 21 does not require an accountant to perform any procedures that involve analyzing cancelled checks to determine whether signatures or payments are authorized, for comparison of payee and endorsement, or for any other purpose. Moreover, the accountant is not required to perform any review procedures designed to detect
employee embezzlement or other fraudulent activities. If the accountant does discover fraud, the accountant is required to expand procedures and notify management as to the fraud.

I. Risk of Open-Ended and Multi-Year Engagement Letters

It is common for some firms to issue multi-year engagement letters as part of a multiple-year fee agreement.

Although such letters may be efficient, in some cases they can expose the CPA firm to greater risk in litigation.

The prime reason is that having a single, multi-year or open-ended engagement letter may leave the statute of limitations open for a client to sue the CPA.

Statute of limitations

The statute of limitations defines the time by which one party must sue another, such as in the case of a client suing an accountant. The statute of limitations for accounting malpractice actions varies among the states, as most states did not adopt the Uniform Accountancy Act which provides a uniform statute of limitations.

The Uniform Accountancy Act, for example, provides that no action may be brought against an accountant unless the suit is commenced on or before the earlier of:

a. One year from the date the alleged act, omission or neglect is discovered or should have been discovered by the exercise of reasonable diligence

b. Three years after completion of the service for which the suit is brought has been performed, or

c. Three years after the date of the initial issuance of the accountant’s report on the financial statements or other information.

The problem is that most states have not adopted the Uniform Accountancy Act or have passed the Act with significant variations to it.

Thus, each state has its own rules regarding statute of limitations involving accounting services:

- In some states the statute begins to run upon the discovery of an error or when the plaintiff has incurred damage.

- Other states have a fixed amount of time to sue from the event occurring such as six years from the date of the act or omission.

- Some states keep the statute open (a tolling of the statute of limitations) if there is continuous representation of the client by the accountant.
Therefore, if an accounting firm signs a multi-year or continuous engagement letter, some states will keep the statute of limitations open, which may eliminate a defense an accountant has: that the statute of limitations has expired.

**What should the accountant do?**

To ensure that the statute of limitations expires and does not extent (toll) as a continuous representation engagement, here are some rules an accountant may wish to follow:

Each engagement letter should include:

- Specific and clearly defined scope
- Time period for which the engagement applies, and
- Language that the engagement will conclude upon delivery of the work product (financial statements, tax returns) for the particular year.

If multi-year engagements are negotiated, make sure:

- Either annual engagements letters are signed, or
- An addendum/appendix or separate statement of work is added to a base contract each year defining the new fees and other changes in terms.

Avoid any engagement letter that:

- Is continuous and open ended
- Will continue until either party terminates the relationship
- Includes language stating that the terms of the engagement letter will automatically renew annually until the firm or client terminates the engagement or changes the terms.

If new services are provided, either add a new engagement letter or an addendum to an existing engagement letter that defines the new scope and services to be rendered

**J. Avoid Being Sued and Increase Billing-The Likeability and Communication Factors**

*Why do professionals get sued and why is it that some professionals can charge more than others?*

There have been several studies published in connection with factors that determine whether doctors, lawyers, CPAs and other professionals get sued. The lessons learned in these studies apply not only to the issue of litigation, but also whether clients are willing to pay more for a professional’s services.

Interestingly, here are a few broad statements:

- There is little correlation between competence and whether a professional gets sued.
- There is also little link between the amount that a professional charges and his or her competence.
The highest probability of being sued is when:

\[
\text{Bad rapport + Bad outcome} = \text{Lawsuit}
\]

**Note:** Good luck to the professional who makes a significant engagement mistake for a client who really does not like that professional. Although most of the studies involve doctors and the reasons why patients sue their doctors, many of the same concepts apply to all professionals, including CPAs.

In general:

- Professionals who are genuinely *liked by their clients* are less likely to be sued, even if there is clearly negligence on the part of the accountant.

- Professionals who communicate with their clients regularly, including promptly returning phone calls, and in person, are less likely to be sued if there is a problem.

More importantly, the same concepts apply to losing clients even if there is no lawsuit. Simply put:

- A client who likes his or her accountant is *likely to pay for a bill increase* without objection.

- A client who communicates regularly with that accountant, is less likely to replace that accountant even if fees get too high.

Details on one study\(^5\) in which a sample of physicians were taped in their interactions with their patients, reached the following conclusions:

a. The way a physician communicates with patients has a major impact on whether the patient sues the doctor for malpractice after bad outcomes are experienced:

   - The most important reason a patient sues is not medical negligence but how the doctor talks with the patient.

   - Simple things made a difference, such as orienting the patient about what to expect during a visit or being sure information and instructions were understood.

b. One can predict those physicians that would be sued and those that would not be sued based solely on the amount of time each physician spends with his or her patient:

   - The study showed that on average, primary care physicians that had not been sued spent 18.3 minutes per patient, while those that had been sued spent 15 minutes per patient.

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\(^5\) *Physician-Patient Communication: The Relationship With Malpractice Claims Among Primary Care Physicians and Surgeons*  
Wendy Levinson, MD et al.
What can an accountant learn from the physician studies?

Regardless of whether a professional is a doctor, lawyer or CPA, human nature is the same. The lessons learned for doctors do, in most cases, apply to other professionals, including CPAs.

Here are some suggestions for CPAs to consider in communicating with their clients:

a. Communicate more often and in person to build rapport with clients.

b. Explain the scope of each engagement in simple terms, to mitigate the effect of the “expectation gap.”
   - Clients still call accountants auditors even when they are performing compilation and review engagements.

Note: In one court case reviewed by the author, in the court transcript, the judge identified the accountant who performed a review engagement as an “auditor.”

- Write engagement letters that have clear and concise language.
- Meet with the client more often to explain the work performed and provide an opportunity to answer questions.

Observation: Although this section of the course addresses actions to take to avoid being sued, it is just as important to use tools to increase billing and effective billable rates with clients. The fact is, if a client likes his or her accountant and also believes he or she is getting excellent service, that client is less likely to change accountants and more likely to pay an increase in billing.

Here is one test to confirm this conclusion. Take a group of clients for which the accountant performs a small service, such as preparation of personal income tax returns. Notify that group of a 25% increase in the fee for the coming year. If the accountant has been giving excellent service, the accountant will find that either none or very few of those clients will leave to find another accountant. The reason is that rarely is price a determining factor that drives whether professionals retain their clients.

Instead, the *key factors for retention* are:

- Likeability, and
- Extent, quality and frequency of communication.

In terms of communication, critical elements are:

- Whether the accountant returns phone calls and emails promptly
- Whether there is regular face-to-face communication, and
- Amount and quality of time that includes time for the client to ask questions.
Simply put, an accountant who gives excellent service to a client and is genuinely liked by that client, will be able to pass along regular price increases for the same service, and retain most, if not all, of the clients.

**K. Definition of a Financial Statement Versus Trial Balance**

An accountant must comply with the requirements found in SSARS No. 21 if *three conditions exist*:

a. The accountant is in public practice  
b. The accountant is engaged (hired) to perform a preparation of financial statements, compilation, or review engagement, and  
c. The subject matter is financial statements.

SSARS No. 21 states that the SSARS provisions *may be applied to other historic or prospective financial information*\(^\text{55}\) for which the accountant is engaged to perform a preparation of financial statements, compilation, or review engagement on:

- Specified elements, accounts or items of a financial statement  
- Supplementary information  
- Required supplementary information  
- Pro forma financial information, and  
- Prospective information (compilation and preparation engagement only)  
- Financial information contained in a tax return

The list above is referred to as “*other financial information.*”

Thus, the following rules apply:

a. If an accountant in public practice is hired (engaged) to prepare, compile or review financial statements, he or she *must* follow the requirements of SSARS No. 21.

b. If an accountant in public practice is hired (engaged) to compile or review “other financial information” based on the above list, the accountant *must* follow the requirements of SSARS No. 21.

c. If an accountant prepares “other financial information” the accountant is *not required to comply with SSARS No. 21*. Instead, he or she can perform a preparation engagement under SSARS No. 21 (AR-C 70) or can prepare the other financial information with no standards requirements.

*Financial statement versus trial balance*

Thus, it is important that an accountant understand the difference between a financial statement and other financial information. In some instances, the differences are not always clear and may require judgement.

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\(^{55}\) SSARS No. 21 does not apply to other prospective financial information in a review engagement.
Simply put: If an accountant is engaged to perform a preparation engagement on financial statements, he or she must comply with SSARS No. 21. Conversely, if the preparation engagement involves other financial information, the accountant is not required to comply with SSARS No. 21, although he may do so.

SSARS No. 21 states that financial statements consist of the following:

- Balance sheet
- Income Statement
- Statement of changes in equity
- Cash flow statement, and
- The related notes to financial statements

AR-C 90 of SSARS No. 21 defines financial statements and historical financial information as follows:

Financial statements:

“A structured representation of historical financial information, including related notes, intended to communicate an entity’s economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term financial statements ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.”

Historical financial information:

“Information expressed in financial terms regarding a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in the past time periods or about economic conditions or circumstances at points in time in the past.”

Let’s look at an example that illustrates why it is important to understand the difference between a financial statement and other financial information.

Example: Joe, a CPA in public practice, is engaged by a client to prepare certain statistical financial information (ratios, supplementary schedules, etc.) on a monthly basis.

Conclusion: Assuming such information is not a financial statement, Joe is not required to comply with SSARS No. 21. Therefore, Joe may choose to issue such information to the client with no specific rules to follow. That means Joe is permitted to distribute the financial information to the client with a simple transmittal letter or with no letter at all.

Change the facts: Joe is engaged to prepare financial statements for a client, and is not engaged to perform a compilation, review or audit engagement.
**Conclusion:** Because Joe, in public practice, is engaged to prepared financial statements, and is not engaged to perform a compilation, review or audit engagement, Joe must follow the SSARS No. 21 requirements for a preparation of financial statements engagement under AR-C 70. The key determinant is that Joe is preparing financial statements instead of other financial information.

**Trial balance versus financial statement**

If an accountant prepares a trial balance, is the accountant preparing a financial statement subject to SSARS No. 21 requirements?

The answer is that a trial balance is not a financial statement even though there are similarities between the two. Thus, preparing a trial balance is not the same as preparing a financial statement and there is no SSARS No. 21 requirements with respect to that trial balance.

Prior to the issuance of SSARS No. 21, there was guidance found in Interpretation No. 4 of SSARS No. 19, *Differentiating a Financial Statement Presentation From a Trial Balance*, that identified the differences between a trial balance and a financial statement. Although Interpretation No. 4 was superseded by SSARS No. 21, the logic of its conclusions remain valid and should be considered in instances in which an accountant is trying to determine whether he or she is engaged to prepare a financial statement or merely other financial information (such as a trial balance).

A trial balance differs from a financial statement as follows:

<table>
<thead>
<tr>
<th>Comparison of Financial Statement versus Trial Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Statement</strong></td>
</tr>
<tr>
<td>Combine similar general ledger accounts such as current assets, current liabilities, etc.</td>
</tr>
<tr>
<td>Presents subtotals and totals</td>
</tr>
<tr>
<td>Contra accounts are netted against related primary accounts (AR less allowance)</td>
</tr>
<tr>
<td>General contain titles that identify the presentation of financial position, results of operations, or cash flows:</td>
</tr>
<tr>
<td>• Balance sheet</td>
</tr>
<tr>
<td>• Statement of income</td>
</tr>
<tr>
<td>• Statement of Comprehensive income</td>
</tr>
<tr>
<td>• Statement of Retained Earnings</td>
</tr>
<tr>
<td>• Statement of Cash flows</td>
</tr>
<tr>
<td>Balance sheet segregates assets, liabilities and equity using a formula: Assets = Liabilities + Equity</td>
</tr>
</tbody>
</table>
Balance sheet usually presents assets in the order of liquidity and liabilities in the order of maturity

Accounts are generally listed in account number order as they appear in the general ledger

Income statement is presented as follows:
Revenues - Expenses + Gains – Losses = Net Income

No attempt is made to establish a mathematical relationship among the elements other than:
Total debits = Total credits

Income statement has a caption similar to “net income”

Trial balance does not have a caption for “net income”

In reviewing the above chart, there are clear elements that a financial statement has versus other financial information, such as a trial balance:

a. General ledger accounts are combined in financial statements.

b. General ledger accounts are netted in financial statements, such as the accounts receivable and the allowance for uncollectible accounts.

c. Financial statement titles are used such as “balance sheet” or “income statement.”

d. Financial statements usually have a formula, such as A = L + E.

e. Financial statements have captions, such as “net income.”

Therefore, if financial information is not a financial statement, it is considered other financial information. If an engagement involves the preparation of “other financial information” there is no requirement to comply with SSARS No. 21, although an accountant may choose to do so if he or she is also engaged to do so.

**L. Reporting on a Tax Return**

A tax return is not a financial statement under SSARS No. 21. Therefore, if an accountant submits a tax return to a client, bank or other third party, there is no reporting requirement.

A tax return can include the following:

- Form 1040, *U.S. Individual Income Tax Return*
- Form 1120, *U.S. Corporation Income Tax Return*
- Form 990, *Return of Organization Exempt from Income Tax*
- Form 1065, *U.S. Partnership Return of Income*
- Form 5500, *Return of Employee Benefit Plan*
- Form 1120S, *U.S. Income Tax Return for an S Corporation*

*Is an accountant permitted to report on a tax return, even if it is not considered a financial statement?*

A tax return is not a financial statement and there is no performance or reporting requirements if an accountant submits that tax return to a client, bank or other third party.
Nevertheless, AR-C 90 of SSARS No. 21 adds to the list of “other historical financial information” a category entitled “financial information contained in a tax return.”

Therefore, an accountant is permitted, but not required, to perform a compilation or review engagement and related report on a tax return. Alternatively, the accountant can merely send the tax return to a third party without any reporting requirements.

As for performing a preparation engagement on the tax return, such an engagement would be moot as there is generally no report that is issued with a preparation engagement under AR-C 70. Thus, if a report is to be issued on a tax return, it is either a compilation or review report.

However, in order for an accountant to perform a compilation or review engagement on a tax return, the requirements of SSARS No. 21 must be met. That is,

a. The accountant must be in public practice,

b. The accountant must be engaged (hired) to perform a compilation or review engagement on the tax return.

c. The accountant must satisfy the performance requirements of SSARS No. 21.

**Observation:** There may be an opportunity for accountants to save time by issue a compilation report on a tax return instead of financial statements. This type of engagement could be performed in lieu of a traditional compilation engagement on financial statements that omit substantially all disclosures.

Yet, few accountants are aware of this opportunity and, in fact, SSARS No. 21 do not provide any guidance or examples as to how to issue such a report.

It is common for a bank or other third party to require that some form of a report be issued by an accountant even if it is a compilation that omits substantially all disclosures. An alternative is to issue a compilation report on a tax return which provides the lender with the comfort of receiving a report from an accountant.

An accountant is also permitted to perform a review engagement on a tax return; however, such an engagement has little demand in the marketplace as a third party would typically require a full set of disclosures and a statement of cash flows, when requesting that a review report be issued.

**Facts:** Johnny CPA prepares a Form 1120 for XYZ Corporation for December 31, 20X1 year end. The client does not want Johnny to prepare financial statements even if they are compiled with no disclosures and a statement of cash flows.

XYZ’s bank asks Johnny to issue a compilation report on XYZ’s tax return.

**Conclusion:** The Form 1120 is not a financial statement under SSARS No. 21 so that if Johnny sends the Form 1120 to the bank, Johnny is not required to issue a compilation or review report on the tax return.
However, because the tax return is “other financial information”, an accountant is permitted to perform a compilation or review engagement on the tax return as long as he or she follows the performance and reporting requirements in SSARS No. 21.

If the accountant chooses to issue a compilation report on the tax return, the author believes the report should be issued as a compilation report that looks like the following format:

**Sample Compilation Report- Tax Return**

Management is responsible for the accompanying Form 1120, U.S. Corporation Income Tax Return of XYZ Company as of December 31, 20X1, and for the year then ended in accordance with the basis of accounting the company uses for federal income tax purposes. We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the tax return nor were we required to perform any procedures to verify the accuracy or completeness of the tax return provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on the tax return.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X2

**Sample Review Report- Tax Return**

**Independent Accountant’s Review Report**

Board of Directors
XYZ Company
Nowhere, Massachusetts

We have reviewed the accompanying Form 1120, U.S. Corporation Income Tax Return of XYZ Company as of December 31, 20X1, and for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the tax return as a whole. Accordingly, we do not express such an opinion.

**Management’s Responsibility for the Financial Statements**
Management is responsible for the preparation and fair presentation of the tax return in accordance with the basis of accounting the company uses for federal income tax purposes: this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the tax return that is free from material misstatement whether due to fraud or error.

**Accountant’s Responsibility**
Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require us to perform procedures to
obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the tax return for it to be in accordance with basis of accounting that the company uses for federal income tax purposes. We believe that the results of our procedures provide a reasonable basis for our report.

Accountant’s Conclusion
Based on our review, we are not aware of any material modifications that should be made to the accompanying tax return in order for it to be in accordance with the basis of accounting that the company uses for federal income tax purposes.

James J. Fox & Company
Burlington, Massachusetts
March 31, 20X2

Observation: The previous sample reports are non-authoritative in that there are no examples found anywhere in SSARS No. 21 or the AICPA Guide. Consequently, the author has created the sample reports by making modifications to the standard compilation report to reflect the fact that the report is being issued on a tax return instead of a financial statement. Note further that the previous report is not a report on tax-basis financial statements because a tax return is not a financial statement.

Would disclosures be required to be attached to the tax return, and, would a third paragraph stating that “management has elected to omit substantially all disclosures…” be required for a compilation report where such disclosures are omitted?

The accountant is reporting on a tax return and not financial statements. Therefore, disclosures are not required and no additional paragraph stating that “management has elected to omit substantially all disclosures…” is required.

Further, in the first paragraph of the review report, no reference is made to “related notes to financial statements” because no such notes are included.

Why isn’t the compilation report on the tax return considered a compilation on a prescribed form financial statement?

A prescribed form is a standard preprinted form designed or adopted by the body to which it is to be submitted, such as a preprinted bank financial statement. In this example, the preprinted form (Form 1120) is designed or adopted by the IRS, and not the bank to whom it will be presented.

Should the tax return have a legend “See Accountant’s Compilation Report?”

SSARS No. 21 eliminated the required to include a legend on each page of financial statements or other financial information, such as “See Accountant’s Compilation Report” or “See Independent Accountant’s Review Report.”

Even though there is no requirement to include a legend, nothing precludes an accountant from including a legend on each page of the tax return. However, as a practical point, it is not clear how the accountant would insert a legend on each page of a tax return such as “See Accountant’s Compilation Report” unless the accountant adds the legend manually.
Consulting Services and SSARS No. 21

**Question:** Is there any exemption from SSARS No. 21 for financial statements included within consulting reports?

**Response:** No. SSARS No. 21 does not provide any exemption for historical financial statements included within consulting reports. The general rule is that SSARS No. 21 applies to any financial statements that meet the requirements of SSARS No. 21, regardless of whether those financial statements are included in a consulting report. Consequently, the accountant must either compile or review the financial statements included in the consulting report.

The exception is where the financial statements are prepared by another accountant or the client prepares the statements and those financial statements are included in the accountant’s consulting report. In such a case, the accountant would not be required to comply with SSARS No. 21 as the accountant has not been engaged to perform a preparation, compilation or review engagement on those financial statements.

In such a case, however, the accountant may wish to include a reference to those statements in the accountant’s consulting report, such as:

“*The financial statements presented on pages x and x were prepared by XYZ Company. We have not compiled, reviewed, or audited the financial statements and, accordingly, we assume no responsibility for them.*”


**Emphasis-of-matter paragraph:**

**Question:** An accountant issues a compilation report on financial statements that omit substantially all disclosures. The accountant wishes to include in his report a disclosure about the date through which management evaluated subsequent events.

Is an accountant permitted to include the disclosure in the compilation report?

**Response:** No. When a compilation report is issued on financial statements that omit substantially all disclosures, the accountant is not permitted to include disclosures in the report unless that information is also included in the notes, which do not exist in this example.

More specifically, paragraphs A95 of AR-C 90, SSARS No. 21 *states that an emphasis-of-a-matter paragraph is not a substitute for disclosures in the financial statements.*

Thus, an accountant should not include an emphasis-of-matter paragraph in a compilation report on financial statements that omits substantially all disclosures unless the matter is disclosed in the financial statements.
An accountant may include an emphasis-of-matter 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-of-matter paragraph is also disclosed in the selected information.

Also note that an accountant may, but is not required to, emphasize in his or her report, a matter that is disclosed in the financial statements. The matter should be presented in a separate paragraph of the accountant’s report.

1. Emphasis-of-a-matter paragraphs are optional at the sole discretion of the accountant.

2. Examples of matters that the accountant may wish to emphasize in a compilation report include the following:
   - Uncertainties
   - A major catastrophe that has a significant effect on an entity’s balance sheet
   - That the entity has had significant transactions with related parties
   - Unusually important subsequent events

Typically, more routine transactions such as purchases of assets in the normal course of business are not matters that would be included in an emphasis-of-a-matter paragraph even though an accountant may choose not to do so.

Can an accountant include a GAAP departure in a compilation report if management has elected to omit substantially all disclosures?

Yes. A compilation report may not have an emphasis-of-a-matter paragraph if there are no disclosures. However, such a report may have a GAAP departure even if there are no disclosures.

Other-matter paragraph:

Question: Is an accountant who issues a compilation report on financial statements that omit substantially all disclosures permitted to include an other-matter paragraph in his or her compilation report?

Response: Yes. Paragraph 54 of AR-C 90, SSARS No. 21 permits an accountant to include an other-matter paragraph in his or her report to “communicate a matter other than those that are presented or disclosed in the financial statements” that the accountant believes is relevant to the users’ understanding of the engagement.

That means that an accountant may address an item in an other-matter paragraph within a compilation report and not disclosure it in the notes to financial statements. Moreover, the content of an other-matter paragraph reflects an other matter that is not required to be presented and disclosed in the financial statements or that must be provided by management.

Although the guidance for using an other-matter paragraph is found in Paragraph 54 within AR-C 90’s review standards, its use can be applied within a compilation engagement, as well.
Review Questions

1. Most changes required by GAAP:
   a. Are important to the smaller nonpublic businesses
   b. Have little cost differences for practitioners preparing reports
   c. Have little usefulness to smaller nonpublic businesses
   d. Are equally as significant to the smaller nonpublic business as large corporations

2. Which of the following is not one of the four most common GAAP departures that can simplify engagement time:
   a. Continue to amortize goodwill and indefinite lived intangibles even though not authorized by GAAP
   b. Eliminate the statement of cash flows
   c. Use income tax depreciation instead of GAAP depreciation
   d. Don’t record deferred income taxes

3. Per the author, how many GAAP departures can generally be included in a compilation or review report without including an additional “significant and pervasive” paragraph:
   a. None; you cannot have GAAP departures and issue a report without modification
   b. Usually one or two departures
   c. Usually up to five departures
   d. A limitless number of departures

4. Which of the following would be the type of general ledger account that could be set up with an imprest balance:
   a. Fixed asset account
   b. Long-term debt
   c. Cash or a cash equivalent
   d. Accrued commissions

5. Under pre-SSARS No. 21 rules, an engagement letter ________________.
   a. Had to be signed by both the client and accountant
   b. Had to be signed by the client, but not the accountant
   c. Had to be signed by the accountant, but not the client
   d. Did not have to be signed

6. Which of the following provisions should be in every engagement letter:
   a. Limit on amount of damages in litigation and time to sue
   b. Management’s responsibility
   c. Record retention policy
   d. Ownership of records and confidentiality of information

7. Which of the following should be included in an engagement letter:
   a. Mediation clause
   b. Arbitration clause
   c. Both mediation and arbitration clauses
   d. Neither a mediation or arbitration clause
8. Which of the following is correct regarding engagement risk:
   a. Audits contain much greater risk than either compilations or bookkeeping services
   b. Clients cannot sue accountants who only perform bookkeeping services
   c. Courts are holding accountants who perform bookkeeping services to a higher level of responsibility when there is employee embezzlement
   d. Accountants are required to obtain an engagement letter in bookkeeping engagements

9. Which of the following is correct with respect to the comparison of a financial statement to a trial balance:
   a. A financial statement does not combine similar general ledger accounts
   b. A trial balance typically includes financial statement titles
   c. A trial balance typically has a net income caption at the bottom
   d. Contra accounts are netted in a financial statement but not netted in a trial balance

10. Facts: Johnny CPA submits a tax return to a client. Which of the following is correct:
    a. The accountant must issue a compilation, review or audit report on the tax return
    b. The accountant is not permitted to issue a report on a tax return
    c. There is no reporting requirement with respect to a tax return
    d. SSARS No. 21 is silent as to whether an accountant is permitted to report on a tax return
N. Ethics and Independence Rule Changes

1. Revisions to Independence Rules

a. General

For years prior to 2014, the independence rules for CPAs were found in Interpretation 101-3 of the AICPA Code of Professional Conduct.

In early 2014, the Professional Ethics Executive Committee (PEEC) of the AICPA issued a new recodified code of conduct. That new code is effective either as of December 15, 2014, or for years beginning after 2014 (calendar 2015).

For years, there has been confusion as to whether an accountant who has management responsibilities taints his or her independence with respect to an attest client.

This issue has become more important as CPA firms have expanded consulting services directed at existing compilation, review and audit clients. For example, today, many firms offer their services to clients as part-time controllers whereby they perform most of the functions as a controller one or two days per week. Such tasks may include managing accounting personnel, signing checks, negotiating with the banks or investors, etc. Do these functions impair the independence of the accountant with respect to that client? At a simpler level, an accountant may perform write-up services, prepare tax returns, prepare financial statements, or perform payroll tax services for attest clients. Those accountants wish to perform a compilation, review or audit on that same client. Is the write-up service a management function?

The general rule is that:

a. An accountant is precluded from issuing a review or audit report on the financial statements of any entity to which he or she is not independent.

b. SSARS No. 21 carves out a special exception for an accountant who performs compilation engagements. That accountant may compile financial statements if he or she is not independent, provided he or she discloses the lack of independence within the compilation report with the following language added to that report:

   “We are (I am) not independent with respect to ABC Company.”

SSARS No. 21 permits an accountant to disclose the reason for the lack of independence as long as all reasons are disclosed.

More than a decade ago, the AICPA Professional Ethics Executive Committee issued Ethics Interpretation 101-3, Performance of Other Services. The purpose of this interpretation was to clarify when an accountant who performs certain nonattest services, taints his or her independence. The original version of Interpretation 101-3 provided guidelines on independence segregated into:

- Bookkeeping (including payroll and other disbursements)
- Benefit plan administration
• Investment advisory and management services
• Corporate finance, consulting and advisory services
• Appraisal, valuation, and actuarial services
• Executive or employee service
• Business risk consulting
• Information systems design, installation, and integration

PEEC amended Interpretation 101-3 with specific changes made to address whether any of the following activities impaired independence:

• Compliance services, including preparing a tax return, transmitting the tax return and related payment to the taxing authority.
• The signing and filing of a tax return on behalf of a client, and
• Forensic accounting services, including litigation and investigative services.

Once again, the PEEC made changes to Interpretation 101-3 including clarifying that certain communications between the member (CPA) and client, such as recommending adjusting entries, are part of the attest engagement, and not considered nonattest services.

In the following sections, wherever there is reference to the term “member,” it refers to a member of the AICPA. The author uses the terms “CPA,” “accountant” and “member” interchangeably within the remainder of this section even though, in limited cases, a member can be a non-CPA.

Moreover, when referring to an "attest engagement", the author refers to the following types of engagements:

• Audit of financial statements
• Review of financial statements
• Compilation with no lack of independence
• Attestation engagement under SSAE No. 10, such as an agreed-upon procedures engagement

Effective December 15, 2014, the AICPA issued a new Code of Professional Conduct which recodifies all of the ethics rules and interpretations. As part of that recodification, the previously issued Interpretation 101-3, now resides in the new ET sec. 1.200, Independence. ET sec. 1.295 is also important because it addresses the specific issue of an accountant who performs nonattest services for an attest client.

b. Changes Made to Independence Rules:

The following are some of the changes made to the independence rule over the past few years, which are now reflected in the new ET sec. 1.200, Independence, of the AICPA Code of Professional Conduct.

CHANGE 1: Nonattest Services:

The PEEC decided to clarify the issue pertaining to whether a member (CPA) who previously performed nonattest services for a client, would have his or her independence impaired in subsequent periods.
The independence rules were amended to state that a member’s (CPA’s) independence would not be impaired if the member (CPA) performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that all of the following conditions exist:

a. The nonattest services were provided prior to the period of the professional engagement

b. The nonattest services related to periods prior to the period covered by the financial statements, and

c. The financial statements for the period to which the nonattest services relate were audited by another firm (or the case of a review engagement, reviewed or audited by another firm).

Example: Joe CPA is hired to review the financial statements of Company X for the year ended December 31, 2015.

- Joe performed nonattest services for Company X in 2013 and part of 2014. The nonattest services consisted of part-time controllership including Joe being a signatory on X’s bank accounts and having authorization to hire and fire certain employees of X.

- Joe stopped his controllership services on or about October 2014 and started the December 31, 2015 year-end review engagement in January 2016. After terminating his controllership services, Joe’s only nonattest services performed for X was the preparation of X’s 2015 corporate tax returns.

- The financial statements for 2013 and 2014 were reviewed by another CPA firm.

Conclusion: Joe’s independence is not impaired for 2015. Therefore, Joe is permitted to perform his review engagement on X’s 2015 financial statements.

The analysis is based on the revised independence rules, using the following facts:

a. The nonattest services (controllership) were provided prior to the period of the professional engagement: Joe performed nonattest services through October 2014, prior to January 1, 2015, the beginning of the year of the review engagement.

b. The nonattest services related to periods prior to the period covered by the financial statements: Joe’s controllership related to 2013 and part of 2014, periods prior to 2015.

c. The financial statements for the period to which the nonattest services relate were audited or reviewed by another firm: According to the facts, another firm reviewed the financial statements for 2013 and 2014, the periods during which Joe performed his nonattest services.

Therefore, Joe is permitted to perform a review of the 2015 financial statements even though Joe performed nonattest services in 2013 and 2014 that, if they had been performed in 2015, would have impaired his independence because Joe had made management decisions during his controllership tenure.
What about the fact that Joe is performing a nonattest service in 2015 by preparing X’s tax return?

The fact that Joe performs a nonattest service for an attest client in 2015, does not, in and of itself, mean that Joe’s independence is impaired.

Performing nonattest services for an attest client, such as preparation of a tax return, bookkeeping services, payroll services, or preparation of financial statements, where the accountant does not have management responsibilities, does not impair an accountant's independence, as long as Joe complies with the requirements of the independence rules. Those requirements include: 1) Joe cannot make management decisions or assume management responsibility, 2) The client, rather than Joe, must agree to assume all management responsibilities for the nonattest service, and 3) The understanding must be in writing (e.g., engagement letter). These three (safeguard) requirements are discussed further on in this section.

CHANGE 2: Change in the Definition of a Covered Member:

Background:

Independence may be considered impaired if there is a self-interest threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, an attest client or persons associated with the attest client.

Examples of self-interest threats include the following:

a. A member (CPA) has a direct financial interest or material indirect financial interest in the attest client.

b. A member (CPA) has a loan from the attest client, an officer or a director of the attest client, or an individual who owns 10 percent or more of the attest client's outstanding equity securities.

c. A member (CPA) or his or her firm relies excessively on revenue from a single attest client.

d. A member (CPA) or member's firm has a material joint venture or other material joint business arrangement with the attest client.

Change made to definition of a covered member:

The 2013 Omnibus Statement changes the definition of a covered member to include a partner equivalent. This new definition is now included in ET .400 of the new codification.

ET sec. .400 expands the definition of a “covered member” subject to the independence rules as follows:

A covered member is:

a. an individual on the attest engagement team

b. an individual in the position to influence the attest engagement
c. a partner, *partner equivalent*, or manager who provides more than 10 hours of nonattest services to the attest client within any fiscal year

d. a partner or *partner equivalent* in the office in which the lead attest engagement partner or partner equivalent primarily practices in connection with the attest engagement

e. the firm, including the firm’s employee benefit plans, or

f. an entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities in (a) to (e), or two or more such individuals or entities if they act together.

There is a new *definition of a partner equivalent* which is now incorporated into ET sec. .400 of the AICPA Code of Professional Conduct.

A partner equivalent is a professional employee who is not a partner of the firm but who either:

a. has the ultimate responsibility for the conduct of an attest engagement, including the authority to sign or affix the firm's name to an attest report or issue, or authorize others to issue, an attest report on behalf of the firm without partner approval, or

b. has authority to bind the firm to conduct an attest engagement without partner approval.

For example, the professional employee has the authority to sign or affix the firm’s name to an *attest engagement* letter or contract to conduct an *attest engagement* without *partner approval*. Firms may use different titles to refer to professional employees with this authority, although a title is not determinative of a partner equivalent. For purposes of this definition, *partner approval* does not include any partner approvals that are part of the firm’s normal approval and quality control review procedures applicable to a partner.

**Note:** The PEEC states that firms may use different titles to refer to professional employees, although a title is not determinative of a partner equivalent. The partner equivalent definition only pertains to independence issues and related interpretations and rulings, and should not be relied upon with respect to any other context, such as whether a partner equivalent is an owner of the firm.

Further, the definition states that the term “*partner approval*” does not include the firm’s normal approval and quality control review procedures.

**Definition of a manager:**

The definition of a *manager*, who is a covered member, has also been changed to the following:

“A professional employee of the firm who has continuing responsibility for the planning and supervision of engagements for specified clients.”

**CHANGE 3: Activities Related to Attest Services:**
The PEEC made the following change to the independence rules pertaining to certain communications that are now considered part of the attest engagement, and *not nonattest services*.

Performing attest services often involves communication between the member (CPA) and client management.

The following communications are considered a *normal part of the attest engagement* and *would not constitute a nonattest service*:

a. the client’s selection and application of accounting standards, or policies and financial disclosure requirements

b. the appropriateness of the client’s methods used in determining the accounting and financial reporting

b. adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and

c. the form or content of the financial statements.

The member (CPA) should exercise judgment in determining whether his or her involvement has become so extensive that it would constitute performing a separate nonattest service that would be subject to the three safeguard requirements that are discussed further on in this section.

**CHANGE 4: Financial Statement Preparation and Cash-to-Accrual Conversions-Nonattest Services:**

The independence rules were changed to provide that certain activities are now considered outside the scope of an attest engagement and *constitute a nonattest service*: Those activities include:

- Financial statement preparation
- Cash-to-accrual conversions, and
- Reconciliations such as cash, accounts receivable and payable reconciliations.

The previous three activities are *nonattest services* and would not impair independence as long as the accountant complies with the three safeguard requirements when nonattest services are performed for an attest client, which is discussed elsewhere in this section.

**Note:** There were revisions to the *Government Auditing Standards*, with the most significant changes relating to its standards for auditor independence, in particular the performance of nonattest services for an audit client. Although the changes made by the GAO created greater consistency between the AICPA’s and the GAO’s nonattest independence standards, the preparation of financial statements and cash-to-accrual conversions, were identified as services where the PEEC believed the independence rules should be revised. The GAO ruled that the preparation of financial statements was a nonattest service separate from the audit attest engagement. In the end, the PEEC changed the independence rules to make them consistent with GAO standards, by stating that the preparation of financial statements, cash-to-accrual conversions, and reconciliations are all nonattest services.
CHANGE 5: Internal Audit Assistance Services:

Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as *internal audit outsourcing*. In evaluating whether independence would be impaired with respect to an attest client, the nature of the service needs to be considered.

The independence rules segregate the internal audit assistance services into two categories:

- Assisting the client in performing financial and operational internal audit activities, and
- Designing, implementing, or maintaining the client’s *monitoring* activities of a client’s internal control.

1. **Assisting the client in performing financial and operational internal audit activities**:

   a. An example of assisting a client in performing a financial and operational internal audit is where the member assesses whether performance is in compliance with management’s policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making.

   b. Such assisting would impair independence, unless the member takes appropriate steps to be satisfied that the *client accepts its responsibility for designing, implementing, and maintaining internal control and for directing the internal audit function*, including the management thereof:

      1) Any outsourcing of the internal audit function to the member whereby the member, in effect, manages the internal audit activities of the client would impair independence.

2. **Designing, implementing, or maintaining the client’s monitoring activities** (of a client’s internal control):

   a. Such activities are management responsibilities and would impair a member’s independence if a member accepts responsibility for performing such activities.

   b. Monitoring activities are procedures performed to assess whether components of internal control are present and functioning.

   c. Monitoring can be done through either *ongoing evaluations* or *separate evaluations*, or some combination of the two.
## Monitoring

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<th>Type of monitoring</th>
<th>Effect on member’s independence</th>
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| Ongoing evaluations        | • Independence *is impaired.*  
• Member is deemed to be accepting management’s responsibility for the client’s internal control.  
• No safeguards can reduce a member’s management participation threat to an acceptable level. |
| Separate evaluations       | • Independence generally is *not impaired.*  
Independence is impaired only if member accepts management responsibility.  
• Member is generally not deemed to be accepting responsibility for the client’s internal control.  
• Threat of a member’s management participation is low. |

1) *Ongoing evaluations* are generally defined, routine operations, built in to the client’s business processes and performed on a real-time basis. Such monitoring, including managerial activities and everyday supervision of employees, monitor the presence and functioning of the components of internal control in the ordinary course of managing the business.

   • A member who performs such ongoing evaluations for a client would be considered to be accepting responsibility for maintaining the client’s internal control. Therefore, the management participation threat created by a member performing ongoing evaluations is so significant that *no safeguards could reduce the threat to an acceptable level*. Therefore, member independence would be impaired, regardless of whether any other actions are taken.

2) *Separate evaluations* are conducted periodically and are generally not ingrained within the business but can be useful in taking a fresh look at whether internal controls are present and functioning.

   • Separate evaluations include observations, inquiries, reviews, and other examinations to determine whether controls are designed, implemented, and conducted.
The scope and frequency of separate evaluations is a matter of judgment and vary depending on assessment of risks, effectiveness of ongoing evaluations, and other considerations. Because separate evaluations are not built into the client’s business process (and performed on a real-time basis), separate evaluations generally do not create a significant management participation threat to independence.

As long as the member complies with the three requirements for performing nonattest services for an attest client (including not assuming management responsibility (as discussed further on in this section), the accountant’s independence is not impaired by performing separate evaluations.

Note: Members should use judgment in determining whether the internal audit services performed, including separate evaluations, may result in a significant management participation threat to independence, considering factors such as:

- The significance of the controls being tested
- The scope or extent of the controls being tested in relation to the overall financial statements of the client, and
- The frequency of the internal audit services.

If there is a significant threat to independence, the member should apply safeguards to eliminate or reduce the threat to an acceptable level. If no safeguards could reduce the threat to an acceptable level, independence would be impaired.

3. With respect to internal audit services, to reduce the threat of the member assuming management responsibility, in addition to the general requirements of this interpretation, the member should be satisfied that client management:

a. designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably within senior management, to be responsible for the internal audit function

b. determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services

c. evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services, and

d. evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures.

Note: The member may assist the individual(s) responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. The member should also be satisfied that those charged with governance are informed about the member’s and management’s respective roles and responsibilities in connection with the engagement. Such information should provide those charged with governance a basis for
developing guidelines for management and the member to follow in carrying out these responsibilities, and, monitoring how well the respective responsibilities have been met.

The following are examples of activities that, if performed as part of an internal audit services engagement, would impair independence:

- **Performing ongoing monitoring activities or control activities** (for example, reviewing loan originations as part of the client’s approval process or reviewing customer credit information as part of the customer’s sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client’s operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- Performing separate evaluations on the effectiveness of a significant control such that the member is, in effect, performing routine operations that are built into the client’s business process
- Having client management rely on the member’s work as the primary basis for the client’s assertions on the design or operating effectiveness of internal controls
- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures, and
- Being connected with the client as an employee, or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client’s internal audit function, or using the client’s letterhead or internal correspondence forms in communications).

4. When a member performs internal audit services that would not impair independence under this interpretation and is subsequently engaged to perform an attestation engagement to report on management’s assertion regarding the effectiveness of its internal control, independence would not be considered impaired, provided the member is satisfied that client management does not rely on the member’s work as the primary basis for its assertion.

**CHANGE 6: Engagements Subject to Independence Rules of Certain Bodies:**

The independence rules were amended to require compliance with independence regulations of authoritative regulatory bodies when a member performs nonattest services for an attest client and is required to be independent of the client under the regulations of the applicable regulatory body. Failure to comply with the nonattest services provisions contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of the AICPA independence rules, would constitute a violation of the Code of Professional Conduct.
The interpretation expands the list of identified applicable regulatory bodies to include:

- SEC
- Government Accountability Office (GAO)
- Department of Labor (DOL)
- Public Company Accounting Oversight Board (PCAOB)
- State boards of accountancy

**CHANGE 7: Expanded List of Unacceptable Nonattest services- CPA Assumes Management Responsibilities:**

The independence rules were expanded to include examples of activities that, if performed by an accountant, would result in the accountant assuming management responsibilities and impair independence.

Following is an updated list of activities that, if performed by an accountant for an attest client, would impair independence:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent
- **Setting policies or strategic direction for the client**
- **Directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards**
- **Accepting responsibility for the management of a client’s project**
- **Accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework**
- **Accepting responsibility for designing, implementing, or maintaining internal controls**
- **Performing ongoing evaluations of the client’s internal control as part of its monitoring services**

**Note:** If any of the previous listed activities are performed, an accountant’s independence is impaired.

**CHANGE 8: Expanded List of Acceptable Nonattest Services:**

The independence rules were amended to add two new nonattest services to the list of nonattest services that **do not impair an accountant’s independence** with respect to a nonattest client:
• Prepare a reconciliation (for example, cash and accounts receivable) that identifies reconciling items for the client’s evaluation.

• Perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request.

As long as an accountant satisfies the *Three Safeguards* for performing nonattest services (see Change 9 below), an accountant is permitted to perform the above two nonattest services for an attest client and not impair independence.

**CHANGE 9: Changes to the General Requirements for Performing Nonattest Services:**

**a. General requirements for performing nonattest services for an attest client:**

The nonattest services element of the independence rules, now found in ET sec. 1.295 of the AICPA Code of Professional Conduct, was amended so that there are *three requirements* that must be satisfied in order for a member (CPA) to perform certain nonattest services for an attest client:

These three requirements are referred to as "*Three Safeguards*" to ensure independence is maintained:

**SAFEGUARD 1: Client must agree to perform certain functions:**

Before performing nonattest services, the member should determine that the client has agreed to:

• Assume all management responsibilities,
• Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience*,
• Evaluate the adequacy and results of the nonattest services performed, and
• Accept responsibility for the results of the nonattest services.

**SAFEGUARD 2: Member (CPA) does not assume management responsibilities for the nonattest service:**

• The member (accountant) does not assume management responsibilities for the nonattest service and
• The member is satisfied that the client and its management will:
  - Be able to meet the criteria in Safeguard 1
  - Make an informed judgment on the results of the nonattest services, and
  - Accept responsibility for making the significant judgments and decisions that are the proper responsibility of management

**SAFEGUARD 3: Written establishment and documentation with client:**

Before performing the nonattest services, the member should establish and *document in writing* his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:
Objectives of the nonattest engagement
(Nonattest) services to be performed
Client’s acceptance of its responsibilities
Member’s responsibilities
Any limitations of the engagement

Cumulative Effect on Independence When Providing Multiple Nonattest Services

ET sec. 1.295 adds a new requirement with respect to an accountant performing multiple nonattest services for the same attest client.

a. Before agreeing to perform nonattest services, the member (CPA) should evaluate whether the performance of multiple nonattest services by the member or member’s firm in the aggregate creates a significant threat to the member’s independence that cannot be reduced to an acceptable level by the application of the Three Safeguards.

b. In situations in which a member determines that threats are not at an acceptable level, safeguards in addition to the Three Safeguards should be applied to eliminate the threats or reduce them to an acceptable level.

If no safeguards exist that will eliminate or reduce the threats to an acceptable level, independence would be impaired.

c. The member is not required to consider the possible threats to independence created due to the provision of nonattest services by other network firms within the firm’s network.

2. THREE SAFEGUARDS (Requirements) For a CPA to Perform Nonattest Services for an Attest Client

ET 1.295 of the Code of Professional Conduct (formerly Interpretation 101-3) requires an accountant to satisfy three safeguards (requirements) in order to perform a non-attest service for an attest client.

SAFEGUARD 1: Client must agree to perform certain functions:

The first safeguard (requirement) in order for a CPA to perform nonattest services for an attest client is that the client must agree to perform certain functions.

More specifically, before performing nonattest services, the member should determine that the client has agreed to:

a. Assume all management responsibilities,
b. Oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,
c. Evaluate the adequacy and results of the nonattest services performed, and
d. Accept responsibility for the results of the nonattest services.
Note: The member (CPA) should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the service.

What if the client does not have an individual with the necessary skill, knowledge, and/or experience to oversee the nonattest services?

The Ethics Committee has stated that in establishing the requirement that the CPA should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. Moreover, the individual is not required to possess the expertise to perform or reperform the service. That means that if the nonattest service performed by the CPA is the preparation of the corporate tax return of the entity for whom the CPA is performing a review engagement, the designated individual does not have to possess sufficient skill to prepare the tax return.

Instead, the designated employee should have a sufficient level of understanding of the results of the services rendered so that he or she could effectively oversee them, including making any necessary management decisions related to the nonattest service. In all cases, the skill, knowledge, and/or experience level should be sufficient to allow the employee to understand the nonattest service to be rendered and allow him or her to make all management decisions and perform all management functions associated with that service, and to evaluate the adequacy and results of the service, accept responsibility for those results, including monitoring activities, over the subject matter of the service. Note further that the individual is not required to have any expertise regarding the services being performed.

Example: A member is hired by an attest client to perform bookkeeping services. The client designates an employee with suitable skill, knowledge, and experience to oversee the bookkeeping services.

Conclusion: The designated employee should be able to understand the bookkeeping service to be rendered and to perform all management functions related to that bookkeeping service, including understanding the adequacy of the member’s services performed. In doing so, for example, the employee should be able to assess the journal entries and general ledger account classifications proposed by the member. This would suggest that the employee must, at a minimum, have a general understanding of the accounting function in order to understand the entries and classifications proposed by the member.

Observation: It would appear that in most small business scenarios, there is someone within the entity who can take responsibility as a designated employee. In the worst case, the owner/manager should be able to act as the designated employee as that person usually has enough overall knowledge of the business to be considered to have suitable skill, knowledge, and/or experience to oversee the services performed. Also, although ET 1.295 suggests that it is preferable for a senior manager to play the role as a designated employee to oversee the nonattest function, there is no requirement to do so. That means that a bookkeeper or controller could be assigned the role as the designated employee.

If an owner/manager has an inadequate knowledge of accounting to approve the accountant’s proposed entries and general ledger classifications, that owner-manager still could be the designated employee by having the bookkeeper or controller review the entries and classifications for the owner/manager.

Must the designated person be an employee?
No. One change previously made to the independence rules was the removal of the term “employee” and replacing it with the term “individual” so the client must designate an individual who may or may not be an employee. By doing so, an owner or individual outside the company such as an outsourced bookkeeper or controller, can act as the designated individual.

**SAFEGUARD 2: Member (CPA) does not assume management responsibilities for the nonattest service:**

The second safeguard (requirement) of ET 1.295 is that the member (CPA) should not assume management responsibilities for the attest client.

In addition, the member is satisfied that the client and its management will:

- Be able to meet the criteria in Safeguard 1
- Make an informed judgment on the results of the nonattest services, and
- Accept responsibility for making the significant judgments and decisions that are the proper responsibility of management

ET sec. 1.295 addresses certain issues related to a CPA’s requirement that he or she not assume management responsibilities for an attest client.

a. If a member were to assume a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. Thus, independence would be impaired.

b. Management responsibilities involve leading and directing an entity, including making significant decisions regarding acquisition, deployment, and control of human, financial, physical, and intangible resources.

c. Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment.

Examples of activities that would be considered a management responsibility and, therefore, impair independence if performed for an attest client include the following:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent
- Setting policies or strategic direction for the client
• Directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
• Accepting responsibility for the management of a client’s project
• Accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework
• Accepting responsibility for designing, implementing, or maintaining internal controls
• Performing ongoing evaluations of the client’s internal control as part of its monitoring services

SAFEGUARD 3: Written establishment and documentation with client:

The third safeguard requirement in order for a CPA to perform nonattest services for an attest client is that there must be a written establishment and documentation with the client as to the nonattest work to be performed.

Before performing the nonattest services, the member should establish and document in writing his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:

• Objectives of the nonattest engagement
• Nonattest services to be performed
• Client’s acceptance of its responsibilities
• Member’s responsibilities
• Any limitations of the engagement

Here is some guidance on achieving this requirement:

a. The documentation of the understanding can be in the form of:

   1) An engagement letter to the client, or

   2) An internal memorandum to the member’s file that is not issued to or signed by the client.

b. The documentation requirement does not apply to certain routine activities performed by the member including providing advice and responding to the client’s technical inquiry as part of the client-member relationship.

c. The member’s failure to prepare the required documentation would not impair independence, provided the member did establish the understanding with the client.

Example: Mary CPA is hired by her attest client to perform bookkeeping services. Mary meets with the client and establishes an understanding of the services to be provided including:

• Objectives of the engagement
• Nonattest services to be performed
• Client’s acceptance of its responsibilities
• Member’s responsibilities
• Any limitations of the engagement.
Mary forgets to document the understanding either in an engagement letter or in a memorandum to her file. One year later, the failure to document the understanding is discovered while Mary goes through a peer review. She immediately documents the understanding upon discovery of her failure to do so.

**Conclusion:** Mary’s independence is not impaired with respect to the attest client. Mary’s failure to document the understanding does not impair independence because she established an understanding with the client.

The author suggests *two options* with which to document the understanding with the client as follows:

a. Include reference to the nonattest service within the attest *engagement letter* assuming one is obtained for the engagement, or

b. Prepare an *internal memorandum* to be placed in the accountant’s file and not to be distributed to the client.

Following are examples of each of the two documents.

**OPTION 1: Include reference to the nonattest service within the attest engagement letter**

The clearest way to satisfy SAFEGUARD 3 and document the client’s understanding of the nonattest services to be performed for an attest client, is to simply include reference to the nonattest service in the attest engagement letter.

**Example:** An accountant is hired to perform a review engagement for a company, as required by the company’s bank. The client has no bookkeeper and seeks to hire the accountant to perform bookkeeping services prior to performing the review engagement including:

- Coding all checks and deposits for the year
- Posting all cash receipts and disbursements to the general ledger

The accountant is also hired to prepare the tax return for the company.

**Conclusion:** The accountant should document the client’s understanding of the nonattest services to be provided (bookkeeping and tax return preparation). One way to do so is to include language in the review engagement letter that clarifies the:

- Objectives of the engagement
- Services to be performed
- Client’s acceptance of its responsibilities
- Member’s responsibilities
- Any limitations of the engagement.

Following is the author’s nonauthoritative language that can be placed in the engagement letter:
ENGAGEMENT LETTER LANGUAGE WHEN NONATTEST SERVICES ARE PERFORMED FOR AN ATTEST CLIENT

SAFEGUARD 3

Part of Engagement Language for the Attest Engagement Letter

**Abbreviated version: Nonattest Services**

You are also responsible for all management decisions and responsibilities, and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of services performed and accepting responsibility for such services.

**Elaborate version: Nonattest Services**

In addition to the performance of our review engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, preparation of financial statements, and the preparation of the Company’s federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as assuming management responsibilities, including determining general ledger account classifications of certain transactions and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must take all management responsibility with regard to those matters.

You agree that in connection with our performance of any nonattest service, you will:

a. Assume all management responsibilities.

b. Oversee the nonattest service, by designating an individual, preferably within senior management, who possesses the skill, knowledge and experience.

c. Evaluate the adequacy and results of the services, and

d. Accept responsibility for the results of our services.

**OPTION 2: Prepare an internal memorandum to be placed in the accountant’s file and not to be distributed to the client**

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56 The sample engagement letter found in SSARS No. 21 uses this abbreviated language to address the requirement of ET 1.295 of the code of ethics when nonattest services are performed in an attest engagement. The author includes the elaborate version as an alternative to the abbreviated version.
Safeguard 3 requires that there be *written documentation* of the client’s understanding of the nonattest services to be performed for an attest client. That documentation does not have to be in the form of an engagement letter. Instead, the accountant can draft a memorandum of the understanding and place it in his or her file.

The author has drafted the following non-authoritative memorandum.

<table>
<thead>
<tr>
<th>Firm Name: _________________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Memorandum on Performance of Non-Attest Services</strong></td>
</tr>
<tr>
<td><strong>for an Attest Client</strong></td>
</tr>
<tr>
<td>Client name: __________________________ Year end of attest engagement: __________</td>
</tr>
</tbody>
</table>

Type of attest engagement:

- Review
- Audit
- Attestation- SSAE No. 10
- Compilation with no disclaimer for lack of independence

Type of nonattest services to be performed:

- Bookkeeping
- Payroll tax prep/other disbursements
- Benefit plan services
- Investment advisory/management
- Corporate finance/consulting/advisory
- Tax return preparation
- Preparation of financial statements

Comments on performance of nonattest services:

<table>
<thead>
<tr>
<th>1. Is the client aware of the objectives of the engagement?</th>
<th>Yes</th>
<th>No</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Does the client understand the type of nonattest services the accountant is about to perform?</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>3. Before performing the nonattest services, has the client agreed to the following:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Assume all management responsibilities for the nonattest service?</td>
<td></td>
<td></td>
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<tr>
<td>b. Oversee the service by designating an individual who possesses suitable skill, knowledge, and/or experience, (preferably someone within senior management)?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Name: ________________________</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>-------------------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Evaluate the adequacy and results of the nonattest services performed?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Accept responsibility for the results of the nonattest services?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Does the designated individual understand the nonattest services to be performed by the CPA?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NOTE: The designated individual is not required to possess the expertise to perform or re-perform the service.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Is the accountant satisfied that management can meet all of the above criteria in (3)(a) through (d), can make an informed judgment as to the results of the nonattest services, and be responsible for making the significant judgments and decisions that are proper responsibility of management?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Is there any indication that the client is unable or unwilling to assume the responsibilities in (3)(a) through (d), such as the client cannot oversee the nonattest services provided, or is unwilling to carry out such responsibilities due to lack of time or design?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NOTE: If the answer to this question is “yes,” the accountant’s independence is impaired.</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

**Conclusion:**

_______The accountant has documented an understanding with the client with respect to the nonattest services to be performed. Independence is not impaired based on the requirements of ET sec. 1.295.

_______The requirements of ET sec. 1.295 have not been satisfied. By performing the nonattest service, the firm’s independence will be impaired with respect to that client and any attest service that is performed for that client.

**Comments:**
3. AICPA Q&A

Following are excerpts from an AICPA Q&A related to independence, some of which have been modified by the author. The AICPA has not updated this Q&A since the new ethics codification was passed in early 2014. The author has updated it to reflect the key changes made since its issuance.

**What clients are affected by the documentation requirement found in the Three Safeguards in ET 1.295?**

The documentation requirement applies to any nonattest service (such as bookkeeping, tax or consulting services) performed by the member for an attest client. An attest client is any client for which the member performs any service for which independence is required such as a (an):

- Audit
- Review of financial statements
- Compilation in which the compilation report does not disclose lack of independence
- Attestation under the SSAEs.

Where a member only provides nonattest services to a client, the requirements of the interpretation, including the documentation requirement, are not effective until the client becomes an attest client.

**Example:** A member provides only tax planning and bookkeeping services for a client and is subsequently asked to perform a review of the client’s financial statements.

**Conclusion:** The member could perform the tax planning and bookkeeping services if, upon acceptance of the review engagement, he or she prepares the required documentation and can demonstrate that he or she has complied with the Three Safeguards of ET 1.295 during the period covered by the financial statements, including the requirement to establish an understanding with the client regarding the matters identified.

**What form of documentation is required?**

The rule requires that the understanding with the client be in writing, but leaves the form of such documentation to the member’s discretion. The method of documentation is not as important as the content of the documentation.

**Example:** A member performs a consulting engagement for an audit client.

**Conclusion:** The member may decide to document the required elements of the consulting engagement in the audit engagement letter. Alternatively, the understanding could be documented in a separate engagement letter specific to the consulting engagement, in a memo to the audit files, or in a checklist that is completed as part of the audit.

If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member’s billing or correspondence files (e.g., separate from the client work paper files).


**Would independence be impaired if a member establishes an understanding with the client, but failed to document that understanding with the client about a nonattest service to be performed?**

No. ET 1.295 states that the failure to prepare the required documentation (in the engagement letter) would not impair independence provided the member did establish an understanding with the client. However, it would be considered a violation of ET 1.2310, *Compliance With Standards.*

**Definition of suitable skill, knowledge and/or experience:**
ET 1.295 requires that the client agree to perform certain functions in connection with the engagement to perform nonattest services. One of those requirements is that the client designate an individual who possesses suitable *skill, knowledge, and/or experience*, preferably within senior management, to *oversee* the services.

**What does “suitable skill, knowledge and/or experience” mean in the context of ET 1.295?**
Suitable skill, knowledge, and/or experience means that the designated individual has the ability to understand the nature, objective and scope of the nonattest service.

In accepting responsibility for the nonattest service, to oversee the services, the employee is not required to supervise the member in the day-to-day rendering of the services. Instead, the employee should:

- Agree on the nature, objectives and scope of the services
- Receive periodic progress reports where appropriate
- Make all significant judgments
- Evaluate the adequacy and results of the service
- Accept responsibility for the service results, and
- Ensure that the resulting work product meets the agreed-upon specifications.

The skill, knowledge, and/or experience needed will vary depending on the nature of the nonattest service performed.

**Example:** The skill, knowledge, and/or experience needed to oversee a payroll service can be expected to be different than the skill, knowledge, and/or experience needed to oversee a complex tax service.

Moreover, the requirement for the client employee to possess suitable skill, knowledge and/or experience, does not, however, require that the individual possess the technical expertise that the member possesses, or the competence of performance, or to re-perform the services.

**Why must an individual possess suitable skill, knowledge and/or experience under ET 1.295?**
If a designated employee does not possess suitable skill, knowledge and/or experience to oversee the nonattest service, there would be no one, other than the member, to make significant judgments that are needed during the delivery of the service or to discharge the other client responsibilities under ET 1.295. Performing those activities on behalf of the attest client would be inconsistent with the member’s requirement to be independent of the client.
Who, within the client, could serve as the designee with the skill, knowledge and/or experience to oversee a nonattest service?

The designee will depend on the structure of the client’s organization and the nature of the nonattest engagement being performed.

In an owner-managed business, that person will often be the owner. However, it could also be a controller, bookkeeper, another employee, or a third-party not employed depending on the nature of the nonattest services and the qualifications of other client employees.

**Example:** Assume there is a nonattest engagement where the member has been asked to provide investment advisory services, including recommendations on the allocation of funds that the client should invest in various asset classes based on the client’s desired rate of return and risk tolerance. Assume further that the owner makes all investment decisions related to the allocation of funds and investment selections and accepts responsibility for the resulting investment plan.

**Conclusion:** With respect to the nonattest engagement, the member may conclude that the owner possesses the skill, knowledge and/or experience to oversee the service.

**Change the facts:** Assume the engagement involves the installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format for a small business client. The owner is traveling and designates the office manager to oversee the installation service. The office manager performs routine clerical and receptionist functions, has a limited understanding of the company’s operations, and has never used accounting or financial software such as the application being installed by the practitioner. Further, because the company hires a part-time bookkeeper to maintain the general ledger and subsidiary records, the office manager has no understanding of the company’s books and records and financial statements.

**Conclusion:** For purposes of the performance of the nonattest engagement (installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format), it is unlikely that the office manager would be deemed to possess the skill, knowledge and/or experience as he or she is not in a position to understand the services being performed sufficiently to oversee them and accept responsibility for the resulting accounting system.

**May a client contract with a third party who is not an employee of the client to oversee or advise on the member’s performance of the nonattest service?**

Yes. The client may contract with a third party to advise management about the nature of the services and the evaluation of the adequacy and results of the services in order to enable management to oversee the services, perform all management functions, make management decisions, accept responsibility for the services performed, and maintain internal controls over the services.

If the client outsources employee functions to a third party, that third party may serve as the individual who possesses the skill, knowledge and/or experience, functions in a capacity equivalent to that of a client employee, and has the authority to make decisions on behalf of the client.
How can a member be satisfied that the client designee understands the nonattest services performed and the work product?

Members must utilize their professional judgment and experience to recognize which individuals are able and willing to fulfill the client responsibilities. Practitioners should be able to assess whether the designated client employee possesses the skill, knowledge and experience to effectively oversee the nonattest services. This can be accomplished through interaction with the client owner or individual.

What are examples of nonattest services and the level of understanding that the client designee should possess to be considered competent under the Interpretation?

**Bookkeeping services**: If bookkeeping services are performed for an audit, review or compilation client, the member should be satisfied that the designated individual understands the reason why the journal entries are being proposed and the effect on the financial statements.

**Recurring/standard entries**: For recurring or standard journal entries (such as depreciation), the client may require no explanation as to the reason for the entry if the member has previously discussed the entries with the individual.

**More complex journal entries**: For more complex entries such as those related to deferred income taxes, the member may need to explain the reason for the entry and the basis for the entry and its impact on the financial statements. The individual should be in the position to approve the proposed entries and to accept responsibility for its financial statements.

**Tax services**: For tax return preparation engagements, the individual does not have to understand tax law. Instead, the member should have the individual review the tax return with emphasis on the key tax positions taken and be satisfied that the individual understands the company’s tax situation, and has a general understanding of how the amounts on the tax return were determined. The individual must also make all decisions regarding significant tax positions taken in the return.

**Valuation services**: For permitted valuation services, the member may need to explain to the individual the valuation methodologies used and all significant assumptions. The individual should approve all significant assumptions and accept responsibility for the resulting valuation.

4. Nonattest Services That Impair a CPA’s Independence:

One of the *Three Safeguards* (requirements) found in ET 1.295 is that in performing a nonattest service for an attest client, the accountant does not assume management responsibilities for the attest client. The accountant should avoid certain nonattest activities that will be considered assuming management responsibilities, and thus impair the accountant's independence.

The following are some nonattest services that ET 1.295 states would impair a member's independence, because the accountant would be considered to assume management responsibilities for the attest client:
• Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
• Prepare source documents, in electronic or other form, evidencing the occurrence of a transaction\textsuperscript{57}
• Having custody of client assets
• Deciding which recommendations of the member or other third parties to implement or prioritize
• Report to those in charge of governance (typically the board of directors) on behalf of management
• Serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent
• Setting policies or strategic direction for the client
• Directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
• Accepting responsibility for the management of a client’s project
• Accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework
• Accepting responsibility for designing, implementing, or maintaining internal controls
• Performing ongoing evaluations of the client’s internal control as part of its monitoring services

If an accountant does any of the above list of nonattest services during the period during which an attest engagement relates, the accountant’s independence is impaired and \textbf{NOTHING} can cure him or her of that lack of independence. Thus, the accountant cannot perform an attest engagement (compilation, review or audit engagement) for that client. However, the accountant could compile the financial statements and disclose the lack of independence.

5. \textbf{List of Acceptable Non-Attest Services for an Attest Client:}

Unlike the list of nonattest services that impair an accountant’s independence, an accountant is permitted to perform certain non-attest services for an attest client as long as the accountant complies with the \textit{Three Safeguards} previously discussed in this section.

\textit{a. Client must agree to perform certain functions:}

Before performing nonattest services, the member should determine that the client has agreed to:

• Assume all management responsibilities,
• Oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,
• Evaluate the adequacy and results of the nonattest services performed, and
• Accept responsibility for the results of the nonattest services.

\textit{b. Member (CPA) does not assume management responsibilities for the nonattest service.}

\textsuperscript{57} A source document is defined as the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
c. There must be a *written establishment and documentation* with client as to the nonattest services to be performed.

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member’s independence. These examples presume that the *Three Safeguards (requirements) have been met* and are not intended to be all-inclusive of the types of nonattest services performed by a member.

<table>
<thead>
<tr>
<th>NON-ATTEST SERVICES</th>
<th>INDEPENDENCE WOULD NOT BE IMPAIRED (accountant does not assume management responsibilities)</th>
<th>INDEPENDENCE WOULD BE IMPAIRED (accountant assumes management responsibilities)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bookkeeping</strong></td>
<td>• Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client’s general ledger.</td>
<td>• Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval.</td>
</tr>
<tr>
<td></td>
<td>• Prepare financial statements based on information in the trial balance.</td>
<td>• Authorize or approve transactions.</td>
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<tr>
<td></td>
<td>• Post client approved entries to a client’s trial balance.</td>
<td>• Prepare source documents.</td>
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<tr>
<td></td>
<td>• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.</td>
<td>• Make changes to source documents without client approval.</td>
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<tr>
<td></td>
<td>• Preparation of financial statements</td>
<td></td>
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<tr>
<td></td>
<td>• Cash to accrual conversion</td>
<td></td>
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<tr>
<td></td>
<td>• Prepare a reconciliation (for example, bank, accounts receivable, and so forth) that identifies reconciling items for the client’s evaluation.</td>
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<tr>
<td><strong>Non-tax Disbursement</strong></td>
<td>• Using payroll time records provided and approved by the client, generate unsigned checks or process client’s payroll.</td>
<td>• Accept responsibility to authorize payment of client funds, electronically or otherwise, except as</td>
</tr>
<tr>
<td><strong>Benefit Plan Administration</strong></td>
<td><strong>Investment Advisory &amp; Management</strong></td>
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<tr>
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<tr>
<td>• Transmit client approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.</td>
<td>Specifically provided for with respect to electronic payroll tax payments.</td>
<td></td>
</tr>
<tr>
<td>• Accept responsibility to sign or cosign client checks, even if only in emergency situations.</td>
<td>• Make policy decisions on behalf of client management.</td>
<td></td>
</tr>
<tr>
<td>• Maintain a client’s bank account or otherwise have custody of a client’s funds or make credit or banking decisions for the client.</td>
<td>• When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management’s concurrence.</td>
<td></td>
</tr>
<tr>
<td>• Approve vendor invoices for payment.</td>
<td>• Make disbursements on behalf of the plan.</td>
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<tr>
<td></td>
<td>• Have custody of assets of a plan.</td>
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<tr>
<td></td>
<td>• Serve a plan as a fiduciary as defined by ERISA.</td>
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</tr>
</tbody>
</table>

Benefit Plan Administration

- Communicate summary plan data to plan trustee.
- Advise client management regarding the application or impact of provisions of the plan document.
- Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member’s electronic medium, such as an interactive voice response system or Internet connection or other media.
- Prepare account valuations for plan participants using data collected through the member’s electronic or other media.
- Prepare and transmit participant statements to plan participants based on data collected through the member’s electronic or other medium.

Investment Advisory & Management

- Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client’s desired rate of return, risk tolerance, etc.
- Perform record keeping and reporting of client’s portfolio balances including providing a comparative analysis of the client’s account valuations.
- Make investment decisions on behalf of client management or otherwise have discretionary authority over a client’s investments.
- Execute a transaction to buy or sell a client’s investment.
- Have custody of client assets, such as taking temporary control.
| Corporate Finance Consulting or Advisory | Investments to third party benchmarks.  
- Review the manner in which a client’s portfolio is being managed by investment account managers, including determining whether the managers are: (1) following the guidelines of the client’s investment policy statement; (2) meeting the client’s investment objectives; and (3) conforming to the client’s stated investment styles.  
- Transmit a client’s investment selection to a broker/dealer or equivalent provided the client has authorized the broker dealer or equivalent to execute the transaction. | Possession of securities purchased by a client.  
- Assist in developing corporate strategies.  
- Assist in identifying or introducing the client to possible sources of capital that meet the client’s specifications or criteria.  
- Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers or capital sources.  
- Assist in drafting an offering document or memorandum.  
- Participate in transaction negotiations in an advisory capacity.  
- Be named as a financial adviser in a client’s private placement memoranda or offering documents. |  
| Appraisal, Valuation or Actuarial | Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would not be material to the financial statements, and the appraisal, valuation, or actuarial service does not involve a significant degree of subjectivity such as an actuarial valuation of a client’s pension or postemployment benefit liabilities.  
- Appraisal, valuation, and actuarial service where the results, individually or in the aggregate, would be material to the financial statements, and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity such as those in connection with employee stock ownership plans, business combinations, or |  
|  |  |  |
services performed for nonfinancial statement purposes that otherwise meet all other requirements of the Interpretation, including those performed for tax compliance, estate and gift taxation and divorce proceedings.

**Executive or Employee Search**
- Recommend a position description or candidate specifications.
- Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g. required skills and experience).
- Participate in employee hiring or compensation discussions in an advisory capacity.

**Executive or Employee Search**
- Commit the client to employee compensation or benefits arrangements.
- Hire or terminate client employees.

**Business Risk Consulting**
- Provide assistance in assessing the client’s business risks and control processes.
- Recommend a plan for making improvements to a client’s control processes and assist in implementing these improvements.

**Business Risk Consulting**
- Make or approve business risk decisions.
- Present business risk considerations to the Board or others on behalf of management.

**Information Systems Design, Installation & Integration**
- Install or integrate a client’s financial information system, that was not designed or developed by the member (e.g., an off-the-shelf accounting package).
- Assist in setting up the client’s chart of accounts and financial statement format with respect to the client’s financial information system.
- Design, develop, install, or integrate a client’s information system that is unrelated to the client’s financial statements or accounting records.
- Provide training and instruction to client employees on an information and control system.
- Perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request.

**Information Systems Design, Installation & Integration**
- Design or develop a client’s financial information system.
- Make other than insignificant modifications to source code underlying a client’s existing financial information system.
- Supervise client personnel in the daily operation of a client’s information system.
- Operate a client's local area network (LAN) system.
Each of the categories of nonattest services is addressed in the following section.

**Performing Bookkeeping Services for an Attest Client**

Perhaps the most common nonattest service conducted by accountants for their attest clients is the performance of bookkeeping services. The nonattest services portion of the independence rules that are now encapsulated within ET 1.295 of the new AICPA Code of Professional Conduct, offers a framework for conducting bookkeeping services and clarifies those bookkeeping functions that impair independence from those that do not.

Specifically, bookkeeping services include the performance of any of the following:

- Recording (cash receipts and disbursement) transactions to the general ledger
- Prepare financial statements based on information in the trial balance
- Proposing and/or posting standard, adjusting, or correcting entries to a client’s trial balance.
- Preparing a bank reconciliation or reconciliation of accounts receivable or account payable
- Conversion of cash to accrual basis

In 2013, an ethics ruling concluded that the following services are now considered **nonattest services** and not part of an audit, review or compilation engagement:

- Preparation of financial statements
- Conversion of cash to accrual basis
- Reconciliations such as cash, accounts receivable and accounts payable

Prior to the issuance of the 2013 opinion, the ethics committee had ruled that the preparation of financial statements and the conversion of cash to accrual were a part of the normal attest engagement process, not part of nonattest services.

**Note:** Although the above list includes services categorized as bookkeeping nonattest services, the performance of some bookkeeping services taint independence, while others do not.

The key factor in determining whether the performance of bookkeeping services impairs an accountant’s independence is whether the accountant assumes management responsibilities in performing those services. For example, if a client determines the general ledger accounts in which to post transactions and the accountant merely posts those transactions to the client-selected general ledger accounts, the accountant is simply recording transactions authorized by the client. Conversely, if the accountant selects the general ledger accounts to post checks and deposits, the accountant is making a decision in the capacity of management and, thus, impairs his or her independence.

A quick summary is that in order for an accountant to perform bookkeeping services for an attest client without impairing his or her independence, the client (not the accountant) must:

- Approve all standard, journal, correcting, and audit entries
- Approve all general ledger account classifications

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58 In January 2013, the AICPA ethics committee issued an Omnibus Statement that concluded that the preparation of financial statements and the conversion of cash to accrual basis are nonattest services, not part of an audit, review or compilation engagement.
Approve all bank, receivable, payable or other reconciliations regardless of whether the accountant prepares them or not
Prepare source documents such as invoices, deposits or checks
Be a signatory to any bank accounts
Oversee, direct or accept responsibility for the client’s bookkeeping or accounting function
Make the ultimate management decisions for a client involving accounting and bookkeeping functions
Accept responsibility for the financial statements whether or not prepared by the accountant, and
Accept responsibility for the client’s internal control

The accountant can initially prepare entries and make decisions as to general ledger account classifications of income and expense items. However, those journal entries and account classifications _must ultimately be reviewed and approved by the client_. Moreover, with respect to proposed journal entries, the accountant must be satisfied that management _understands the nature of the proposed entries and the impact they have on the financial statements_. Another issue that is critical with respect to bookkeeping is that the accountant may not prepare or alter any source documents. To do so means the accountant is acting in the capacity as a member of management. A source document is defined as a document upon which evidence of an accounting transaction is initially recorded. Examples include payroll time cards, customer orders, purchase orders. Checks are not source documents, so an accountant may prepare a check but may not sign it on behalf of the client.

_Can a client approve the journal entries and account classifications after the accountant performs the bookkeeping services?_

The independence rules do not address the timing of any approval. Presumably, an accountant can complete his or her bookkeeping services and then submit the general ledger and entries to the client for approval. Otherwise, there would be a logistical challenge in that the accountant would be precluded from preparing any proposed journal entries or account classifications until the client approved each entry and classification.

**Example:** An accountant is hired to perform bookkeeping services for an attest client.

- He receives the bank statements from the client that include all checks and deposits for the fiscal year. The client has not coded the checks or deposits with general ledger account classifications.
- The accountant selects the general ledger accounts to which to post the checks and deposits and also makes a series of journal entries to adjust the trial balance to accrual basis GAAP.
- All source documents such as invoices, sales orders, etc. have been prepared by the client, not the accountant.
- Upon completion, the accountant prints out the general ledger and all journal entries and submits them to the client to review.
- The client reviews the categorization of the checks and deposits, and journal entries, and approves them.
- The accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

**Conclusion:** The accountant’s _independence is not impaired_ by his performance of bookkeeping services for an attest client.
First, the client approves all journal entries and account classifications even though that approval is done after the accountant performs his bookkeeping function.

Further, the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

**How must an accountant obtain evidence that a client has approved the accountant’s journal entries and general ledger account classifications?**

There is no answer. The author recommends that the accountant ask the client to review the final adjusted general ledger and approve it. The accountant can send a transmittal letter to the client that looks something like this:

```
Mr. Jimmy Smith
Smith’s Silly Biscuits
Boston, MA

Dear Mr. Smith:

In accordance with our engagement letter dated January 18, 20X2, we have performed certain bookkeeping services for Smith’s Silly Biscuits as of December 31, 20X1 and for the year then ended.

Enclosed please find the company’s general ledger for the year ended December 31, 20X1, that reflects our proposed account classifications for transactions we recorded, and general journal entries we recommend be made.

Please review the enclosed general ledger and note your approval or disapproval of all account classifications and general journal entries. If we do not receive your response by March 15, 20X2, we will assume you have reviewed the enclosed documents and are approving the classifications and entries.\(^5\)

We also assume that you understand the nature of the proposed entries and the impact they have on the financial statements.

We would appreciate your indicating approval of all transactions and entries by initialing the first page of both the general ledger and schedule of general journal entries, and returning both to our office. Any exceptions should be highlighted. Upon receiving your approved documents, we will begin our review engagement.

Please call my office with questions.

Very truly yours,

Mary Macky, CPA
Macky, Wacky and Daffy, LLP
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\(^5\) The sample transmittal letter is written like a negative confirmation. Nothing in the Ethics Code precludes an accountant from using this method to obtain client approval for nonattest services performed.
May the client approval be noted in management’s representation letter for the review or audit engagement?

Practically, the answer is yes. In many instances a bookkeeping service is performed in conjunction with the attest service. That is, an accountant might perform bookkeeping services while he or she is also conducting his or her review or audit engagement. For example, a portion of the adjustments made by an accountant during an attest engagement might be entries that are actually part of the bookkeeping service such as adjustments of accruals, prepaid expense accounts, or adjustments to convert standard journal entries to actual. Such entries are actually part of bookkeeping which is interrelated with the review or audit engagement. It may not be practical for a client to approve such entries until the accountant has completed the review or audit engagement. If the accountant wishes to document that management has approved the entries and classifications, one way to do so is to include the client approval in the management representation letter obtained for the engagement.

The author suggests that the following language can be inserted into the representation letter:

“We have reviewed all journal entries and account classifications proposed by you (the accountant) and approve them. We understand the nature of the proposed entries and the impact the entries have on the financial statements. We also take responsibility for the journal entries and account classifications proposed and for establishing and maintaining internal controls over your bookkeeping services performed as part of your review (audit) engagement.”

Observation: Some individuals conclude that approval of the entries and classifications cannot be included in the management representation letter. Their opinion is based on the assertion that management must approve all entries and classifications before the attest engagement begins. Otherwise, the accountant is reviewing or auditing his own work. The author believes that in theory, client approval should be obtained prior to commencing the review or audit engagement. However, in practice, there is not necessarily a clear cut delineation between the end of bookkeeping services and the beginning of the review or audit engagement. The reason is because some bookkeeping services might be performed during the review or audit engagement.

Must management’s approval for the entries and classification be in writing?

There is no requirement that management notes its approval for the entries and classifications in writing. However, absent such a written confirmation, the accountant has no evidence that management has, in fact, given approval.

The author believes that in substance, management approves journal entries by recording them. That is, if an accountant submits proposed entries to a client and that client or his/her bookkeeper/controller records the proposed entries, the recording could be considered an approval and acceptance of those entries.

Is the preparation of financial statements from a client trial balance a nonattest?

Yes. The preparation of financial statements is a nonattest service based on a change made to the codification in 2012 which has been carried over into the new ethics codification as part of ET 1.295. Note further that the newly issued SSARS No. 21 codifies that the preparation of financial statements is a nonattest service which can be performed independently under SSARS No. 21.
The good news is that the preparation of financial statements (or the performance of any other nonattest service) does not impair independence, provided the Three Safeguards of ET 1.295 are met.

However, communication between the client and accountant regarding the form and content of the financial statements is not considered a nonattest service and, instead, is considered part of the attest engagement.

**Is a written understanding required if an accountant performs nonattest services (e.g., bookkeeping services) as part of a compilation engagement?**

Yes. Safeguard 3 requires that a written documentation be made in situations in which nonattest services are performed for an attest client (e.g., review, audit, or compilation that does not disclaim independence). Therefore, written documentation is required.

Moreover, the same issues regarding independence apply to a compilation engagement as they do an audit or review engagement. If an accountant performs bookkeeping services for a client for whom he or she also performs a compilation engagement, the accountant will violate his or her independence by assuming management responsibilities in performing the bookkeeping service.

Therefore, the accountant cannot assume management responsibilities by doing any of the following:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance (typically the board of directors) on behalf of management
- Serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent
- Setting policies or strategic direction for the client
- Directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
- Accepting responsibility for the management of a client’s project
- Accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework
- Accepting responsibility for designing, implementing, or maintaining internal controls
- Performing ongoing evaluations of the client’s internal control as part of its monitoring services

If bookkeeping services are performed, the client (rather than the accountant) must:

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60 A source document is defined as the document upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
• Approve any standard, journal, correcting, and audit entries
• Approve any general ledger account classifications
• Accept responsibility for the financial statements
• Prepare any source documents
• Be a signatory on a bank account
• Accept responsibility for internal control
• Accept responsibility for the results of the nonattest services

If the accountant performs any of the above functions, his or her independence would be impaired and he or she would have to disclaim independence in the compilation report as follows:

“We are (I am) not independent with respect to ABC Company.”

Although not required, nothing precludes an accountant from documenting the client’s understanding in writing in a compilation engagement letter.

Example: Fred CPA is hired to perform monthly write-up and bookkeeping services for Company X. Fred also issues a monthly compilation report with no footnotes. The bookkeeping services will include:

• Coding all checks and deposits
• Posting all cash receipts and disbursements to the general ledger
• Posting adjusting entries to convert the general ledger to the accrual basis of accounting.

Conclusion: The accountant is performing a nonattest service for an attest client. The reason is because the accountant is coding checks and deposits and posting cash receipts and disbursements in developing a trial balance. Transactions performed to create a general ledger are considered a nonattest service. Posting adjusting entries to convert the general ledger to the accrual basis are also considered a nonattest service.

Because the accountant is performing some nonattest services for an attest client, the accountant is required to comply with the rules for performing nonattest services for an attest client, including documenting the client’s understanding of the nonattest services to be provided (bookkeeping services).

In order for Fred not to impair his independence with respect to the Company X, Fred must comply with the Three Safeguards of ET sec. 1.295:

1. Company X must agree to perform certain functions:

Before performing nonattest services, Fred should determine that Company X has agreed to:

• Assume all management responsibilities,
• Oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience,
• Evaluate the adequacy and results of the nonattest services performed, and
• Accept responsibility for the results of the nonattest services.
2. **Fred should not assume management responsibilities for the attest client:**

Company X, rather than Fred, must assume management responsibilities by:

- Approving any standard, journal, correcting, and audit entries
- Approving any general ledger account classifications
- Preparing any source documents, not the accountant, and
- Establishing and maintain internal controls over the bookkeeping services, including monitoring ongoing activities.

3. There must be a written establishment and documentation with Company X as to the nonattest services (bookkeeping services) to be performed.

If Fred complies with the *Three Safeguards* above, Fred is permitted to perform his bookkeeping services for Company X and not impair his independence. If Fred does not comply with the *Three Safeguards*, Fred’s independence is impaired. Because he is performing a compilation engagement, Fred could still perform a compilation engagement, but would have to disclaim independence. Fred would not be able to perform a review or audit engagement.

**AICPA Q&A on bookkeeping services**

The AICPA has issued a Q&A related to the performance of bookkeeping services for an attest client. Following are excerpts from that Q&A, as modified by the author. The following Q&A has been modified by the author to reflect ethics opinion changes made to the independence rules. The AICPA has not formally updated the Q&A to reflect any changes, if any, made when the new ethics codification was issued in 2014. Those changes, to the extent they may exist, should be minor.

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**Example 1:**

A member records journal entries while performing monthly bookkeeping services without obtaining client approval. Is independence impaired?

Yes. The client must review and approve the journal entries and the member must be satisfied that management understands the nature of the proposed entries and their impact on the financial statements.

**Example 2:**

In performing bookkeeping services, the following services are performed:

- The client approves the invoice for payment and notes the appropriate general ledger account classification.
- The member receives approved invoices from the client.
- The member prepares the client’s checks for payment and records the transactions in the client’s general ledger system, and returns the checks to the client for approval and signature.
• The member has no signature authority.

**Is the member’s independence impaired?**

No. The reason is because management determined and approved the appropriate account classifications, approved the invoices for payment, and reviewed and signed the prepared checks.

**Example 3:**
In performing monthly bookkeeping services, the following services are performed:

• The member discusses with the client the need to record recurring journal entries (such as depreciation) each month in the general ledger.

• The client approves the recurring entries and makes any necessary decisions, such as the useful lives of the assets.

• The member records the entries in the client’s general ledger each month.

• The member is satisfied that the client understands the general nature of the entries and their impact on the financial statements.

**Is the member’s independence impaired?**

No. Because the client approves the entries and understands the general nature of the entries and their impact on the financial statements, independence is not impaired.

**Example 4:**
In performing monthly bookkeeping services, the following services are performed:

• The client records all disbursements in its checkbook and identifies the type of expense (such as telephone, rent, etc.) on the checkbook stubs.

• The member assigns the general ledger account number based on the type of expense (identified by the client on the checkbook stub) and the member records the cash disbursements in the client’s accounting system.

**Is the member’s independence impaired?**

No. The client coded the transactions on the check stubs. In doing so, the client approved the classification of the cash disbursements. The member merely recorded the client’s classifications in the client’s accounting system.

**Example 5:**
A member is engaged to perform an audit, review or compilation of the client’s financial statements. During the course of the engagement, the member proposes audit adjustments to the financial statements as follows:

• Current tax accrual
• Deferred tax adjustment
• Depreciation and amortization adjustment

The client reviews the entries and understands their impact on the financial statements and records the adjustments in the client’s general ledger.

*Is the proposal of such entries a nonattest service subject to the independence rules?*

No. The independence rules provide that communication between a member (CPA) and client management, regarding adjusting journal entries that the member (CPA) has prepared or proposed, is considered a normal part of the attest engagement and would not constitute performing a nonattest service.

**Example 6:**
Same facts as Example 5 except the proposed adjustments relate to converting the general ledger from the cash basis to accrual basis, including:

• Adjusting accruals and prepaid accounts to actual
• Recording accounts receivable to actual, and
• Recording accounts payable to actual.

*Is the proposal of such entries a nonattest service?*

Yes. A key change made to the independence rules states that entries to convert the client’s general ledger from a cash basis to an accrual basis constitutes a nonattest service (bookkeeping service).

**Example 6A:** What if the accountant records cash receipts and cash disbursements entries to convert the general ledger to cash basis?

Such entries are a nonattest service.

A client’s books and records need to be *substantially complete and current* to conduct the attest engagement of those books and records. If the member performs a service to bring those books and records current or complete (such as reconciling subsidiary information such as an accounts receivable and accounts payable, or performing cash receipt and disbursement transactions), the service does constitute a nonattest service.

Further, the nonattest services rules would also apply if the member is engaged to perform a stand-alone engagement to perform bookkeeping services for the client (e.g., cash receipts and disbursements), such as in the case where a member is engaged to perform monthly bookkeeping services, including the preparation of monthly compiled financial statements.

**Example 7:**
A member performs year-end tax planning and prepares the tax returns for an attest client.

*Aren these tax services considered nonattest services?*

Yes. Tax services are considered nonattest services and are, therefore, subject to the general three
safeguards (requirements), including the member’s understanding with the client with respect to the tax services being documented in writing.

**Example 8:**
A member prepares a bank reconciliation of a client’s bank account in connection with monthly bookkeeping services. The client reviews and approves the reconciliation.

**Are these services considered nonattest services?**
Yes. The performance of bookkeeping services including creating reconciliations and converting from cash to accrual basis for an attest client is considered a nonattest service.

**Is the member’s independence impaired?**
No. Because the client reviews and approves the bank reconciliation, and understands the service being performed, the member’s independence is not impaired.

**Example 9:**
With respect to the performance of a nonattest service for an attest client, ET 1.295 (formerly Interpretation 101-3) requires a member to establish and document in writing his or her understanding with the client about the a) objectives of the engagement, b) services to be performed, c) client’s acceptance of its responsibilities, d) member’s responsibilities, and e) any limitations of the engagement.

**Is the member in compliance with this requirement if the documentation comes in the form of a) an engagement letter, b) a planning memorandum, or c) a memo of understanding in the member’s billing files?**
Yes. All of the above forms would be in compliance. However, the general requirements of ET 1.295 only require that the member document in writing his or her understanding. It does not suggest any specific method of documentation. As a result, the above methods would be appropriate, along with other methods that are not identified.

**Example 10:**
During 20X6, a member performs only nonattest services (bookkeeping services) for a client for the year ended December 31, 20X6. In February 20X7, the member is asked to perform a review of the client’s year-end 20X6 financial statements.

**Is independence impaired because the firm did not comply with the documentation requirement with respect to the nonattest services performed in 20X6?**
No. The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client. However, once the member accepts the review engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements of ET 1.295 during the period covered by the financial statements (January 1 to December 31, 20X6).
**Example 11:**
A member performs bookkeeping services recording adjusting and reclassification entries and compiles financial statements. The member delivers the financial statements and compilation report to the client and provides the client with copies of the general ledger, journals and adjusting entries, which contain a description of the nature of each entry.

The member asks the client to review the entries and then asks whether the client has any questions about any of the entries. The client has no comments or questions.

**Are the requirements for the client to approve the nonattest service (Safeguard 1) met?**

Yes, they are met. The client has reviewed the entries and approved them. Provided the member is satisfied that the client understands the nature and impact of the entries, the requirements of ET 1.295 are met. Moreover, the member must obtain a written understanding of the nonattest services to be performed.

**Example 12:**
A member prepares proposed journal entries.

**Must the member review them with the client and explain their impact on the financial statements in person, or can the review take place by phone, fax, mail, or email?**

The review can take place in person, by phone, fax, mail, e-mail, or any combination thereof. Regardless of the method used, the member must be satisfied that the client understands the nature and impact the entries have on the financial statements.

**Example 13:**
In performing a nonattest service, a member prepares journal entries to be reviewed and approved by the client.

**Must the member document the review and approval of the entries by the client?**

No. there is no requirement that the member document the client’s review and approval of the entries. However, the member may wish to document the name of the client representative who reviewed and approved the journal entries and the date of his or her review and approval to provide evidence that such review and approval took place.

**Example 14:**
Safeguard 1 requires that the client designate a competent employee, preferably within senior management, to oversee the nonattest service.

**Which individual at the client is expected to possess the skill, knowledge and experience (e.g., the owner(s), controller, bookkeeper)?**

The designated individual(s) will likely depend on the nature of the client’s organization and the nature of the nonattest engagement. In an owner-manager business, it will often be the owner. But depending on the nature of the nonattest services and the skill, knowledge and experience of other
client employees or individuals, it could be the controller, bookkeeper or an outside individual. In larger organizations, a senior officer might be designated to oversee the services.

Regardless of the selection, the designated individual needs to understand the services sufficiently to oversee them, but does not need to possess the technical qualifications to perform or re-perform the services.

Example 15:
As part of a bookkeeping service, a member prepared journal entries related to a tax provision involving deferred income taxes. In obtaining the client’s approval of the entries, the member is concerned the client does not understand the nature and impact the deferred income tax entries have on the financial statements.

What must a client know about deferred income taxes in order to meet the competency requirement under Safeguard 1 of the independence rules?

Safeguard 1 does not require that the client possess a level of technical expertise commensurate with that of the member. In connection with deferred income taxes, the client should understand the general basis for the deferred income taxes and their impact on the financial statements.

Is the member permitted to assist the client in understanding the nature of the adjusting entries related to deferred income taxes and their impact on the financial statements?

Yes. The member may assist by explaining the accounting principles giving rise to the adjustments, as well as their impact on the financial statements.

Example 16:
A member prepares tax returns for its attest client. As a matter of practice, a member does not require its clients to sign engagement letters for tax return preparation services.

How does the documentation requirement in Safeguard 1 for the client to approve the nonattest service apply with respect to these nonattest services?

Tax services are nonattest services subject to the independence rules and satisfaction of the three safeguards (requirements) in order not to impair independence with respect to an attest client. As a result, the documentation requirement applies where the member provides tax services to a client for which the member also provides attest services. However, the method of documentation is not stated within ET 1.295. Ways in which such documentation could be made include, but are not limited to:

- Documentation in the engagement letter of the attest engagement
- A tax organizer or attest service working papers memorandum

Example 17:
A member prepares personal tax returns for the owners of an attest client.

Is this a nonattest service performed for an attest client for which the three safeguards must be satisfied?
No. If the personal returns are prepared without having to rely on representations of the client, ET 1.295 does not apply. Also, the mere fact that the client pays for the services also does not cause ET 1.295 to apply.

Example 18:
A member provides temporary controllership services and other types of accounting services for attest clients during client maternity leaves, illness, and sudden departures.

*Is this considered a nonattest service performed for an attest client?*

Yes. These services are nonattest services performed for attest clients.

*Do these activities impair independence?*

Perhaps. If the member performs controller-type activities, independence is impaired because such activities usually involve the performance of management functions or the supervision of client employees. However, if the member performs temporary accounting and other services in compliance with the requirements of ET 1.295 (including documentation of the understanding with the client), and does not perform management functions or make any management decisions, independence is not impaired. The key is that the member not perform any management functions or make any management decisions while he or she is performing the controller-type activities. Moreover, the member should ensure that he or she does not have the title of controller as such a title would clearly impair independence based on the assumption that such a title holds with it, the authority to perform management functions and the performance of management services.

Example 19:
As part of performing bookkeeping services for an attest client, a member records adjusting and reclassification entries and prepares the client’s preliminary financial statements. The member does not review each and every journal entry with the client but rather, the member describes the nature of the journal entries and their impact on the financial statements. The client approves the financial statements and issues them to the bank.

*Would the requirements for a client to approve the nonattest service found in Safeguard 1 be met?*

Yes, provided all of the other requirements of ET 1.295 are met such as having a written understanding of the nonattest services to be performed.

Example 20:
ET 1.295 states that a member should not assume management responsibilities for the attest client.

*What are some examples of activities that would involve a member assuming management’s responsibilities?*

A management function would generally include doing or having the authority to:

- Authorizing, executing or consummating transactions, otherwise exercising authority on behalf of a client or having the authority to do so
- Prepare source documents, in electronic or other form, evidencing the occurrence of a
Having custody of client assets
Deciding which recommendations of the member or other third parties to implement or prioritize
Report to those in charge of governance (typically the board of directors) on behalf of management
Serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent
Setting policies or strategic direction for the client
Directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
Accepting responsibility for the management of a client’s project
Accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework
Accepting responsibility for designing, implementing, or maintaining internal controls
Performing ongoing evaluations of the client’s internal control as part of its monitoring services

Providing advice, research materials, and recommendations to assist the client’s management in performing its functions and making decisions do not constitute the performance of a management function.

Confusion: work performed during an attest engagement versus before the engagement

As discussed previously in this section, bookkeeping services are a nonattest service separate and distinct from an attest engagement, and subject to the Three Safeguards.

Moreover, the following services are now considered nonattest services and not part of an audit, review or compilation engagement:

- Preparation of financial statements
- Conversion of cash to accrual basis (adjusting journal entries)
- Reconciliations such as cash, accounts receivable and accounts payable

Included in the list of bookkeeping services identified in ET 1.295 are the following:

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61 A source document is defined as the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.
Bookkeeping Services Considered Non-Attest Services Subject to The Three Safeguard Requirements of ET 1.295 (Formerly Interpretation 101-3)

- Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client’s general ledger.
- Prepare financial statements based on information in the trial balance.
- Post client approved entries to a client’s trial balance.
- Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.
- **Cash to accrual conversion (1)**
- **Prepare a reconciliation (for example, bank, accounts receivable, and so forth) that identifies reconciling items for the client’s evaluation. (1)**

(1): Added to the list with changes made in 2013.

Included in the list of bookkeeping services is the accountant proposing and/or posting standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

**Note:** The preparation of financial statements is a nonattest service but is not considered a bookkeeping service.

The ethics rules differentiate between whether proposed entries are part of a nonattest or attest engagement.

Here are the basic rules:

<table>
<thead>
<tr>
<th>Types of Proposed Entries</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposed entries (transaction entries and others) to convert the general ledger to cash basis</td>
<td>Nonattest service (1)</td>
</tr>
<tr>
<td>Proposed entries to convert the general ledger from cash to accrual basis</td>
<td>Nonattest service (1)</td>
</tr>
<tr>
<td>Proposed entries made during the audit, review or compilation engagement</td>
<td>Attest service. Communication between a member (CPA) and client management regarding adjusting journal entries that the member (CPA) has prepared or proposed is considered a normal part of the attest engagement and would not constitute performing a nonattest service</td>
</tr>
</tbody>
</table>

(1): Based on 2013 Omnibus Statement change and codified in new ET 1.295
There are instances in which an accountant performing adjusting entries or communicates with the client during an attest engagement. Such work is considered to be part of the attest engagement, and not a separate nonattest engagement.

In general, all proposed entries up to the conversion to accrual basis are considered a nonattest service. That means, transaction entries (cash receipts and cash disbursements) to convert to cash basis, and then all adjusting entries to convert from cash to accrual basis, are part of a bookkeeping function which is a nonattest service, subject to the requirements of ET 1.295 (formerly Interpretation 101-3.)

Once the general ledger is converted to accrual basis, any adjusting entries proposed during the audit, review or compilation engagement are part of the attest engagement, and not a nonattest service.

Of course, there are instances in which there is overlap.

What happens when an accountant who is performing a review engagement, makes a series of entries to adjust accruals and prepaid accounts. Are those entries part of a nonattest service (converting from cash to accrual basis), or are they the communication of proposed adjusting entries made during the attest engagement?

The answer is that it is unclear as ET 1.295 (formerly Interpretation 101-3), does not give a bright line delineation between proposed entries that occur as part of a nonattest service versus entries proposed as part of the attest engagement.

The author suggests that the guiding determination should be based on the type of proposed entries instead of the timing. That is, if an accountant proposes a series of adjusting entries to convert from cash to accrual basis, and those entries are proposed to the client during the attest engagement, those entries should be considered a nonattest service even though the entries are made and communicated during the attest service.

**Change the facts:** Assume that during a review engagement, the accountant proposes a couple of adjusting entries consisting of a year-end depreciation adjustment and a final tax entry. These proposed entries are part of the attest service and not a nonattest service.

*What about communications made between an accountant and a client during an attest engagement?*

The 2012 revision to the independence rules made one change involving communications between the CPA and client during an attest engagement.

ET 1.295 states that the following communications are considered a normal part of the attest engagement and would not constitute a nonattest service:

a. The client’s selection and application of accounting standards or policies and financial disclosure requirements,

b. The appropriateness of the client’s methods used in determining the accounting and financial reporting,
c. Adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and

d. The form or content of the financial statements.

What this list means is that if during an attest engagement, an accountant communicates with a client with respect to a) the client’s selection and application of accounting standards or policies and financial disclosure requirements, b) the appropriateness of the client’s methods used in determining the accounting and financial reporting, c) adjusting journal entries that the member (CPA) has prepared or proposed for client management consideration, and d) the form or content of the financial statements, such communications are considered part of the attest engagement and not a nonattest engagement.

Although the exclusion of communications during an attest service from the definition of a nonattest service might appear helpful, in practice, all it does is create confusion. For example, if an accountant is hired to actually perform bookkeeping services such as propose journal entries, that bookkeeping function is a nonattest service. Yet, if, during the performance of an attest service (e.g., review engagement), an accountant discussions (communicates) with a client with respect to proposed journal entries, that communication is part of the attest service, and not a nonattest service.

The problem is that in practice, there is no bright line between actually proposing journal entries (a nonattest service) and communicating the proposal to make entries (part of the attest service). Moreover, in most nonpublic business engagements, the accountant performs some bookkeeping function as part of the attest engagement.

The author believes that in cases in which an accountant is going to be involved in proposing journal entries, the accountant should treat such entries as being a nonattest service and should ensure that he or she complies with the three safeguards (requirements) of ET 1.295 to ensure that his or her independence is not impaired.

**Tax Compliance and Tax Preparation Services, including Payroll Services**

**a. Dealing with the Preparation of Tax Returns for an Attest Client**

Under the nonattest section of the independence rules found in ET 1.295, an accountant who prepares tax returns or performs tax consulting is performing a nonattest service for an attest client, and therefore must comply with the requirements of the Interpretation as they relate to nonattest services.

Those requirements include:

1. The accountant should not assume management responsibilities for the attest client.

2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
   - Assume all management responsibilities,
   - Oversee the service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience*,
   - Evaluate the adequacy and results of the nonattest services performed, and
• Accept responsibility for the results of the nonattest services.

3. Written establishment and documentation with client: The member should establish and document in writing his or her understanding with respect to:
• Objectives of the nonattest tax engagement
• Nonattest tax services to be performed
• Client’s acceptance of its responsibilities
• Member’s responsibilities
• Any limitations of the engagement

Accountants may provide a variety of payroll-related and income tax services for attest clients that include:

a. Preparing payroll returns for client signature.

b. Preparing federal and state income tax returns, including transmitting the tax returns and related tax payment to the taxing authority electronically.

**Tax compliance services:**

ET 1.295 (formerly Interpretation 101-3) clarifies whether an accountant who provides tax compliance services for attest clients impairs his or her independence with respect to that client.

For purposes of the Interpretation, tax compliance services include:

• Preparing a tax return
• Transmitting a tax return and transmittal of any related tax payment to the taxing authority
• Signing and filing a tax return
• Authorized representation of clients in administrative proceedings before a taxing authority

As with all other non-attest services performed on an attest client, an accountant who performs non-attest services for an attest client must follow *Three Safeguards* to maintain his or her independence with respect to the attest client:

1. The accountant may not assume management responsibilities as they relate to the tax return or other tax compliance services performed.

2. The client must agree to perform certain functions in connection with the nonattest tax services such as:

   • Assume all management responsibilities
   • Oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience
   • Evaluate the adequacy and results of the nonattest services performed, and
   • Accept responsibility for the results of the nonattest services.

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62 A tax return includes informational tax forms (such as estimated tax vouchers, extension forms, and Forms 990, 5500 and W-2) filed with a taxing authority or other regulatory agencies.
3. **Written establishment and documentation with client:** The accountant should establish and document in writing his or her understanding with the client with respect to:

- Objectives of the nonattest tax engagement
- Nonattest tax services to be performed
- Client’s acceptance of its responsibilities
- Member’s responsibilities
- Any limitations of the engagement

**Observation:** In most instances, a client does not have an individual who has an expertise in taxation. Consequently, how could a person be designated to possess the skill, knowledge, and experience to oversee the accountant’s preparation of tax returns? In general, in complying with the three safeguards, the designated individual should have a general understanding of how the amounts presented on the tax return were obtained, through the general ledger, etc. Moreover, the individual should understand basic, significant tax positions taken such as whether the company is on the accrual basis, and whether equipment purchases were expensed under Section 179 of the IRC. The individual should also approve those significant tax positions. What the individual is not required to do is have a technical understanding of the tax law and its regulations. That skill belongs to the accountant and is the reason why the accountant is hired in the first place.

In an earlier Q&A published by the Ethics Committee of the AICPA, the Q&A makes reference to an individual who hires an electrician to perform work on the individual’s home. That individual would oversee the electrician by having a general understanding of the work that he or she wants the electrician to perform and a basic knowledge of how electricity works (e.g., turn on a switch and the lights go on). However, the individual does not have to have technical expertise as to how to wire the house or fix the electrical problem at hand.

**With respect to tax compliance services, when is an accountant deemed to assume management responsibilities thereby impairing his or her independence?**

ET 1.295 addresses the issue of an accountant assuming management responsibilities in conducting tax compliance services for an attest client. How far can an accountant go in performing tax compliance services beyond which he or she is deemed to assume management responsibilities thereby impairing independence?

The rules are as follows:

a. Preparing a tax return and transmitting the tax return and related tax payment to a taxing authority (in paper or electronic form) would not impair independence, provided the accountant *does not have custody or control over the client’s funds* and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment, and
- Signs the tax return (if signature is required) prior to the accountant transmitting the return to the taxing authority.
Note: Making electronic tax payments under a taxing authority’s specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client’s funds.

b. The signing and filing of a tax return on behalf of client management impairs independence, unless the accountant has the legal authority to do so.

1) The taxing authority has prescribed procedures in place for a client to permit an accountant to sign and file a tax return on behalf of the client and such procedures meet, at a minimum, standards for electronic originators and officers outlined in IRS Form 8879,

Examples:
   Form 8879 for IRS e-file Signature Authorization, or
   Form 8453: U.S. Individual Income Tax Declaration for an IRS e-file return
   or,

2) An individual in client management who is authorized to sign and file the client’s tax return provides the accountant with a signed statement that clearly identifies the return being filed and represents that:

   - Such individual is authorized to sign and file the tax return,
   - Such individual has reviewed the tax return, including accompanying schedules and statements, and it is true, correct and complete to the best of his or her knowledge and belief, and
   - Such individual authorizes the accountant or another named individual in the accountant’s firm to sign and file the tax return on behalf of the client.

**Observation:** An accountant who signs a tax return on behalf of a client impairs his or her independence unless certain conditions are satisfied. The term “on behalf” means signing the return under a power of attorney or similar document. It does not apply to a situation in which an accountant signs a return as a preparer, which would not, by itself, impair independence.

c. Authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.

1) Representing a client in a court or in a public hearing to resolve a tax dispute would impair an accountant’s independence.

What is the definition of a tax return?

ET 1.295.160 defines a tax return to include all tax filings, including informational tax forms, such as estimated tax vouchers and extensions, and tax forms such as Forms 990, 5500, W-2, 1099, among others. The list is not all inclusive and extends to Form 1065, 1120, and 1120S, and presumably extends to other related tax forms such as Forms 941, 940, and W-3.

What if the accountant signs an extension to file?
Typically, an accountant files an extension in the capacity as a paid preparer.

1. ET 1.295 states that preparing a tax return and transmitting the tax return and related tax payment to a taxing authority would not impair independence, provided the accountant does not have custody or control over the client’s funds and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment, and
- If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.

2. Making electronic tax payments under a taxing authority’s specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client’s funds.

3. Assuming the accountant does not have custody or control over client funds (e.g., he or she is not a signatory on the cash account), the signing of an extension does not impair independence provided the client reviews and approves the extension and related payment. Thus, an accountant should send a copy of an extension to a client for review and approval.

Example 1: Joe CPA performs a review engagement on Company X. Joe also prepares paper form federal and state tax returns, and sends them to the client for review, signature and payment.

Conclusion: Joe has not performed management functions or made management decisions with respect to the preparation of the tax returns. The client reviews and approves the tax returns and related payments, and signs the return. Provided Joe complies with the other two safeguard requirements of ET 1.295 (e.g., the client agrees to assume management responsibilities in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

Example 2: Same facts as Example 1, except that the following actions occur:

- Joe prepares the federal and state tax returns.
- Joe sends a copy of the returns to Mary, who is Company X’s controller and the individual designated by X to oversee the tax services. Mary reviews and approves the tax returns.
- Company X (Mary) signs a Form 8879 authorization for e-filing and returns it to Joe.
- Joe files the tax returns and related tax payments electronically with each taxing authority.
- Joe does not have custody or control over the client’s funds.

Conclusion: Joe has not assumed management responsibilities with respect to the preparation and filing of the tax returns and related tax payments.

The reasons are as follows:

- Joe does not have custody or control over the client’s funds even though Joe has filed the tax payment electronically along with the filing of the tax return.
- Mary reviewed and approved the tax return and related payment.
Mary signs Form 8879 prior to Joe filing the tax return.

Provided Joe complies with the other requirements of ET 1.295 (e.g., the client agrees to perform certain functions in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

**Example 3:** Same facts as Example 2, except that Joe is also a signatory to Company X’s bank account.

**Conclusion:** The fact that Joe is a signatory to the bank account means Joe has custody over X’s funds. As a result, Joe’s independence is impaired with respect to Company X, regardless of all other factors related to his tax service. Joe is not permitted to perform a review engagement due to the lack of independence.

**Example 4:** Elisa, CPA performs a review engagement for Company Y. Elisa represents Company Y in an IRS audit and receives a power of attorney from the client with respect to that IRS audit.

**Conclusion:** Elisa’s independence is not impaired provided Elisa obtains agreement from Y prior to committing Y to a specific resolution with the IRS.

**Note:** The same conclusion would be reached if Elisa represented Y in an IRS appeal conference as it is an administrative proceeding. ET 1.295 states that authorized representation of a client in administrative proceedings before a taxing authority would not impair independence, provided the accountant obtains client agreement prior to committing the attest client to a specific resolution with the taxing authority.

**Change in facts:** Assume Elisa represents Y in tax court.

**Conclusion:** Elisa’s independence is impaired, regardless of all other factors. Representing a client in court or in a public hearing to resolve a tax dispute impairs an accountant’s independence.

**Payroll services:**

Similar to other nonattest functions, an accountant impairs his or her independence if he or she acts like a member of management by having authority to consummate payroll transactions, has custody of company assets, or prepares source documents.

With respect to payroll services, an accountant *impairs independence* if he or she:

- Authorizes and approves payment of payroll and payroll taxes, or
- Has custody or control over client funds by being a signer or co-signer of payroll checks or payroll tax disbursements, or
- Signs a payroll tax return on behalf of a client without the client reviewing the return and approving it in advance.

Independence is *not impaired* if the accountant:
- Processes client payroll and generates unsigned checks from the client approved payroll time records.
- Transmits client-approved and reviewed payroll tax returns and tax payments.
- Signs a payroll tax return on behalf of a client after the client has reviewed and approved the return and authorized the signing and submission of the return and related payment.

**Observation:** An accountant should ensure that he or she does not have custody of any client assets such as being a co-signer on a payroll or checking account, having custody of investments, etc. To do so automatically impairs the accountant's independence. Many accountants perform payroll services for their clients. ET 1.295 gives examples of payroll functions that do and do not impair independence. The general rule is that independence is impaired in a payroll function if the accountant can authorize payment of funds for payroll, is a signer or co-signer of checks, maintains a client's payroll account, signs payroll tax returns, or approves any payroll records for payment. Again, the key point is authorization and custody of assets. However, ET 1.295 permits an accountant to execute or record transactions that have been reviewed and approved by a client, including submission of tax returns and related payments. The Ethics committee took the position that the accountant’s ability to make electronic payroll tax payments or other client-approved transmittals does not impair independence, provided the client reviews and approves the transaction in advance. With such a limit, the accountant actually does not have authority and, instead, is merely executing a previously approved client transaction. Further, signing a payroll or other return in the capacity as an outside accountant, rather than management, does not impair the accountant's independence.

**What if an accountant is a signatory on a client's bank account?**

In some instances, a client may ask an accountant to be a backup signatory on the company’s bank account. The reason may be to allow the accountant to sign checks in the client’s absence. If the accountant is a signatory on an attest client’s bank account, he or she has custody of client assets (the bank account) and authority, and is acting in the capacity as a member of management. Therefore, he or she is not independent with respect to the attest client. This is the fact even if the accountant never actually signs checks and merely acts as a backup signatory for emergency purposes only.

**What if an accountant prepares payroll tax returns (Forms 941, 940, W-3, etc.) and transmits the tax return and related tax payments directly to the taxing authority (IRS, state tax bureau, etc.)?**

The amended Interpretation states that preparing a tax return and transmitting the tax return and related tax payments to the taxing authority, in paper or electronic form, would not impair independence provided:

a. The accountant does not have custody or control over the client’s funds, and

b. The client (designated individual of the client) reviews and approves the tax return and related payment, and, if required for filing, signs the tax return prior to the accountant transmitting the return to the taxing authority.

What this means is that an accountant may prepare the payroll tax returns (e.g., Forms 941, 940, W-3, and state forms) and may submit them electronically along with the tax payment as long as the accountant does not sign the payroll tax check(s) and the client reviews and approves the returns before they are submitted. If the payroll taxes are filed electronically, the accountant is required to give the
client a copy of the returns, and the client is required to file an e-file authorization. The e-file authorization signed by the client states that the client has examined a copy of the payroll tax returns filed. The result is that the standard electronic filing procedures for payroll tax returns do not impair an accountant’s independence with respect to that e-file client.

**Doesn’t the fact that the accountant is making the electronic payments to the IRS or state agency mean that the accountant has custody or control over the client’s funds?**

No.

ET 1.295.160 states:

The following are not considered having custody or control over an attest client's funds:

> “Making electronic tax payments authorized by an attest client pursuant to a taxing authority’s prescribed criteria, affixing the attest client’s depository account information on a tax return, or remitting an attest client’s check made payable to the taxing authority”

The key is that the accountant is merely executing the transfer of the funds from the client’s account to the taxing authority. In such a situation, the accountant’s control is limited to defining the amount of the funds transferred with no discretion over where the funds are transferred. Thus, ET 1.295 considers control or custody to be limited because the accountant does not have full decision-making over the funds being transferred.

**What if the accountant signs and files the payroll tax returns on behalf of the client, and not as a tax preparer?**

The signing and filing of a tax return on behalf of a client impairs independence unless the accountant has legal authority to sign the return, and either:

1. The taxing authority has procedures in place for a client to permit the accountant to sign and file the return on behalf of the client (similar to a Form 8879 being filed), or

2. The individual in client management provides the accountant with a signed statement that clearly identifies the return filed and states that:
   
   a. The individual is authorized to sign and file the return
   
   b. The individual has reviewed the tax return and believes it is correct and complete, and
   
   c. The individual authorizes the accountant to sign and file the return on behalf of the client.

**Note:** Both of the above requirements are almost the equivalent of the accountant having power of attorney to sign on behalf of the client. The one key difference is that in either case, the client has reviewed and approved the return prior to the accountant signing and filing on behalf of the client. In requirement 1 above, procedures are similar to those found on Form 8879 (the e-filing authorization form) that require the client to certify that he or she has reviewed the tax return and believes it is correct and accurate. In the second requirement, the client is authorizing the accountant to sign the
return on its behalf, but only after the client has reviewed the return for correctness and completeness. Thus, in both cases, responsibility for reviewing and approving the tax return prior to filing rests with the client, not the accountant.

Consider the following difference. If an accountant has power of attorney to sign a tax return on behalf of a client, the accountant is acting in the capacity of management and impairs his or her independence. Change the facts. If, instead, the accountant has power of attorney to sign on behalf of the client, but the client is required to review and approve the return first, then the client, and not the accountant, retains his or her capacity as management.

**Examples illustrating the application of the independence rules found in ET 1.295 (formerly Interpretation 101-3)**

The author has drafted the following examples to illustrate his understanding of the rules related to the performance of bookkeeping and payroll transactions for an attest client.

**Example 1:**
Harry is an accountant who performs bookkeeping services for his client and has been asked to perform a review engagement. Harry satisfies the *Three Safeguards* for performing nonattest services for an attest client including obtaining, in writing, an engagement letter from the client establishing an understanding of the services to be performed and each party’s responsibilities. In that letter, the client has agreed to:

- Assume all management responsibilities with respect to the bookkeeping function,
- Oversee the bookkeeping service, by designating an *individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience*,
- Evaluate the adequacy and results of the bookkeeping services performed, and
- Accept responsibility for the results of the bookkeeping services.

In performing the bookkeeping function, Harry receives a shoebox of source documents (e.g., bills, receipts, deposit slips), check stubs and bank statements, all of which are prepared by the client. From the bank statements, Harry performs the following functions:

a. Enters the checks and deposits into the computer and develops a cash basis general ledger and trial balance. On most of the checks, the client has a notation describing the type of expense to which the check relates. Each deposit slip has a description of the source of the deposit. For those checks and deposit slips that are missing notations or descriptions, Harry calls the client who tells him what the checks or deposits relate to and the general ledger account to which each unidentified item should be posted.

b. Makes a series of general journal entries to adjust the general ledger to a cash basis.

c. Sends the journal entries and general ledger to the client and receives client approval.

The accountant believes that the client understands the nature of the entries and the impact the entries have on the financial statements.

From the adjusted trial balance, the accountant performs review engagement procedures.
Conclusion:
First, do the ET 1.295 rules apply? Yes. Harry is performing nonattest services for an attest client. Those nonattest services consist of entering bookkeeping: the checks and deposits into the computer and developing a cash-basis general ledger and trial balance. The entries to convert from cash to accrual basis are also a nonattest bookkeeping service.

Second, is Harry independent with respect to the bookkeeping service?

According to ET 1.295, Harry’s independence is not impaired and he may perform a review engagement. The client (not the accountant) has approved the journal entries, and approved all general ledger account classifications by coding the checks. Further, the client prepared all source documents, not the accountant.

Through the signing of the engagement letter, the client has agreed to:

- Assume all management responsibilities with respect to the bookkeeping function
- Oversee the bookkeeping service by designating and individual who possesses the skill, knowledge and experience to oversee the bookkeeping function
- Evaluate the adequacy and results of the bookkeeping services performed, and
- Accept responsibility for the results of the bookkeeping services

Example 2:
Same facts as Example 1, except that Harry receives the bank statements from the client along with the deposit slips. None of the checks are coded, few have descriptions and there are no descriptions on the deposit slips. Because Harry is familiar with his client’s business including vendors and customers, he is able to code most of the checks and deposit slips without asking the client. There are only a few items that he is unable to classify for which he asks the client for clarification.

Harry does not submit the journal entries and general ledger to the client for approval.

Conclusion:
Harry’s independence is impaired and he is precluded from performing a review engagement. By performing the functions of account coding and classification of transactions without obtaining the client’s approval, Harry is assuming management responsibilities for the general ledger. Thus, his independence is impaired.

Change the facts:
Assume that Harry’s independence is impaired in Example 2. Is Harry permitted to perform a compilation engagement noting that he is not independent?

Conclusion:
Under existing authority, SSARS No. 21 permits Harry to issue a compilation report, as long as he states in his compilation report that he is not independent.

Example 3:
Mary is an accountant who performs payroll-related services for an attest client.
Mary has satisfied the *Three Safeguards* in ET 1.295 including obtaining an engagement letter from her client noting the understanding of the nonattest service (e.g., payroll services) to be provided for the attest client.

Specifically, Mary receives weekly time sheets from the client with the number of hours worked, the pay rate and required withholdings elections. She calculates the payroll and related withholdings, by employee and prepares unsigned checks and payroll tax returns and depositories, all of which are delivered to the client for signature and distribution. Mary also performs a review engagement on the client's financial statements.

**Conclusion:**
Mary’s independence is not impaired with respect to the attest client. Specifically, ET 1.295 (formerly Interpretation 101-3) states that the processing of payroll and preparation of unsigned checks are functions that do not impair independence because neither function involves assuming management responsibilities. Moreover, Mary has complied with the Three Safeguards of ET 1.295 with respect to nonattest services performed on an attest client.

Therefore, Mary may perform a review engagement as her independence is not impaired.

**Example 4:**
Same facts as the previous example except that unsigned checks, payroll tax returns and depositories are not delivered to the client. Instead, Mary sends the payroll information to a bank who prepares the payroll checks for delivery back to the client and distribution. The bank calls the client for approval before issuing the checks. Mary makes the electronic tax payments from the client's account. The client has instructed the bank to limit the amounts and payees of the checks and to limit the payee of electronic payments to the taxing authorities. Mary prepares the payroll tax returns for delivery to the client for signature and mailing. Mary prepares a review of the client's financial statements. Mary has obtained an engagement letter that includes the necessary language regarding nonattest services performed for an attest client.

**Conclusion:**
Independence is not impaired. ET 1.295 permits an accountant to transmit payroll information to a financial institution and to process electronic tax payments provided the accountant is merely processing client-authorized transactions. Specifically, the client must restrict the amount and payee of such transactions that are processed by the bank. In this example, the client continues to authorize the transactions, not the accountant.

**Example 5:**
Mary is processing the payroll as noted in the previous examples. However, the owner of the company suddenly becomes ill and is required to take an emergency vacation for six months in Bora Bora from September 30 to March 31. During this time, the client gives Mary control over all aspects of the payroll function. The company manager sends to Mary the weekly payroll information (e.g., hours and rates, by employee). Mary prepares the payroll checks and co-signs each check, delivering the batch back to the company manager for a second signature and distribution to the employees. Mary also prepares and executes the electronic tax payments and the transfer from the main checking account to the payroll account to cover the payroll. She also prepares the quarterly payroll returns, signs them and sends them to the taxing authorities.
Mary also performs a review of the client's December 31 year-end financial statements while the owner is on vacation. When the owner returns, Mary is removed from the payroll functions and is involved with only processing payroll that is authorized by the owner.

Mary obtains an engagement letter for the review engagement in which she properly includes the necessary language regarding performing a nonattest service for an attest client.

**Is Mary's independence impaired with respect to the client while she is performing the review of the financial statements?**

**Conclusion:**
Yes. Clearly, Mary is performing functions in the capacity as assuming management responsibilities. First, she is co-signing checks. Second, she is signing payroll tax returns. Third, she is transferring funds from the main checking account to the payroll account. None of these functions are subject to the owner's authorization. Thus, she is acting as if she were part of management and her independence is impaired, precluding her from issuing a review report.

The fact that Mary included the proper language in the engagement letter regarding performing nonattest services for an attest engagement, means that only two of the three safeguard requirements have been satisfied. That is, management has taken responsibility for the nonattest service (Safeguard 1) and the responsibility has been placed in writing (Safeguard 3). However, the fact that Mary is assuming management responsibilities violates Safeguard 2 in which the accountant shall not assume management responsibilities in performing the nonattest service. Thus, independence is impaired.

**Investment Functions Performed for the Client**

As it relates to investment functions, ET 1.295 states that an accountant may not:

- Have custody of the client's portfolio
- Make investment decisions

However, the accountant may:

- Perform recordkeeping and reporting of the attest client's portfolio balances
- Evaluate the manner in which an attest client's portfolio is being managed by investment account including assessing whether the managers are following client guidelines, meeting client investment objectives, and conforming to client stated investment parameters and risk tolerance.
- Recommend the attest client's allocation of funds among various funds based upon the attest client's desired return, risk tolerance, or other parameters
- Transmit an attest client's investment selection, with client consent, to the attest client's broker-dealer provided that the attest client has authorized the broker-dealer to execute the transaction.

If an accountant acts as an investment advisor for a company's investment portfolio, the accountant's independence would not be impaired if the client first decides the investment transactions to make and the accountant merely executes the transaction. Conversely, if the accountant makes the investment decisions without client approval, the accountant's independence would be impaired with respect to that company.
Another issue is whether the independence rules apply to the owners or retirement plan of the company that the accountant reviews or audits. The independence rules that we are discussing apply to the company that the accountant audits, reviews or compiles. They do not apply to the owner of the company or to the company's retirement plan. That means that the accountant could manage the owner's personal portfolio or the assets of the company's 401(k) plan and not taint his or her independence with respect to the company.

Example 1:
Ralph is an outside accountant for a company owned by Fred. Ralph reviews the financial statements of the company. Ralph is also a CFP and a registered securities advisor who performs personal financial and tax planning for Fred's company on a fee basis. The investments are processed through Charles Schwab. Ralph recommends to the company certain asset allocations that are in line with the company's investment objectives and risk level. Ralph also maintains all investment records on behalf of the company. However, the client executes all transactions directly with Schwab and has the investment statements sent directly to Ralph.

Is Ralph independent with respect to Fred's company?

Conclusion: Yes. Ralph merely advises the client of investment transactions and does not have authority to execute transactions on behalf of the client.

Change the facts: Ralph not only advises Fred about investment decisions, but also transmits the funds to the Schwab broker after it is approved and called into the broker by the client.

Conclusion: Ralph is still independent. The reason is that Ralph is only transmitting the transactions on behalf of the client. Ralph has no authority to execute transactions without client approval.

Change the facts again: Ralph advises the company of transactions and then is authorized to execute the transactions directly with the broker on behalf of the company.

Conclusion: Ralph is not independent. The fact that he can execute transactions for the company impairs independence unless the execution is merely transmitting the paperwork after the company authorizes the transaction directly with the broker. In this case, the client has no direct correspondence with the broker and is, thus, out of the authorization process.

Change the facts again: Ralph manages the investment portfolio of Harry, the owner of a company. Ralph advises Harry of transactions and then is authorized to execute the transactions directly with the broker on behalf of the client. Ralph deals with Harry's personal portfolio only and has nothing to do with the company's portfolio.

Conclusion: Ralph's independence with the company is not affected by the fact that he manages the personal portfolio of the company's owner. The same result would apply if Ralph managed the investment portfolio of the company's 401(k) plan as long as he is not auditing, reviewing or compiling the financial statements of the 401(k) plan.

Appraisal, Valuation and Actuarial Services
ET 1.295 provides significant restrictions to an attest accountant’s ability to perform appraisal, valuation, or actuarial services for an attest client.

Under the rules, an accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

a. The results of the service, individually or in the aggregate, would be material to the attest client’s financial statements, and

b. The service requires a significant degree of subjectivity.

Valuations performed that generally require a significant degree of subjectivity include:

- ESOPs
- Business combinations
- Appraisals of assets or liabilities

If material, these types of valuations are likely to impair independence.

Exceptions for certain appraisal, valuation, and actuarial services:

ET 1.295 provides two exceptions under which the performance of an appraisal, valuation or actuarial service for an attest client does not impair independence with respect to that attest client, which follow:

1. Valuation services that typically produce reasonably consistent results and do not require a significant degree of subjectivity, such as:

   - An actuarial valuation of a client’s pension or postemployment benefit liabilities.

2. Appraisal, valuation, and actuarial services performed for nonfinancial statement purposes such as:

   - Tax planning or compliance
   - Estate and gift taxation
   - Divorce proceedings
   - Cross purchase, buy-sell agreement among shareholders or partners

For both exceptions not to impair independence, all other requirements of ET 1.295 should be met, including having a written documentation of the understanding with the client as to the nonattest service to be performed.

Observation: An accountant might be asked to perform a business valuation of an attest client for estate and gift taxation or divorce purposes. The performance of such a valuation is one of the two exceptions under which the accountant does not impair independence. However, the Three Safeguards in ET 1.295 must be satisfied including the accountant documenting in writing the understanding with the client about the nonattest services to be performed.
Example: Ed is an accountant who is also a business valuation specialist. Ed is asked to perform a business valuation of the common stock of Company X for gift tax purposes. Ed's firm also issues a review report on the company. In performing the valuation, all significant assumptions are approved by the client.

Conclusion: Ed’s independence is not impaired with respect to the attest client. ET 1.295 states that when an accountant performs valuation services for nonfinancial statement purposes, the accountant’s independence is not impaired.

Examples of nonfinancial statement purposes include tax planning or compliance, estate and gift taxation, and divorce proceedings. The accountant still must satisfy the Three Safeguards of ET 1.295 including having the client approve all significant assumptions and matters of judgment used in the valuation.

The dilemma for valuation of GAAP statement components

The FASB has as its goal to move toward fair value accounting. Over the past decade, several important FASB statements have been issued, some of which have, as their basis, the requirement to determine fair value of the reporting entity or selected assets.

Examples include:

<table>
<thead>
<tr>
<th>FASB Statement</th>
<th>Fair Value Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Combinations (ASC 805)</td>
<td>Requires that fair value be used in allocating the purchase price to net assets in a business combination</td>
</tr>
<tr>
<td>Intangibles- Goodwill and Other (ASC 350)</td>
<td>Requires that fair value be used in performing an annual test of impairment of goodwill and other intangible assets</td>
</tr>
<tr>
<td>Property, Plant and Equipment (ASC 360)</td>
<td>Requires that fair value be used to test the impairment of long-lived assets if certain criteria are met</td>
</tr>
<tr>
<td>Consolidation (ASC 810)</td>
<td>Requires that fair value be used to determine whether an entity is a variable interest entity (VIE) that should be consolidated</td>
</tr>
<tr>
<td>Guarantees (ASC 460)</td>
<td>Requires that fair value be used to measure the value of a guarantee obligation</td>
</tr>
</tbody>
</table>

The previous list is just the beginning of what is likely to be a much more active use of fair value.

To no surprise, the FASB requires companies to measure fair value yet gives little guidance on exactly how to do it. Larger publicly held companies can hire valuation specialists to determine fair value. Yet, it is usually not cost effective for smaller nonpublic businesses to obtain an outside valuation. Further, many nonpublic businesses look to the outside accountant to comply with GAAP and are unwilling to spend additional funds to obtain an outside valuation particularly when there is no financial gain to doing so other than satisfying the bank’s need to issue GAAP financial statements.
Does an accountant impair his or her independence if he or she computes fair value for a client?

An accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

a. The results of the service, individually or in the aggregate, would be material to the financial statements, and

b. The service requires a significant degree of subjectivity.

This means that an accountant cannot be involved in a valuation if that valuation involves an element(s) that will be material to the financial statements, and the valuation has a significant degree of subjectivity.

Note: In discussions with the AICPA Ethics Division staff, the author determined that the staff is taking a general position that a valuation performed by an accountant for a client in connection with the requirements of ASC 805, regarding business combinations, ASC 350, regarding goodwill and certain intangibles, or ASC 810 (formerly FIN 46R) involving variable interest entities, would require a significant degree of subjectivity. If the item being valued is material to the financial statements, independence would be impaired.

Example: Joe accountant is hired to review the financial statements of Company X. Company X has goodwill and is required to perform an annual test of goodwill for impairment in accordance with ASC 350 (formerly FASB No. 142). Because X does not have expertise in valuation, X asks its outside accountant to compute the entity’s fair value for purposes of performing the goodwill test. The accountant did the fair value test for the client. Goodwill is material to the financial statements.

Conclusion: The accountant is not independent with respect to X. The reason is two-fold:

An accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

a. The results of the service, individually or in the aggregate, would be material to the financial statements, and

b. The service requires a significant degree of subjectivity.

Both of these factors have been met.

Observation: The independence issue related to valuation came to the forefront due to the issuance of ASC 810 (formerly FIN 46R), involving the consolidation of variable interest entities. Specifically, ASC 810 deals with the consolidation of variable interest entities (VIEs) and can result in a related party real estate lessor being consolidated into an operating company lessee.

More particularly, under certain tests, ASC 810 requires that a valuation be done of the fair value of the real estate leasing entity. Depending on the results of that valuation, the entity might be categorized as a VIE and, thus, consolidated into the operating company.
Because of the complexity in valuing the real estate lessor, many small businesses will look to their accountants to perform an informal valuation to test under ASC 810.

It appears that if an accountant does perform a valuation under ASC 810, the accountant impairs his or her independence because:

a. The results of the valuation *would be material to the financial statements as they would result in the consolidation of another entity*, and

b. The service requires a *significant degree of subjectivity*.

**One possible solution**

One possible solution is for an accountant to perform a valuation test along with the client so that the client, rather than the accountant, is actually performing the test. In doing so, the accountant would have to explain the methodology, assumptions and computations used and ensure that the client takes responsibility for those items.

The problem with this approach is that it assumes the client has the skill, knowledge and experience needed to oversee this process. The Interpretation states that the member must be satisfied that the client can meet all of the criteria required and can make an informed judgment as to the results of the member’s nonattest services. With respect to a valuation, it is difficult to assume a client can make an informed judgment as to the results of the valuation services performed.

The author believes this approach is more “form over substance” in that most nonpublic businesses lack anyone with even minimal skill to oversee a valuation. The reality is that the valuation is the accountant’s, not the client’s regardless of the “window dressing.”

**Information Systems- Design, Installation, or Integration Services**

ET 1.295 addresses changes to the types of information systems nonattest services that can be performed for an attest client. In particular, under ET 1.295, an accountant may not *design and develop* a client’s financial information system, while he or she may participate in certain installations of systems.

Specifically, an accountant’s *independence is impaired* if he or she:

- Designs or develops a client’s financial information system
- Makes *more than insignificant modifications* to source code underlying an attest client’s existing financial information system
- Supervises attest client personnel in the daily operation of the attest client’s information system, or
- Operates an attest client’s network
Conversely, an accountant is permitted to perform certain information system services for an attest client *without impairing independence*. Those services include:

- Installing or integrating an attest client’s financial information system that was not designed or developed by the accountant, such as an off-the-shelf accounting package

- Assisting in setting up the attest client's a chart of accounts and financial statement format with respect to the attest client's financial information system

- Designing, developing, installing, or integrating an attest client’s system that is *unrelated to the attest client’s financial statements or accounting records*

- Providing training and instruction to attest client's employees on the information and control system.

- Performing network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request.

**Note:** In the 2012 revision to Interpretation 101-3 (now part of ET 1.295), the AICPA ethics committee added to the list of acceptable nonattest services for an attest client, the *performance of network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings consistent with management’s request*.

**Example:** An accountant is hired by his client to install QuickBooks® accounting software and to assist the client in setting up the chart of accounts and financial statement format on the new accounting package. The accountant also audits the client.

**Conclusion:** The accountant’s independence is not impaired. The accountant is only involved in installing off-the-shelf software and assisting the client in setting up the chart of accounts and financial statements on the new system. These functions do not impair independence in accordance with ET 1.295.

The AICPA issued a Q&A related to the performance of information technology services for an attest client. Following are excerpts from that Q&A, as modified by the author:

| Question: Why does ET 1.295 indicate that independence is impaired if a member is operating a client’s network? | 
| Reply: Operating a client’s network is considered a management function that violates the general requirements of the Interpretation. |
| Question: Would outsourcing a client’s entire network operation and independently operating the client’s network impair independence? | 
| Reply: Yes. |
| Question: Would performing network maintenance (such as updating virus protection, |
applying updates and patches, or configuring user settings consistent with management’s request) impair independence?

**Reply:** No. Performing network maintenance is not considered to be operating a client’s network and does not impair independence, provided a competent client employee is making all decisions and approving all activities.

**Question:** Does assisting a client with a server project (such as installing, migrating or updating a network operating system, adding equipment and users, or copying data to another computer) impair independence?

**Reply:** No, provided the member does not make other than insignificant modifications to the source code underlying the client’s financial information system.

**Question:** Does the supervising of client personnel in the daily operation of the client’s information system impair independence?

**Reply:** Yes. By supervising client personnel, the member is performing management duties which impair independence.

**Question:** Does assisting a client with procuring and securing Internet access impair independence?

**Reply:** No, provided a competent client employee makes all decisions as to the Internet provider and services to be provided.

**Question:** ET 1.295 provides that it does not apply to designing, developing, installing, or integrating a client’s system that is *unrelated to the client’s financial statements*. What criteria should a member use to determine whether a client’s information system is unrelated to the financial statements or accounting records?

**Reply:** Information systems that produce information that is reflected in the amounts and disclosures in the client’s financial statements, used in determining such amounts and disclosures, or used in effecting internal controls over financial reporting are considered to be related to the financial statements and accounting records. However, information systems that are used only in connection with controlling the efficiency and effectiveness of operations are considered to be unrelated to the financial statements and accounting records.

**Question:** What factors should a member consider in determining whether the modifications made to source code underlying a client’s financial information system are “other than significant?”

**Reply:** If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be other than insignificant.

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**Forensic Accounting Services**
One significant change made by an amendment to Interpretation 101-3 that is now part of ET 1.295, was to address the independence issues related to the performance of forensic accounting services for an attest client.

Forensic accounting services are defined as non-attest services that involve the application of special skills in accounting, auditing, finance, quantitative methods, and certain areas of law, research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Forensic accounting services consist of:

- Litigation services, and
- Investigative services.

**Rules for litigation services:**

Litigation services consist of accountant services in the capacity as an expert or consultant and involve providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties.

Litigation services are segregated into:

- Expert witness services
- Litigation consulting services, and
- Other services related to litigation.

Following is a table that summarizes the rules of independence as they relate to the three litigation services previously noted.

<table>
<thead>
<tr>
<th>Impact of Litigation Services on Independence</th>
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<tbody>
<tr>
<td><strong>Type of litigation service</strong></td>
</tr>
<tr>
<td>Expert witness services:</td>
</tr>
<tr>
<td>Accountant is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the accountant’s expertise, rather than his or her direct knowledge of the disputed facts or events.</td>
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</table>
of the group, and
c. No attest client has the sole
decision-making power to
select or approve the expert
witness.

Fact witness services:63
Answering questions while
testifying as a fact witness would
not impair independence.

<table>
<thead>
<tr>
<th>Type of litigation service</th>
<th>Impact on independence</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Litigation consulting services:</td>
<td>Independence is not impaired, provided the accountant complies with the three</td>
<td>If the accountant who provides</td>
</tr>
<tr>
<td>Litigation services where an accountant provides</td>
<td>general safeguard requirements under ET 1.295 for providing non-attest services for</td>
<td>litigation consulting services</td>
</tr>
<tr>
<td>advice about the facts, issues, and strategy</td>
<td>an attest client.</td>
<td>subsequently agrees to serve as an expert witness, independence</td>
</tr>
<tr>
<td>of a matter. The consultant does not testify</td>
<td></td>
<td>would be impaired.</td>
</tr>
<tr>
<td>as an expert witness before a trier of fact.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other litigation services:</td>
<td>Independence is impaired as these services create the appearance that the accountant</td>
<td>Independence is not impaired if</td>
</tr>
<tr>
<td>Consist of those litigation services where an</td>
<td>is not independent.</td>
<td>the accountant serves as a mediator or any similar role in a matter</td>
</tr>
<tr>
<td>accountant serves as a trier of fact, special</td>
<td></td>
<td>involving a client, provided the accountant is not making any decisions</td>
</tr>
<tr>
<td>master, court-appointed expert, or arbitrator</td>
<td></td>
<td>on behalf of the parties, but rather is acting as a facilitator by</td>
</tr>
<tr>
<td>(including serving on an arbitration panel), in</td>
<td></td>
<td>assisting the parties in reaching their own agreement.</td>
</tr>
<tr>
<td>a matter involving a client.</td>
<td></td>
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</tr>
</tbody>
</table>

Rules for investigative services:

Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Such services do not impair independence provided the accountant complies with the three safeguard requirements under ET 1.295 for an accountant who performs non-attest services for an attest client. Remember, the three general safeguard requirements are: 1) The accountant may not assume management responsibilities, 2) The client must take responsibility for the non-attest services being performed, and 3) The understanding must be in writing.

Other Management Functions

ET 1.295 provides other examples of services performed by an accountant which may be deemed management functions. These functions include corporate finance consulting, employee search, and consulting. All of these functions follow the same theme in determining if independence is impaired. If

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63 A fact witness is one who gives testimony based on his or her direct knowledge of the facts or events in dispute, and, for his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the accountant’s role is to provide factual testimony to the trier of fact.
the accountant can authorize transactions, has custody of assets, or supervises employees, he or she is clearly not independent. A few areas are worth noting. If the accountant is asked to interview client personnel, the accountant may not negotiate employee compensation or benefits or actually hire the employee. Instead, the final decision to hire the employee must be made by the client, not the accountant.

All other negotiation services follow a similar track in that an accountant may not negotiate on behalf of the client, suggesting that the accountant may not have authority to consummate the deal. If, instead, the accountant merely negotiates and reports back to the client who makes the ultimate decision, the accountant's independence may still be impaired because the accountant is acting in the capacity of management by meeting with the buyers or sellers in the first place.

Consider the following examples that illustrate these points:

**Example 1:** Elisa is an outside accountant for a client that she audits. The client is looking to hire a controller for the company and asks Elisa to assist in the process. The client interviews various candidates. After two interviews with a candidate, the client asks Elisa to interview a candidate and give her opinion as to whether the person should be hired and the rate of pay to offer. Elisa also recommends a few individuals to the client for consideration. The client makes the ultimate hiring decision. Is Elisa independent?

**Conclusion:** Yes. The fact that Elisa interviews candidates and participates in the hiring and compensation discussions does not impair independence. The client makes the ultimate decisions.

**Example 2:** Because Elisa will be working with the new controller, the client asks Elisa to find a controller for the company. The client gives Elisa an acceptable range of pay and full authority to hire a suitable person.

**Conclusion:** Elisa is not independent with respect to the client. Elisa has "crossed the line" and is now negotiating compensation and hiring an employee, both of which involving Elisa assuming management responsibilities.

**Example 3:** An accountant’s client is establishing a new operation in another locality. The client has asked the member to recruit and hire for the company a controller and a cost accountant for its new operation.

**Conclusion:** Independence is impaired because decisions as to employment of personnel entails assuming management responsibilities. However, an accountant may perform services consisting of recommending a position description and candidate specifications, searching for and initially screening candidates, and recommending qualified candidates to the client. Such consulting assistance would not impair independence, provided the client management is responsible for any ultimate hiring decision.

**Example 4:** Julie is an outside accountant for a client that she audits. The client has decided to sell the business and has asked Julie to negotiate the terms and conditions (including price) with three potential buyers. Once a portion of the terms is negotiated, Julie is to report back to the owners and receive feedback as to how the owners want to proceed. The ultimate decision on a sale and acceptance of the terms and conditions rest with the owners, not Julie. Is Julie independent with respect to the company?
Conclusion: No. ET 1.295 states that negotiating or consummating a transaction on behalf of owners impairs independence. This is the case even though the decision rests with the owners, not the accountant. If instead, Julie assisted in the negotiation in terms of performing analysis and providing financial information to suited buyers, independence would not be impaired.

Observation: An accountant should be careful not to impair his or her independence in situations involving the sale or purchase of a business. If the firm is hired to negotiate the terms and conditions of a sale or purchase, this activity may be deemed to impair independence even though the client makes the ultimate decision. This can be a trap in the first year of an acquisition where the firm may be precluded from auditing or reviewing the entity's financial statements. Instead, the firm should limit its negotiating to acting as an advisor as well as providing information and analysis on the transaction. The difference between negotiating and acting as an advisor is a subtle one. The author believes that if a negotiation is done solely by the accountant without the assistance of the client, the accountant is not acting as an advisor. Instead, he or she is acting as part of management and independence would be impaired. Conversely, when the client is negotiating the transaction and the accountant only assists in the negotiating, the accountant's role is one of being an advisor and independence would not be impaired.

How do consulting services fit into ET 1.295?

The AICPA’s Division of Management Consulting Services has issued a Statement on Standards for Consulting Services (SSCS) that sets the definitions and standards for consulting services engagements. The term “consulting” supersedes the term “management consulting services.”

The Standard states that:

“The performance of Consulting Services for an attest client does not, in and of itself, impair independence. However, members and their firms performing attest services for a client should comply with applicable independence standards, rules and regulations issued by AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.”

What this means is that the performance of a consulting engagement for a client does not, by definition, impair independence. The accountant should look at the other independence rules to determine whether he or she is independent. The concern is that in performing the consulting engagement, the accountant may inadvertently act in the capacity of management. In such circumstances, the accountant should follow the general rules found in ET 1.295. That is, make sure he or she does not authorize transactions, supervise employees, make decisions on behalf of the client, etc. Specifically, the role of advisor and analyzer is not considered assuming management responsibilities.

Acting as a Trustee

It is quite common for an accountant to be asked to serve as a trustee for a client or as an executor of a client’s estate. The client is alive and well and the trust does not become activated until the client dies. An example may be a trust that will hold the common stock of a company that the member presently audits or reviews, but again, not until the owner dies. There may also be an irrevocable insurance trust that owns an insurance policy that will be used to fund estate taxes. Or, the accountant will be an
executor or co-executor of the owner’s estate. How do these situations affect independence? Is the fact that the accountant will become a trustee or executor impair his or her independence now?

1. When an accountant is designated to serve as a trustee of a trust or an executor or administrator of an estate that held, or was committed to acquire, any direct financial interest or any material indirect financial interest in an attest client during the period of the professional engagement does not in itself create an impairment of independence with respect to the attest client.

2. When an accountant serves as the trustee or executor during the period of the professional engagement, independence would be impaired regardless of whether the Three Safeguards are satisfied if:
   a. the accountant (individually or with others) has the authority to make investment decisions for the trust or estate,
   b. the trust or estate owned or was committed to acquire more than 10 percent of the attest client’s outstanding equity securities or other ownership interests, or
   c. the value of the trust’s or estate’s holdings in the attest client exceeds 10 percent of the total assets of the trust or estate.

The Ethics Board has issued several rulings that deal with this issue on point. The fact that an accountant has been named as an executor or trustee in a client’s will does not affect his or her independence now. The key is whether the accountant was independent during the year being audited or reviewed and the period up to the date the report is issued. The fundamental problem lies in the risk that a client may die in the middle of a year, and immediately the accountant is named as executor or trustee. At that point, independence is impaired and the accountant and his or her firm are precluded from performing the engagement. Let’s look at a few examples that illustrate these important points:

**Example 1:** An accountant is the sole trustee of a trust that holds all of the voting stock of Company C during 20X1. As the trustee, the accountant is actively involved in all management functions.

**Conclusion:** The accountant is not independent with respect to Company C for 20X1 because he is acting as a trustee of a trust that holds the company’s stock during that year.

**Example 2:** An accountant is a named trustee of a trust that will hold 100% of the common stock of Company B upon the death of Harry, the 100% shareholder. Presently, the trust has no assets and Harry, not the accountant, provides all of the management of Company B. The accountant reviews the financial statements of Company B for the year ended December 31, 20X1 and issues his review report on March 1, 20X2. Harry is alive and kicking for the entire period.

**Conclusion:** The accountant is independent provided he is not a trustee during the period January 1, 20X1 through March 1, 20X2. The fact that the accountant will become a trustee upon a certain event occurring (e.g., death of Harry) is not an issue in this case. Because the accountant was not a trustee during the period of the financial statements, the engagement period or at the date that the review report was issued, independence is not impaired.

**Example 3:** Same facts as Example 2, except that Harry dies on October 1, 20X1 and the accountant is named as the trustee of the trust that now holds 100% of the common stock of Company B.
Conclusion: Too bad for the accountant. Effective October 1, 20X1, he is not independent with respect to Company B and therefore, taints the entire financial statement period. Thus, he is precluded from issuing a review report for the year ended December 31, 20X1. He could issue a compilation report and include a disclaimer for lack of independence.

Example 4: Same facts as Example 3, except that the accountant is one of four trustees and the trust only owns 10% of the common stock of the company.

Conclusion: The accountant is still not independent because the trust has a direct financial interest in Company B. ET 1.295 provides a materiality threshold only for indirect financial interests, not direct interests. Any direct interest in the attest client held by the trust impairs independence. The fact that the accountant is a trustee means that he is deemed part of management, which impairs independence.

Example 5: Bill is the co-trustee of an insurance trust set up for a client who is deceased. The son of the deceased client is now the 100% shareholder of Company X, which is an audit client of Bill and one of the beneficiaries of the insurance trust.

Conclusion: The fact that Bill is a trustee of an insurance trust does not impair his independence with respect to Company X. The insurance trust has no direct or indirect investment in the common stock of Company X. The fact that the son happens to be both a beneficiary of the trust and a 100% shareholder of Company X has no effect on Bill’s independence with respect to X.

Example 6: Same facts as Example 5, except that Bill is a co-trustee of the insurance trust. The trust has no direct or indirect investment in the common stock of Company X. The other trustee is the son of the deceased client who is also the 100% shareholder of Company X, an audit client.

Conclusion: Oddly enough, independence is not impaired. The trust does not have a direct or indirect financial interest in Company X. Further, the fact that the son is both the co-trustee and 100% shareholder of Company X has no bearing on Bill’s independence with respect to Company X.

Observation: The author included example 6 to illustrate a common scenario in practice. It is typical for an accountant to be named as a co-trustee with a family member. The client trusts (no pun intended) the accountant but not enough to control the family affairs outright. The key point to remember is that the trust must have a direct or material indirect investment in the client in order to impair independence with respect to the client. The mere fact that there is commonality of control between the trust and the client with the same family member in both roles, is not important. We are not dealing with rules of attribution and related party issues as customarily used in tax law and accounting. The ethics rules are separate and distinct from other areas that may deal with attribution differently. There is further discussion made in this chapter about attribution with respect to spouses and close relatives.

Member of Social Club

Question: A member belongs to a social club (e.g., country club, tennis club) in which membership requirements involve the acquisition of a pro rata share of equity or debt securities. Is the member’s independence impaired with respect to the club?
Response: Probably not. As long as membership in a club is essentially a social matter, independence is not impaired because such equity or debt ownership is not considered a direct financial interest. However, the member should not serve on the club’s governing board or take part in management. To do so would impair the member’s independence.

Unpaid Fees

Question: A member’s client has not paid fees for previously rendered professional services. Is independence impaired with respect to the client for the current year?

Response: ET 1.230, Unpaid Fees, states that independence is impaired if:

   a covered member has unpaid fees from an attest client for any previously rendered professional service provided more than one year prior to the date of the current-year report.

Unpaid fees include fees that are unbilled or a note receivable arising from such fees.

ET 1.230 does not apply to fees outstanding from an attest client in bankruptcy.

Observation: The author believes that this one-year rule should be changed to reflect a materiality threshold. There may be circumstances in which a client owes a de minimis amount of fees incurred more than one year from the date of the report. Yet, regardless of the amount outstanding, independence is impaired. In the present economic climate, unpaid fees has become a chronic problem among accounting firms as firms are barraged with unpaid fees from good clients that have encountered short-term cash flow problems. The result is the firms are being placed in a very difficult position of having impaired independence with a large percentage of clients. The solution is not an easy one. A purist might suggest that an accountant give up an audit or review engagement for a long-term client who is unable to fully pay the prior year’s audit or review fees before issuance of the audit or review report. However, there are a few possible options for the accountant to comply with the independence ruling and still keep the client.

1. Option one is for the accountant to delay issuance of the report until the bill is paid. That is, the field work and all other work related to the engagement could be completed, but the report could be held by the accountant until the bill is paid. Of course, this may require cooperation with the third party (e.g., bank, etc.) who may insist on receiving the report on a timely basis.

2. Another option is to drop the engagement level to the issuance of a compilation report with a disclaimer for lack of independence. Although SSARS No. 21 permits (but does not require) disclosure of the reason for lack of independence (e.g., unpaid fees) in the accountant’s compilation report, few clients would want to disclose this fact as it suggests that the client has cash flow problems.

3. As a last resort, the accountant could forgive a portion or all of the unpaid fees and, perhaps, make up the difference in later engagements. If the accountant does forgive a portion or all of the unpaid fees, he or she should not make an agreement to recover the fees in a later engagement. Such an arrangement could be construed to be the equivalent of a defacto loan which may still impair independence.
Leasing Property to or from a Client

Question: A member or his/her firm leases property to or from a client. Is independence impaired with respect to the client?

Response: It depends whether the lease qualifies as an operating lease or a capital lease based on ASC 840, *Leases* (formerly FASB No. 13) criteria.

Independence is not impaired if:

- The lease qualifies as an operating lease,
- The terms and conditions of the lease are comparable with other leases of similar nature, and
- All amounts are paid in accordance with the lease terms or provisions

Independence is impaired if the lease meets the criteria of a capital lease as defined in ASC 840 (formerly FASB No. 13), *Leases*, because the lease would be considered a loan with an attest client. The exception is where the lease qualifies for certain grandfathering rules found in ET 1.260.020 with respect to loans and leases with lending institutions.

Observation: Under the above ruling, a member could rent office space from a client and still audit or review the client provided the lease terms and conditions were arm’s length and payments were made in accordance with the payment terms. Typically the lease of real property will not qualify as a capitalized lease because the lease term is less than 75% of the remaining useful life of the building and the lease does not satisfy the other three criteria for capitalizing a lease found in ASC 840.

Member Performs Services for Common Interest Realty Association

Question: A member or his/her firm is associated with, or a member of, a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Is the member or his/her firm’s independence impaired with respect to the CIRA?

Response: Yes. However, there is an exception whereby independence is not considered impaired if *all of the following conditions* are met:

- The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- The member or his/her firm’s annual assessment is not material to either the accountant or his/her firm or the CIRA’s operating budgeted assessments.
- The liquidation of the CIRA or the sale of common assets would not result in a distribution to the accountant or his/her firm, and
- Creditors of the CIRA would not have recourse to the accountant or CPA's firm if the CIRA became insolvent.

6. AICPA Professional Ethics Division FAQ
The AICPA’s Professional Ethics Division staff issued a FAQ regarding recent ethics inquiries. This Q&A is now incorporated into the new ethics codification.

The answers to these frequently asked questions (FAQs) are based on guidance the AICPA Professional Ethics Division staff provided in response to members’ inquiries and cover the following topics:

- Blind Trusts
- Campaign Contributions
- Disclosure of Commissions
- Independent Contractors
- Letter of Intent to Purchase Practice
- Pro Bono/Below Cost Fees

**Blind Trusts**

**Question:** A covered member creates a blind trust and transfers assets into the blind trust. The covered member will not supervise or participate in the trust’s investment decisions during the term of the trust. Will the trust and the underlying assets be considered the covered member’s direct financial interests?

**Answer:** Although the covered member will not supervise or participate in the trust’s investment decisions during the term of the trust, the trust and the underlying investments will be considered the covered member’s direct financial interest if: (1) the covered member retains the right to amend or revoke the trust, or (2) the underlying trust investments will ultimately revert to the covered member as the grantor of the trust.

**Campaign Contributions**

**Question:** May a member make a political contribution to the campaign of an individual that is associated with an attest client in a key position or holds a financial interest in the attest client that is material and/or enables the individual to exercise significant influence over the attest client without impairing independence or violating any other rule of conduct?

**Answer:** Yes. A member would not impair independence or be in violation of any other rule of conduct, provided the political contribution is not made with the intention of influencing the procurement of professional services or in contravention of federal or state laws or regulations.

**Disclosure of Commissions**

**Question:** When is a member required to disclose to a client that a commission will be received.

**Answer:** A member should disclose that a commission would be received at the time the referral is being made so that the client can decide whether to act on the recommendation.

**Independent Contractors**
**Question:** Would independence be impaired if a CPA firm retained an independent contractor (as defined by IRS regulations and other federal regulatory guidance such as case law and revenue rulings) on a part-time basis that is employed by or associated with an attest client in a key position?

**Answer:** Yes. Independence would be impaired if an independent contractor retained by the firm was simultaneously employed by or associated with an attest client in a key position. However, if the independent contractor is employed by or associated with the attest client in a non-key position, a member should consider the following criteria when determining if independence (in fact and appearance) is impaired:

a. Location of the firm office where the independent contractor will work in relation to the location of the office providing services to the attest client.

b. Whether the independent contractor performs services for other firms or entities or solely to the member’s firm. Factors to consider include but are not limited to:
   - The percentage of income the individual derives from the member’s firm in relation to the individual’s total “self-employed” or earned income.
   - The percentage of income the individual derives from the client entity in relation to the individual’s total earned income.
   - The amount of time the individual devotes to the member’s firm versus time devoted to the attest client.
   - The amount of time the individual devotes to the member’s firm versus time devoted to other firms or entities.

In situations where the threats to independence (in fact or appearance) are deemed not significant, the member and/or the member’s firm should consider the potential conflict of interest arising from such a relationship. If threats are significant, the member should consider whether safeguards are available to eliminate or reduce them to an acceptable level. If no safeguards could eliminate or reduce threats to an acceptable level, independence would be considered impaired.

**Letter of Intent to Purchase Practice**

**Question:** Would independence be impaired if a member enters into a non-binding letter of intent to sell his or her practice to a purchaser that is not independent with respect to one or more of the member’s attest clients?

**Answer:** No. A non-binding letter of intent to sell the member’s practice would not impair the independence of the member if the purchaser is not independent with respect to one or more of the member’s attest clients.

**Pro Bono/Below Cost Fees**

**Question:** May a member perform professional services for a client for no fee, or for a fee that is below cost without impairing independence or violating any other rule of conduct?

**Answer:** Yes. However, regardless of what fee is charged, members are required to comply with all professional standards that are applicable to the services performed. For example, a member must comply with the General Standards rule, which requires members to:
only undertake those professional services that the member or the member’s firm can reasonably expect to be completed with professional competence.

- exercise due professional care in the performance of professional services.
- adequately plan and supervise the performance of professional services.
- obtain relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

The member’s state board(s) of accountancy may have rules that are more restrictive than provided in the above guidance. Accordingly, members should consult with their state board(s) of accountancy for guidance.

**O. Responsibility to Third Parties: The Privity Standard**

Lawsuits initiated by clients against the accountant may take a different form than those from third parties, such as banks, investors, etc. Most frequently, the client sues for breach of contract using the notion that the accountant failed to render the agreed-upon services in the manner contracted in the engagement letter. Generally, an accountant may be sued under any one of the following *five causes of action:*

- **Breach of contract:** The accountant failed to perform the agreed-upon services in the manner contracted in the engagement letter (or verbally, if no engagement letter was signed).

- **Negligence:** The accountant failed to meet professional accounting standards.

- **Negligent misrepresentation:** The accountant provided erroneous information to the client through failure to exercise due care.

- **Fraud:** The accountant knowingly or recklessly made a material false statement of fact or omitted a material fact.

- **Breach of fiduciary duty:** The accountant failed to uphold the responsibility associated with professionalism and accountability. One example is the unauthorized disclosure of confidential client information.

Any one or all of the above five causes of action can be brought by a client against an accountant. However, what about damages claimed by third parties such as a bank, investor or bonding company? Since they usually are not a party to the contract (e.g., engagement letter), what causes of action can they bring?

For years, the answer has been found in the so-called *privity standard, developed* after a 1931 court case, *Ultramares Corp. v. Touche, Niven & Co.* (New York, 1931).

The privity (contract) standard states:

> “Accountants’ liability is limited to those third parties with whom the accountant has a contractual relationship.”
Under a strict interpretation of this standard, the accountant is exempt from responsibility to third parties unless the accountant has a contract with the third party. And, usually, the third party is not a party to the contract (engagement letter), giving the accountant a shield against third party lawsuits.

Unfortunately for accountants, since the inception of the privity standard in 1931, case law and most state statutes have watered down the privity standard to the extent that it now only applies in a few states such as Pennsylvania and Virginia.

The result is that, depending on the state of jurisdiction, responsibility to third parties can be categorized into four different levels as follows:

1. Privity (discussed above)
2. Near-privity
3. Restatement approach
4. Foreseeability approach

The most common approach adopted by states is the restatement approach, followed by the near-privity and then the least common being the foreseeability approach.

**Near-privity**: Under the near-privity (near-contract) standard, a third-party that does not have a contractual relationship with the accountant can still bring suit against an accountant for negligence if all three of the following conditions apply:

a. The accountant is aware that his or her financial report is to be used for a particular purpose,

b. A specific, known third party, intends to rely on the financial report, and

c. The accountant’s conduct clearly demonstrates that the accountant is aware the third party will rely on the financial report.

**Note**: The near-privity standard is based on the case of Credit Alliance Corporation v. Arthur Andersen & Co. (1985) in which an auditor was sued by a lender in connection with a client that filed bankruptcy. Under the near-privity standard, the accountant must know who the third party is and the fact that the specific third party will rely on the accountant’s report. The task of documenting that an accountant was aware of the third party’s reliance on the report has not been clearly decided by the courts since the Credit Alliance case. For example, is a telephone call initiated by a third party to an accountant adequate to confirm that the accountant knew the third party and that the party would rely on his or her report? It is not clear. What is clear is that knowing that some unidentified third party will receive the report is usually not enough. The identity of the third party must be known for the near-privity defense to be challenged by a third-party.

**Observation**: SSARS No. 21 permits an accountant to restrict the use of compiled or reviewed financial statements. This change provides an excellent opportunity for accountants in states that have near-privity third-party defenses to limit third-party liability. For example, in his or her compilation or review report, an accountant in New York State (currently a near-privity state) could restrict the use of the compiled or reviewed financial statements to a known named third party such as a particular bank. In doing so, the accountant restricts his or her liability to that named third party.
**Restatement approach:** In those states that follow the restatement approach, accountants are responsible to third parties who fall into *either one of two categories*:

1. Third parties the accountant *expressly knows* will be provided with the financial report, and

2. Third parties who are members of a *limited class of persons* to whom the accountant knows the financial report will be given.

**Note:** The restatement approach requires that the accountant know the *class of third party* (e.g., bankers, insurance companies, etc.), but not necessarily the name of the party. This is different from the requirement of the near-privity defense where the third party must be identified.

**Example 1:** Fred, an accountant reviews a client’s financial statements and issues a review report. Fred gives the client several copies of the financial statements *without knowing* specifically to whom the statements will be provided. The client gives a copy of the statements to a vendor who grants credit to the client. Subsequently, the client’s business fails and the vendor sues Fred for negligence. The state of jurisdiction follows the restatement approach for responsibility to third parties.

**Conclusion:** Fred is not liable to the vendor because he did not have notice that the financial statements would be given to the creditor or to a class of third parties (e.g. vendors).

**Example 2:** Same facts as example 1, except that during the review engagement, the client informs Fred that the statements will be issued to the vendor, names the vendor, and states that the vendor will be using the statements to grant credit to the client.

**Conclusion:** Under the restatement approach, Fred would be responsible to the vendor because he expressly knew the financial statements would be given to the vendor.

**Example 3:** Same facts as example 2, except that during the review engagement, the client informs Fred that the statements will be issued to one or more vendors without disclosing names.

**Conclusion:** Under the restatement approach, Fred would be responsible to any vendor to whom the statements were given because Fred was aware the statements would be given to a *particular class of third parties* (vendors).

**Note:** In the above series of examples, if the state of jurisdiction followed the near-privity standard, Fred would have been liable to the third party only in Example 2, where Fred was informed that a known, third party would rely on the report for a particular purpose: to grant credit.

**Foreseeability approach:** The accountant is liable to *any “reasonably foreseeable”* third-party recipient of the accountant’s financial report, provided the third party relies on the report for its proper business purpose. Further, the accountant is not required to know the specific third party or how the report will be used.

**Example:** An insurance company obtains a copy of a client’s financial statements used to issue an employee fraud policy. Subsequently, employee fraud was found and a claim was made against the policy. The insurance company sues the accountant, claiming that the accountant did not disclose
certain known information that would have resulted in rejection of the application. The state of jurisdiction follows the foreseeability approach to third-party liability.

**Conclusion:** Assuming there is negligence, the accountant is liable to the insurance company under the foreseeability approach. It was “reasonably foreseeable” for the insurance company to be the recipient of the accountant’s financial report. This is the case even though the accountant did not know about the insurance company or the purpose for which the insurance company would use the report.

**Observation:** The foreseeability approach is a very dangerous standard for accountants. The good news is that only a few states follow the foreseeability approach to third party liability. Luckily, very few states follow the foreseeability approach to accountant’s liability.

**P. Providing Records to a “Dead-Beat” Client**

**Facts:** Mary Jones, CPA has had XYZ Company as a client for twenty years. One day, XYZ calls Mary and tells her that XYZ is going to obtain a new CPA and asks Mary to return records in her possession. Mary is not overly disappointed with the loss of the client, but is very upset at the fact that XYZ has not paid its most recent bill due to Mary that remains outstanding. Mary wants to withhold the records until XYZ pays her bill in full. XYZ informs Mary that the records belong to XYZ and that Mary must return the records regardless of whether the bill is paid.

*What responsibility does an accountant have to return records to a client who has not paid his or her bill?*

ET sec. 1.400.200, *Records Requests*, gives guidance on this matter.

**Terminology**

The following terms are defined subsequently solely for use with this interpretation:

- The term **client** includes current and former clients.

- **Client-provided records** are accounting or other records belonging to the client that were provided to the member, by or on behalf of, the client, including hardcopy or electronic reproductions of such records.

- **Member-prepared records** are accounting or other records that the member was not specifically engaged to prepare and that are not in the client’s books and records or are otherwise not available to the client, with the result that the client’s financial information is incomplete. Examples include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) and supporting schedules and documents that are proposed or prepared by the member as part of an engagement (for example, an audit).

- **Member’s work products** are deliverables as set forth in the terms of the engagement, such as tax returns.

- **Member’s working papers** are all other items prepared solely for purposes of the engagement and include items prepared by the member, such as audit programs, analytical review
schedules, and statistical sampling results and analyses, and client, at the request of the member and reflecting testing or other work done by the member.

ET sec. 1.400.200 states:

1. Members must comply with the rules and regulations of authoritative regulatory bodies, such as the member's state board(s) of accountancy, when the member performs services for a client and is subject to the rules and regulations of such regulatory body.

For example, a member's state board(s) of accountancy may not permit a member to withhold certain records notwithstanding fees due to the member for the work performed. Failure to comply with the more restrictive provisions contained in the rules and regulations of the applicable regulatory body concerning the return of certain records would constitute a violation of ET sec. 1.400.200.

a. **Client-provided records**: in the member's custody or control should be returned to the client at the client’s request.

b. **Member-prepared records**: Unless a member and the client have agreed to the contrary, when a client makes a request for member-prepared records, or a member's work products that are in the custody or control of the member or the member's firm (member) that have not previously been provided to the client, the member should respond to the client’s request as follows:

- Member-prepared records relating to a completed and issued work product should be provided to the client, except that such records may be withheld if there are fees due to the member for the specific work product.

- Member's work products should be provided to the client, except that such work products may be withheld:
  - if there are fees due to the member for the specific work product
  - if the work product is incomplete
  - for purposes of complying with professional standards (for example, withholding an audit report due to outstanding audit issues), or
  - if threatened or outstanding litigation exists concerning the engagement or member's work.

- **Member's working papers** are the member’s property and do not have to be provided to the client; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

2. Once the member has complied with these requirements, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such records.

3. In connection with any request for client-provided records, member-prepared records, or a member's work products, the member may:
a. charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client
b. provide the requested records in any format usable by the client, and
c. make and retain copies of any records returned or provided to the client.

4. The member is *not required* to convert records that are not in electronic format to electronic format or to convert electronic records into a different type of electronic format. However, if the client requests records in a specific format, and the records are available in such format within the member's custody and control, the client's request should be honored. In addition, the member is not required to provide the client with formulas, unless the formulas support the client's underlying accounting or other records, or the member was engaged to provide such formulas as part of a completed work product.

5. Where a member is required to return or provide records to the client, the member should comply with the client’s request as soon as practicable but, absent extenuating circumstances, *no later than 45 days* after the request is made. The fact that the statutes of the state in which the member practices grant the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation.

**Observation:** ET sec. 1.400.200 gives accountants leverage in dealing with clients that have not paid their bills. More specifically, an accountant may withhold most client or accountant-prepared records until the bill is paid in full. Of course, many state licensing boards may not take the AICPA’s accountant-friendly approach outlined in ET sec. 1.400.200, and instead may require the accountant to give the client all applicable records and sue the client for collection of the unpaid bill.

**Q. Number of Days Test on Trade Receivables**

In a review or audit engagement, a practitioner is likely to perform a test of the number of days sales in accounts receivable.

Typically, the formula used is as follows:

\[
\text{Average AR} \times 365 = \text{Number of days sales in AR} \\
\text{Credit sales} \\
\text{Beginning plus ending AR/2}
\]

* Beginning plus ending AR/2

The above formula works from year to year if sales are consistent from month to month. If, however, there are fluctuations in monthly sales, the above formula will generate distort the results in comparing the number of days from year to year. Notice that the formula averages AR by adding beginning and ending AR and dividing by two. Unfortunately, that approach does not take into account cyclical fluctuations in monthly sales.
The result is that practitioners rely on the above formula which most software programs use. Then, when the result differs significantly from the prior year or expected number of days, the accountant has to explain the difference and perform additional procedures. In the end, the accountant typically determines that the difference from year to year is nothing more than a fluctuation in monthly sales.

Is there a better formula?

A more useful formula is to compute a weighted average number of days sales in AR.

Assume that as of December 31, 20X2 and 20X1, accounts receivable aging is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Current December</th>
<th>31-60 November</th>
<th>61-90 October</th>
<th>&gt; 90 September</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-31-X2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR</td>
<td>$2,400,000</td>
<td>$1,800,000</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Sales (given)</td>
<td>18,000,000</td>
<td>2,500,000</td>
<td>2,000,000</td>
<td>1,400,000</td>
<td>1,400,000</td>
</tr>
</tbody>
</table>

12-31-X1 given
AR $1,800,000
# days (weighted-average formula) 34 days

If the number of days is calculated using an average, the results follow:

12-31-X2:

\[
\begin{array}{c}
\text{Average AR} \\
\text{Net sales} \\
\end{array} \times 365 = 42.5 \text{ days}
\]

\[
\begin{array}{c}
2,100,000^* \\
18,000,000 \\
\end{array}
\]

\[
^* \frac{(2,400,000 + 1,800,000)}{2} = 2,100,000
\]

Instead, if the accountant computes number of days based on a weighted-average basis, the calculation is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Current December</th>
<th>31-60 November</th>
<th>61-90 October</th>
<th>&gt; 90 September</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-31-X2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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<td>$1,800,000</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Sales (given)</td>
<td>18,000,000</td>
<td>2,500,000</td>
<td>2,000,000</td>
<td>1,400,000</td>
<td>1,400,000</td>
</tr>
<tr>
<td>% AR/Sales</td>
<td></td>
<td>72.0%</td>
<td>15%</td>
<td>14.4%</td>
<td>7.1%</td>
</tr>
<tr>
<td># days in month</td>
<td>31</td>
<td>30</td>
<td>31</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td># days</td>
<td>33.4</td>
<td>22.3</td>
<td>4.5</td>
<td>4.5</td>
<td>2.1</td>
</tr>
</tbody>
</table>

**Conclusion:** By using the weighted-average calculation, the number of days sales is 33.4 versus 42.5 using a straight average computation. The result is that by using the weighted-average computation, the 33.4 days in 20X2 is comparative with 34 days at the end of 20X1.
Review Questions

1. Facts: Mary CPA is hired to review the financial statements of Company Y for the year ended December 31, 20X4. Mary performed nonattest services including controllership services for Y in 20X2 during a year during which Mary reviewed the financial statements. Which of the following is correct:
   a. Mary’s independence for 20X4 is not impaired
   b. Mary’s independence for 20X4 is impaired because Mary performed controllership services in 20X2
   c. Mary’s independence for 20X4 is impaired because Mary performed a review for Y in 20X2
   d. There is no authority to deal with whether Mary’s independence is impaired in 20X4

2. Which of the following is considered an attest service:
   a. Financial statement preparation
   b. Reconciliations
   c. Cash-to-accrual conversions
   d. Review engagement procedures

3. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client regarding all of the following critical elements except:
   a. Objectives of the nonattest engagement
   b. Client’s acceptance of its responsibilities
   c. Member’s responsibilities
   d. Cost of the services

4. Which of the following is not true regarding the documentation requirement for nonattest services:
   a. Where a member only provides nonattest services for a client, the requirements are not effective until the client becomes an attest client
   b. The rules for documentation do not dictate the form of the written documentation
   c. The failure to prepare the required documentation would impair independence under any circumstances
   d. If a client engages a member to perform tax services, the understanding could be documented in the member’s billing or correspondence files

5. For tax services, which of the following is not one of the skills, knowledge or experience a designated individual for a client should possess to be considered competent:
   a. The client should understand the tax law
   b. The client should understand the company’s tax situation
   c. The client should have a general understanding of how the amounts in the tax return were determined
   d. The client should make all decisions regarding significant tax positions taken in the return

6. The key factor in determining whether the performance of bookkeeping services impairs the accountant’s independence is:
   a. The cost of the services
   b. Whether the accountant assumes management responsibilities for the attest client
   c. The amount of time involved in performing the services
   d. The accountant’s experience level in performing the services
7. Which of the following is correct regarding the performance of nonattest services as part of a compilation engagement:
   a. The written documentation requirement of ET 1.295 does not apply to compilation engagements that do not disclaim independence
   b. The same issues apply to a compilation engagement as they do to an audit or review engagement
   c. If the accountant prepares any source documents, he or she does not have to disclaim independence in the compilation report
   d. The accountant is required to document the client’s understanding of their responsibilities in a compilation engagement letter

8. With regard to tax compliance services performed on an attest client, the accountant should:
   a. Assume management responsibilities
   b. Evaluate the adequacy and results of the nonattest tax services
   c. Document in writing the objectives of the nonattest tax engagement
   d. Accept responsibility for the results of the nonattest tax services

9. Which of the following impairs an accountant’s independence related to payroll services:
   a. Authorizing or approving payment of payroll taxes
   b. Processing the client’s payroll from client-approved payroll time records
   c. Transmitting client-approved and reviewed payroll tax returns
   d. Reviewing the client’s payroll tax returns for errors

10. Harry Callahan, CPA reviews the financial statements of Company X for December 31, 20X1. During 20X1, Harry was a signatory of one of X’s bank accounts solely in the capacity as a backup signatory which Jimmy Jacobs, X’s sole owner, is on vacation. Harry did not actually sign any checks in 20X1. Which of the following is correct:
    a. Harry’s independence is not impaired
    b. Harry is permitted to perform his review engagement because his signatory status was only as a backup
    c. Harry’s independence is impaired
    d. A key factor as to whether Harry’s independence is impaired is whether Harry actually signed any checks during 20X1

11. Which of the following valuations would generally not impair independence:
    a. Valuation of a business combination
    b. Appraisals of assets or liabilities
    c. Valuation of ESOPs
    d. Valuation of pension or postemployment benefit liabilities

12. Which of the following would impair an accountant’s independence with respect to litigation services:
    a. Answering questions while testifying as a fact witness
    b. Serving as a mediator by assisting the parties in reaching their own agreement
    c. Agreeing to serve as an expert witness after providing litigation consulting services
    d. Providing expert witness services for a large group under any circumstances
13. Which of the following services can an accountant perform for a client without impairing independence with regard to hiring personnel:
   a. Interview the candidate
   b. Negotiate the candidate’s employee compensation or benefits
   c. Actually hire the employee
   d. Make the decision on behalf of the client regarding personnel

14. Under which of the following is the accountant exempt from responsibility to third parties unless the accountant has a contract with the third party:
   a. Privity standard
   b. Near-privity
   c. Restatement approach
   d. Foreseeability approach

15. According to ET sec. 1.400.200, Records Requests, which of the following must be returned to a client, even if there are unpaid fees due:
   a. Client-provided records
   b. Member-prepared records
   c. Member’s working papers
   d. Member’s work products
Glossary

**Analytical procedures:** Evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**Applicable financial reporting framework:** The financial reporting framework adopted by management and, when appropriate, those charged with governance, in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation.

**Assurance engagement:** An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

**Attest engagement:** An engagement that requires independence, as defined in AICPA Professional Standards.

**Basic financial statements:** Financial statements excluding supplementary information and required supplementary information.

**Cash basis:** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

**Designated accounting standard-setter:** A body designated by the Council of the AICPA to promulgate accounting principles generally accepted in the United States of America pursuant to Rule 202, Compliance With Standards (AICPA, Professional Standards, ET sec. 202 par. .01), and Rule 203, Accounting Principles (AICPA, Professional Standards, ET sec. 203 par. .01), of the AICPA Code of Professional Conduct.

**Emphasis-of-matter paragraph:** A paragraph included in the accountant’s review report that is required by SSARSs, or is included at the accountant’s discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the accountant’s professional judgment, is of such importance that it is fundamental to the users’ understanding of the financial statements.

**Engagement letter:** An engagement letter spells out the type and extent of the services to be provided, any limitations of these services agreed to, the timing and deadlines for performance, as well as possibly describe what is expected of you, the client.

**Error:** Mistakes in the financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosures.

**Experienced accountant:** An individual (whether internal or external to the firm) who has practical review experience, and a reasonable understanding of review processes, SSARSs and applicable legal
and regulatory requirements, the business environment in which the entity operates, and review and financial reporting issues relevant to the entity’s industry.

**Financial reporting framework:** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (for example, U.S. GAAP, International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework).

**Fraud:** An intentional act that results in a misstatement in financial statements.

**Misstatement:** A difference between the amount, classification, presentation, or disclosure of a reported financial item in the financial statements and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

**Noncompliance:** Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to prevailing laws or regulations. Such acts include transactions entered into, by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

**Other-matter paragraph:** A paragraph included in the accountant’s review report that is required by SSARSs, or is included at the accountant’s discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the accountant’s judgment, is relevant to users’ understanding of the review, the accountant’s responsibilities, or the accountant’s review report.

**Predecessor accountant:** An accountant who has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

**Prescribed form:** Is a standard preprinted (financial statement) form designed or adopted by the body to which it is to be submitted, such as a bank financial statement.

**Privity standard:** Accountant’s liability is limited to those third parties with whom the accountant has a contractual relationship.

**Required supplementary information:** Information that a designated accounting standard-setter requires to accompany an entity’s basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard-setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of that information have been established.

**Review documentation:** The record of review procedures performed, relevant review evidence obtained, and conclusions the accountant reached (terms such as working papers or workpapers are also sometimes used).
**Review evidence:** Information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.

**Special purpose framework:** A financial reporting framework other than generally accepted accounting principles (GAAP) that is one of the following bases of accounting: cash basis, tax basis, regulatory basis, contractual basis, or other basis that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

**Specified parties:** The intended users of the accountant’s review report.

**Subsequent events:** Events occurring between the date of the financial statements and the date of the accountant’s review report.

**Subsequently discovered facts:** Facts that become known to the accountant after the date of the accountant’s review report that, had they been known to the accountant at that date, may have caused the accountant to revise the accountant’s review report.

**Successor accountant** – An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement, or an accountant who has accepted the engagement.

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

**Those charged with governance:** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

**Updated report:** A report issued by a continuing accountant that takes into consideration information that the accountant becomes aware of during the accountant’s current engagement and that re-expresses the accountant’s previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period reviewed by the accountant as of the date of the accountant’s current report.

**Written representation:** A written statement by management provided to the accountant to confirm certain matters or to support other review evidence. Written representations in this context do not include financial statements or supporting books and records.
Review Question Answers

Review Questions – Section 1

1. Which of the following represents a change made by SSARS No. 21 to the compilation and review standards:
   a. Incorrect. AR-C section 60 supersedes previous AR section 60 found in SSARS No. 19.
   b. Correct. SSARS No. 21 introduces a new AR-C section 70 for preparation of financial statements that did not exist under SSARS No. 19 and did not supersede any previous section.
   c. Incorrect. AR-C section 80 replaces previous AR section 80 which was part of SSARS No. 19.
   d. Incorrect. AR-C section 90 supersedes previous AR section 90, which was part of SSARS No. 19.

2. One key change made by SSARS No. 21 which represents a carryover of an element found in auditing standards is which of the following:
   a. Incorrect. SSARS No. 21 carries over the introduction (and not the elimination) of the "other matter" paragraph which is now authorized by auditing standards.
   b. Incorrect. The requirement to perform analytical procedures in a review engagement is not carried over from auditing standards. This requirement has existed in review standards for years and is not influenced by any auditing standards.
   c. Incorrect. SSARS No. 21 does not carry over from auditing standards the requirement that an accountant perform inquiries in a review engagement. Although it is true that inquiry procedures may be part of an audit engagement, as well as a review engagement, such procedures have been required in a review engagement for years and is not influenced by auditing standards.
   d. Correct. Auditing standards changed the term "illegal acts" to a new term "noncompliance with laws and regulations." The new change is reflected in SSARS No. 21 consistent with the change made in auditing standards.

3. Before an accountant accepts any engagement under SSARS No. 21, which of the following is a precondition or condition that, if not satisfied, would result in the accountant not accepting the engagement:
   a. Incorrect. The integrity of third parties who might rely on the financial statements is not listed as a precondition under Paragraph .24 of AR-C 60, making the answer incorrect.
   b. Incorrect. Whether the bank that will receive the financial statements is ethical or not does not impact the accountant. The accountant is performing the engagement for the entity, and not the bank.
   c. Incorrect. In a SSARS No. 21 engagement (compilation, review or preparation), generally, confirmation procedures are not performed so that the accountant would not be concerned about whether the bank responds to receivable and cash confirmations. The accountant would, however, be concerned about getting other information that is necessary to perform the engagement.
   d. Correct. SSARS No. 21 states that an accountant should not accept a SSARS engagement if he or she doubts management's integrity to the extent that it is likely to affect the accountant's performance of the engagement. Thus, the answer is correct.
Review Questions – Section 2

1. To which of the following engagements do the standards found in AR-C 70 of SSARS No. 21 apply assuming an accountant is engaged to perform the engagement:
   a. Incorrect. A preparation of financial statements engagement under AR-C 70 requires the accountant to be in public accounting, not industry, making the answer incorrect. If the accountant were in public accounting, the fact that there is no other engagement performed on those financial statements would make the engagement subject to the AR-C 70 standards.
   b. Incorrect. In order for the preparation of financial statements engagement to be covered by AR-C 70, not only must the accountant be in public practice, but there cannot be any compilation, review or audit engagement performed on those same financial statements. In this case, an audit is performed. Thus, the answer is incorrect.
   c. Correct. A preparation of financial statements engagement is covered by AR-C 70 if an accountant is in public practice and the accountant is not engaged to perform any other engagement on those same financial statements. Both of those requirements are met making the answer correct.
   d. Incorrect. The answer is incorrect for two reasons. First, a preparation of financial statements engagement requires the accountant to be in public practice, which is not the case in this example. Second, there can be no compilation, review or audit engagement performed on the same financial statements. In this example, a review engagement is being performed, thereby disqualifying the engagement for coverage under AR-C 70.

2. Which of the following is correct with respect to the rules for a preparation of financial statements engagement under AR-C 70:
   a. Incorrect. The accountant is not required to be independent to perform a preparation engagement under AR-C 70.
   b. Incorrect. In general, no report is required in a preparation of financial statements engagement.
   c. Incorrect. The engagement letter must be signed by both management and the accountant making the answer incorrect.
   d. Correct. AR-C 70 permits the prepared financial statements to be issued to the client or a third party without any restrictions.

3. An accountant performs a preparation of financial statements engagement under AR-C 70. The accountant obtains information from management to prepare the financial statements. Which of the following properly identifies the accountant's responsibility with respect to the information obtained from management:
   a. Incorrect. AR-C 70 states that the accountant is not required to verify the accuracy of the information or, for that matter, gather evidence to express an opinion.
   b. Incorrect. Per AR-C 70, the accountant is not required to verify the completeness of the information.
   c. Incorrect. AR-C 70 is quite clear that the accountant is not required to verify the completeness or the accuracy of the information.
   d. Correct. AR-C 70 states that the accountant is not required to verify the accuracy or completeness of the information. Moreover, the accountant is not required to gather evidence to express an opinion or a conclusion on the statements.
4. In a preparation of financial statements engagement, which of the following is an appropriate legend to place on each page of the financial statements:
   a. Incorrect. The legend "See Accountant's Preparation Report" is not appropriate primarily because there is no report.
   b. Correct. SSARS No. 21, AR-C 70 states that a legend should be included on each page of prepared financial statements similar to "No assurance is provided on these financial statements" or "These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them."
   c. Incorrect. Although there is nothing to preclude an accountant from including a legend, "See Notes to Financial Statements," AR-C 70 does not mention that legend. Further, in many cases in a preparation engagement, management may elect to omit substantially all disclosures so that there are no notes to reference.
   d. Incorrect. AR-C 70 does not mention a legend such as "See Independent Accountant's Report." In particular, an accountant might not be independent in a preparation of financial statements engagement.

5. Sophia Rapallo is an accountant who is hired to prepare financial statements for her client. The client wants her to prepare her financial statements on the tax basis, which is a special purpose framework. What must the accountant do with respect to the special purpose framework:
   a. Incorrect. There is no report in a preparation of financial statements engagement in which to include a description.
   b. Incorrect. Sophia has a choice of including a description either in the notes to financial statements or on the face of the financial statements making the answer incorrect.
   c. Correct. AR-C 70 provides that a description must be provided either on the face of the financial statements or the notes to the financial statements making the answer correct.
   d. Incorrect. A modification is required which is to provide a description of the tax basis special purpose framework. Thus, the answer is incorrect.

6. Elaine Liberman is performing a preparation of financial statements engagement under AR-C 70. Elaine discovers a significant error that makes the financial statements inaccurate. How should Elaine handle this profound discovery of a significant error:
   a. Incorrect. AR-C 70 does not permit Elaine to stick her head in the sand. Instead, she must bring the matter to the attention of management.
   b. Incorrect. There is no requirement to bring the error or any other notification to the attention of the users. The responsibility is to bring the error to the attention of management.
   c. Correct. AR-C 70 is quite clear that if during a preparation engagement, the accountant becomes aware of incomplete, inaccurate, or otherwise unsatisfactory information, the accountant is required to bring that fact to the attention of management and request additional information or corrected information. Thus, the answer is correct.
   d. Incorrect. There is no report so that there is no mechanism to identify the error in a report.

7. Joseph Coatman is performing a preparation of financial statements engagement under AR-C 70. The financial statements omit substantially all disclosures. Which of the following is the correct way in which Joseph should deal with the omission of disclosures:
   a. Correct. AR-C 70 requires that the disclosure of the omission be made either on the face of the financial statements or in a note, making the answer correct.
   b. Incorrect. Joseph has the choice of presenting the disclosure of the omission either in a note to the financial statements or on the face of the financial statements.
c. Incorrect. AR-C 70 requires that a disclosure of the omission be made, making the answer incorrect.
d. Incorrect. There is no preparation report making the answer incorrect. If there is a disclaimer report, including the disclosure of the omission in that disclaimer report is not appropriate nor authorized by AR-C 70.

8. An accountant is performing a preparation of financial statements engagement under AR-C 70 on a client's financial statements. There is no statement of cash flows and substantially all disclosures are omitted. Which of the following identifies the legends that should be presented on each page of the financial statements:
   a. Correct. There should be three legends as follows: one for "no assurance," one for the omission of a statement of cash flows, and one for substantially all disclosures not being included.
   b. Incorrect. There is automatically one legend regarding the "no assurance on the financial statements." Then, there must be one for the GAAP departure (no statement of cash flows) and one for the omission of disclosures. AR-C 70 requires legends/disclosures when there is a GAAP departure and substantially all disclosures are omitted. Thus, the total cannot be two legends.
   c. Incorrect. The answer cannot be one legend if following the requirements of AR-C 70. There is one "no assurance" legend for all prepared financial statements. Because there is a GAAP departure and substantially all disclosures are omitted, there are two more disclosures/legends. Thus, one legend is incorrect.
   d. Incorrect. There are three legends and certainly more than zero legends, making the answer incorrect. At a minimum, there is a "no assurance" legend. The fact that the accountant does not have a disclaimer report means that the "no assurance" legend is included. That "no assurance" legend, by itself, is at least one legend making the answer incorrect.

9. Which of the following is an item that should be documented in a preparation of financial statements engagement under AR-C 70:
   a. Correct. AR-C 70 states that an accountant's documentation should include a copy of the financial statements that the accountant prepared.
   b. Incorrect. There is no accountant's preparation report making the answer incorrect. If there were a disclaimer report, it would be included. However, a "preparation report" is identified, not a "disclaimer report."
   c. Incorrect. AR-C 70 does not conclude that a preparation checklist should be documented or even used, making the answer incorrect.
   d. Incorrect. AR-C 70 does not require that an accountant obtain a management representation letter in a preparation engagement. Thus, the answer is incorrect.

**Review Questions - Section 3**

1. In accordance with AR-C 80, when is an accountant required to perform a compilation engagement:
   a. Incorrect. The existing rules found in AR 80 have as a threshold that an accountant must compile financial statements if he or she has submitted financial statements. This requirement is eliminated by AR-C 80.
b. Correct. Under AR-C 80, the only time in which an accountant is be required to perform a compilation engagement is when he or she is engaged (hired) to perform a compilation engagement. The accountant is never forced to perform a compilation engagement.

c. Incorrect. AR-C 80 does not provide any guidance for defaulting to a compilation engagement if the accountant is unable to perform a review engagement.

d. Incorrect. A preparation engagement under AR-C 70 is separate and distinct from a compilation engagement under AR-C 80.

2. An accountant is unable to complete his compilation engagement because management has failed to provide records and documents, as requested. What should the accountant do:
   a. Correct. AR-C 80 states that the accountant should withdraw from the engagement and explain the reasons why if he or she is unable to complete the engagement because management has failed to provide records, documents, explanations, or other information.
   b. Incorrect. There is no authority to report the client to the third party users.
   c. Incorrect. The accountant has no authority to go around the client and obtain the information directly from third parties. Such an action would require the client's approval.
   d. Incorrect. AR-C 80 states that the accountant must do something which is to withdraw from the engagement. Thus the answer is incorrect.

3. Monti Hall is preparing a compilation report for a client under the new AR-C 80 compilation standards. Which of the following is correct with respect to the new compilation report:
   a. Incorrect. The new report does not require that an addressee be included.
   b. Correct. AR-C 80's compilation report no longer requires a report title, such as "Accountant's Compilation Report" making the answer correct.
   c. Incorrect. AR-C 80 maintains the requirement that the entity is identified in the report, making the answer incorrect.
   d. Incorrect. The AR-C 80 report carries over the requirement that the date and period covered is still required.

4. Under the new AR-C 80 standards, in a compilation engagement, a legend "See Accountant's Compilation Report" is _________.
   a. Incorrect. AR-C 80 no longer requires that the legend be included on each page of the financial statements, making the answer incorrect.
   b. Correct. AR-C 80 states that an accountant "may request" that management include the reference on each page of the financial statements, which means it is not required.
   c. Incorrect. Nothing found in AR-C 80 states that it is not permitted, making the answer incorrect.
   d. Incorrect. AR-C 80 does not change "See Accountant's Compilation Report" to "See Accountant's Report" making the answer incorrect.

5. Eliah Levin is an accountant who is asked to perform a compilation engagement for his wife's business. How should Eliah address the independence issue in his report:
   a. Incorrect. Eliah and his wife are clearly related parties for which Eliah has an independence issue. There is no special exemption for a husband and wife.
   b. Correct. SSARS No. 21, AR-C 80 requires that Eliah disclose the lack of independence in the compilation report in the final paragraph.
   c. Incorrect. The lack of independence issue is a reporting matter that belongs in Eliah's compilation report, not in the notes to financial statements, making the answer incorrect.
d. Incorrect. The SSARSs do not have any requirement for Eliah to include a legend on each page of the financial statements stating "Accountant is Not Independent." However, there is nothing that precludes the accountant from doing so, either.

6. Jennifer Lopez is issuing a compilation report on financial statements. A schedule of operating expenses is accompanying the financial statements. What are Jennifer's reporting options with respect to the schedule of operating expenses:
   a. Incorrect. AR-C 80 states that an accountant who compiles financial statements is not permitted to review the supplementary information. Thus, the answer is incorrect.
   b. Incorrect. If the financial statements are compiled, the supplementary information may not be audited or reviewed because to do so would mean the level of service performed on the supplementary information would be higher than the level provided on the underlying financial statements.
   c. Correct. AR-C 80 permits the accountant to compile the schedule as supplementary information. In doing so, the accountant must include an other-matter paragraph in the compilation report addressing the compilation of the supplementary information.
   d. Incorrect. The schedule is not a financial statement. Therefore, it should not be treated as a financial statement such as a balance sheet or income statement. Thus, the answer is incorrect.

7. Which option under SSARS No. 21 does the author suggest offers the best alternative to issuing management-use only financial statements previously authorized by SSARS No. 19:
   a. Incorrect. Although a compilation engagement and issuance of a traditional compilation report is an option, it is not a good alternative because a compilation report must be issued. Management-use only financial statements do not require a report under current standards.
   b. Correct. The performance of a preparation of financial statements engagement under AR-C 70 may offer the best alternative to SSARS No. 19's management-use only financial statements option. The primary reason is because both engagements do not require a report to be issued. Moreover, the preparation of financial statements engagement under AR-C 70 may be issued to third parties while the management-use only engagement previously authorized by SSSARS No. 19 could not be issued to third parties.
   c. Incorrect. Upgrading to a review engagement does not appear to be the best alternative because it results in more work than a management-use only engagement and results in a report being issued.
   d. Incorrect. The author suggests that there is a viable alternative which is to perform a preparation of financial statements engagement.

8. Which of the following is a required item that must be documented in a compilation engagement under AR-C 80:
   a. Correct. The accountant should document that he or she has an engagement letter signed by both the accountant and management.
   b. Incorrect. Analytical procedures and the documentation of those procedures are part of a review engagement and do not have to be performed in a compilation engagement. Thus, the answer is incorrect.
   c. Incorrect. Inquiries of management and others and the documentation of those inquiries are not required in a compilation engagement but are required in a review engagement, making the answer incorrect.
   d. Incorrect. A management representation letter is not required in a compilation engagement, and thus is not included in the documentation in a compilation engagement. The answer is incorrect.
Review Questions – Section 4

1. Which of the following is not information on which an accountant may perform a review engagement under AR-C 90:
   a. Incorrect. AR-C 90 provides that a review engagement may be performed on financial statement such as a balance sheet. Thus the answer is incorrect.
   b. Correct. The review standards found in AR-C 90 do not apply to prospective information. The primary reason is because it is difficult to provide limited assurance on prospective information.
   c. Incorrect. AR-C 90 states that the review standards apply to a specified element, such as a schedule of rental income. Thus, the answer is incorrect.
   d. Incorrect. AR-C 90 states that the review standards apply to a specified account, such as a schedule of accounts receivable. Thus, the answer is incorrect.

2. One requirement made by AR-C 90 is that in a review engagement, the accountant should communicate with management about______________:
   a. Incorrect. Deficiencies in internal control, although important, are generally the focus of an audit engagement, not a review engagement.
   b. Correct. AR-C 90 requires that an accountant communicate on a timely basis all matters from the review engagement that are of significant importance to merit the attention of management and those charged with governance.
   c. Incorrect. Although calculations of analytical procedures are an important part of a review engagement, they are not identified as a typical matter that is communicated to management making the answer incorrect.
   d. Incorrect. In general, an accountant may be restricted by law or regulation to communicate certain matters that are specifically prohibited. Thus, the answer is incorrect.

3. John is an accountant performing a review engagement. John has a limited knowledge of the client's industry. Which of the following is correct:
   a. Incorrect. AR-C 90 permits John to perform the engagement as long as he obtains the required level of knowledge of the industry.
   b. Incorrect. John must obtain a level of knowledge but nothing in AR-C 90 requires that he obtain extensive training to obtain that level of knowledge.
   c. Incorrect. Nothing in AR-C 90 requires John to bring on a co-reviewer who has extensive industry experience. Thus, the answer is incorrect.
   d. Correct. AR-C 90 specifically states that there is nothing that prevents John from accepting the review engagement as long as he obtains the required level of knowledge.

4. Alice is an accountant performing a review engagement. She decides to confirm a bank loan directly with the bank. Which of the following is correct:
   a. Incorrect. AR-C 90 states that if an audit procedure is performed, Alice is not required to step up her engagement to an audit. Thus, the answer is incorrect.
   b. Correct. AR-C 90 states that an accountant may perform audit procedures and the engagement remains a review. Thus, the answer is correct.
   c. Incorrect. Alice is not required to perform any audit procedures, making the answer incorrect.
d. Incorrect. Nothing in AR-C 90 prevents Alice from sending the confirmation even if she is performing a review engagement. Thus, the answer is incorrect.

5. Which of the following is a new requirement that AR-C 90 adds for a review engagement:
   a. Incorrect. The requirement that an accountant perform analytical procedures is not a new requirement in a review engagement making the answer incorrect.
   b. Incorrect. Making inquiries of management and others is not a new review procedure. It previously existed in SSARS No. 19.
   c. Correct. SSARS No. 21, AR-C 90 adds a new requirement that an accountant should obtain evidence that the financial statements agree or reconcile with the accounting records, such as the general ledger. This action was implicit under previous standards and now is explicitly required.
   d. Incorrect. Existing standards require an accountant to obtain a management representation letter so that this requirement is not new under AR-C 90.

6. AR-C 90 provides guidance as to what is deemed a material misstatement. It states that misstatements are material if, individually or in the aggregate ____________.
   a. Incorrect. Although rule of thumb approaches based on a percentage of some base are used in practice, the definition of materiality is not codified based on a fixed quantitative percentage, making the answer incorrect.
   b. Incorrect. Materiality is based on how a transaction(s) influences the end users and not management, making the answer incorrect.
   c. Correct. Materiality is measured based on how it affects end users and whether the misstatements could reasonably be expected to influence the economic decisions of those users.
   d. Incorrect. AR-C 90 states that materiality is determined based on consideration of the common financial information needs of users as a group, with the possible effect on specific individual users not considered. Thus, the answer is not correct.

7. Which of the following is not an appropriate paragraph heading in a review report:
   a. Incorrect. AR-C 90 provides that one of the paragraphs in the review report should have the heading "Accountant's Responsibility" and should describe the accountant's responsibility in conducting the review engagement.
   b. Correct. A paragraph labeled with an "Opinion" heading is not authorized by AR-C 90 and, instead, is a paragraph in the audit report. In a review report, because there is limited assurance given by the accountant, the heading "opinion" is inappropriate because an opinion is not given by the accountant.
   c. Incorrect. AR-C 90 provides that one of the paragraphs in the review report is "Management's Responsibility for the Financial Statements" within which the responsibilities of management are identified.
   d. Incorrect. The "Accountant's Conclusion" paragraph is the final paragraph in a review report in which the accountant offers negative assurance on the financial statements.

8. Which of the following is an example of a circumstance in which an auditor may consider it necessary to include an other-matter paragraph in his or her report:
   a. Incorrect. An emphasis-of-matter paragraph is used, instead of an other-matter paragraph, when there are significant transactions with related parties. The reason is because the transaction is also disclosed in the notes to financial statements.
b. **Correct.** Paragraph 80 of AR-C 90 states that an other-matter paragraph should be included in the accountant's review report when there is supplementary information that accompanies reviewed financial statements.

c. **Incorrect.** When there is an uncertainty regarding an entity's ability to continue as a going concern, AR-C 90 requires that an emphasis-of-matter paragraph be used instead of an other-matter paragraph. The prime reason is because the uncertainty would also be disclosed in the notes. An emphasis-of-matter is used when a matter is disclosed in both the report and the notes to financial statements.

d. **Incorrect.** AR-C 90 states that an emphasis-of-matter paragraph, not an other-matter paragraph, must be used when there is an unusually important subsequent event.

9. In AR-C 90, the term "illegal acts" is replaced by the term _____________.
   a. Incorrect. Although fraud is considered in a review engagement, the term "fraudulent activities" is not the successor of illegal activities, making the answer incorrect.
   b. Incorrect. AR-C 90 does not use the term "unconventional transactions" to reflect any type of transactions, making the answer incorrect.
   c. Incorrect. The term "unethical actions" is not used as a successor to illegal acts making the answer incorrect.
   d. **Correct.** AR-C 90 carries over from auditing standards the term "noncompliance with laws and regulations" which supersedes the term "illegal acts." Under the rules, an accountant is required to communicate suspected noncompliance with laws and regulations to management, unless such matters are clearly inconsequential.

**Review Questions – Section 1**

1. Which of the following is correct regarding accountants who perform write-up services for attest clients:
   a. **Correct.** Write-up services are certainly not a risk free engagement evidenced by malpractice cases against accountants in bookkeeping and write-up engagements.
   b. Incorrect. Malpractice cases have actually increased, not declined in recent years. Undetected fraud in cash and accounts receivable is the number one charge against accountants in write-up engagements.
   c. Incorrect. Although write-up engagements are a non-attest service, that fact, in and of itself, does not mean the accountant lacks independence with respect to that particular client.
   d. Incorrect. One way to mitigate risk associated with performing write-up services is to obtain an engagement letter.

2. John is an accountant who is asked to perform certain activities for a client. Which of the following would not impair John's independence:
   a. Incorrect. Preparing source documents, such as purchase orders, does impair independence because the accountant is making management decisions.
   b. Incorrect. Acting as a custodian of client assets impairs independence because the accountant is taking management responsibility.
   c. **Correct.** Acting as an advisor to the board of directors does not impair independence because the accountant is not making management decisions. However, meeting with the board on behalf of management would impair independence.
d. Incorrect. Acting as an escrow agent or registrar for the client does impair independence because the accountant is taking management responsibility and may have custody of client assets.

3. If an accountant is in public practice and performs controllership services as an employee of the entity, the accountant ____________:
   a. Incorrect. The accountant is not required to comply with SSARS No. 21 unless he or she is engaged (hired) to perform a SSARS engagement. Instead, the accountant has a choice to either being hired to perform a SSARS No. 21 engagement, or issuing financial statements in the capacity as an employee of the entity, in which case he or she must communicate the accountant’s relationship to the entity. If hired to perform a SSARS No. 21 engagement, the accountant most likely cannot perform a review engagement because he or she is not independent due to the controllership position.
   b. Incorrect. The accountant has to communicate his or her relationship to the entity only if the accountant chooses to issue financial statements in the capacity as a controller.
   c. Correct. The accountant may have two options depending on the circumstances. First, if he or she is engaged (hired) to perform an engagement under SSARS No. 21, he or she would comply with SSARS No. 21. Alternatively, if not hired to perform a SSARS No. 21 engagement, the accountant may issue financial statements in his or her capacity as a controller in which case he or she must communicate the accountant’s relationship to the entity. Such a communication may be done by using a transmittal letter that identifies the accountant as a controller.
   d. Incorrect. The accountant is permitted to issue a report under SSARS No. 21 (such as a compilation or review report) if hired to perform a SSARS engagement. There is no requirement that he or she be an executive of the entity, making the answer incorrect.

4. Which of the following is true regarding the issuance of draft financial statements:
   a. Incorrect. An accountant may submit draft financial statements under certain situations, making the answer incorrect.
   b. Correct. SSARS No. 21 permits an accountant to issue draft financial statements to a client so that the client has the opportunity to read the financial statements and analyze them before final issuance.
   c. Incorrect. If draft financial statements are issued, they should be clearly labeled as “Preliminary Draft, For Discussion Purposes Only” or a similar label.
   d. Incorrect. An accountant cannot control the distribution of draft financial statements once they are issued to the client, even if restrictions of issuance are noted on those draft statements.

5. As defined in SSARS No. 21, an intentional act that results in a misstatement in compiled or reviewed financial statements is considered a(an):
   a. Correct. Fraud is defined as an intentional act, making the answer correct.
   b. Incorrect. Noncompliance with a law may be intentional or unintentional and represents an act that is contrary to prevailing laws. Such an act does not necessarily result in a financial statement misstatement.
   c. Incorrect. In general, an error is not deemed to be an intentional act. An error differs from a fraud in that an error is generally unintentional while a fraud is an intentional act.
   d. Incorrect. An irregularity is not defined as an intentional act.

6. As it relates to fraud in a review engagement, an accountant is:
a. **Correct.** An accountant is not responsible for considering fraud in either a compilation or review engagement.

b. Incorrect. Management, not the accountant, is responsible for the prevention of fraud.

c. Incorrect. SSARS No. 21 does require the accountant to inform management of any fraud that come to the accountant’s attention, regardless of whether a compilation or review engagement is performed.

d. Incorrect. In a review engagement, SSARS No. 21 requires that an accountant inquire as to whether any frauds have occurred.

7. For which of the following engagements is the accountant required to evaluate internal controls, including risks of material misstatement due to fraud:
   a. Incorrect. Evaluating internal controls and performing a fraud risk assessment is not a requirement for a compilation engagement.
   b. Incorrect. A review engagement involves performing inquiry and analytical procedures, and does not involve evaluating internal control or performing a fraud risk assessment.
   c. **Correct.** An audit engagement does, in fact, involve evaluating internal controls and performing a fraud risk assessment, among other procedures.
   d. Incorrect. Evaluation of internal control is not required for an agreed-upon procedures engagement.

8. Which of the following is an analytical procedure that studies the relationship between two financial statement amounts:
   a. Incorrect. A trend analysis studies the change in accounts over time and not the relationship between two financial statement amounts.
   b. Incorrect. Reasonableness tests estimate a financial statement amount or the change in an amount from the prior year and compare it to the existing financial statement amount. This comparison differs from a study in the relationship between two financial statement amounts.
   c. **Correct.** Ratio analysis is the study of the relationship between two financial statement amounts. For example, the number of days sales ratio studies the relationship between trade receivables and credit sales.
   d. Incorrect. The Altman Z Score is a financial ratio that consists of a weighted average of four separate ratios. It does not involve a study of the relationship between two financial statement amounts.

9. Which of the following is correct regarding analytical procedures in a compilation engagement:
   a. Incorrect. The fact that analytical procedures are performed during a compilation engagement does not upgrade a compilation engagement to an audit engagement.
   b. Incorrect. SSARS No. 21 states specifically that the only way an accountant should issue a review report is if the accountant is hired to conduct a review engagement. Thus, performing certain review procedures, such as analytical procedures, during a compilation engagement, does not elevate the engagement to a review engagement.
   c. **Correct.** An accountant is permitted to perform review-type procedures in any engagement, such as a compilation engagement, and not elevate the engagement to a review engagement.
   d. Incorrect. Selected analytical procedures can be performed in a compilation engagement even though not specifically required in SSARS No. 21.

10. SSARS No. 21 provides the option of which of the following being placed on each page of compiled or reviewed financial statements:
   a. Incorrect. Page numbering is not a requirement in SSARS No. 21.
b. Incorrect. Letterhead is not a requirement in SSARS No. 21 although an accountant may choose to place financial statement pages on an accountant’s letterhead.

c. Correct. SSARS No. 21 provides an option for an accountant to place a legend on each page similar to “See Independent Accountant’s Compilation (Review) Report.”

d. Incorrect. The accountant’s initials are not required by SSARS No. 21.

11. Which of the following is correct regarding going concern in a compilation or review engagement:

a. Incorrect. SSARS No. 21 does provide guidance on an accountant’s responsibility for going concern in a compilation or review engagement.

b. Incorrect. The concept of “substantial doubt” is not appropriate because it is an audit term relating to audit evidence. The term “uncertainty” is used for compilation and review engagements, not “substantial doubt.”

c. Incorrect. A report modification is generally not required for a compilation or review engagement when there is uncertainty of going concern.

d. Correct. Although an accountant is not required to include an uncertainty in a compilation or review report, an accountant may elect to include an emphasis-of-matter paragraph in either a compilation or review report disclosing the uncertainty due to going concern.

12. Which of the following is correct regarding the Altman Z Score:

a. Correct. The Altman Z Score is widely used as a financial ratio that helps indicate a going concern problem.

b. Incorrect. The Altman Z Score works on companies within most traditional industries such as retailers, wholesalers, and manufacturers. It may be distorted for real estate developers and other highly leveraged industries because of the significant amount of debt that might be outstanding at any particular point in time.

c. Incorrect. The Altman Z Score consists of a weighted average of four separate ratios, not three ratios.

d. Incorrect. Typically an entity with a ratio of 2.50 or greater (not 1.0 or greater) is considered to be strong.

Review Questions – Section 2

1. According to SSARS No. 21, which of the following is correct:

a. Incorrect. Tax-basis accrual financial statements may be used only if the company also uses tax basis accrual to prepare and file its income tax return.

b. Correct. Under the provisions of SSARS No. 21, the definition of tax basis includes a basis of accounting that the reporting entity uses to file its income tax return for the period covered by the financial statements.

c. Incorrect. SSARS No. 21 specifically requires a company to issue tax-basis financial statements on the same basis as it prepares its tax return. Thus, issuing financial statements on the accrual basis for tax purposes, while filing the tax return on the cash basis, is not permitted.

d. Incorrect. SSARS No. 21 specifically requires a company to issue tax-basis financial statements on the same basis as it prepares its tax return. If the tax return is filed on the accrual basis of accounting, the tax-basis financial statements may be issued using the accrual basis.

2. In which of the following situations may it not be prudent to use tax-basis financial statements:
a. **Correct.** One situation when it may not be prudent to use tax basis financial statements is if such statements might be perceived to be intentionally misleading to a third party.
b. Incorrect. One situation is when the accountant wishes to save engagement time, not spend extra time on the engagement.
c. Incorrect. A client who is interested in cash flows is a situation in which an accountant may wish to use tax-basis financial statements, making the answer incorrect.
d. Incorrect. A company that has a strong financial position is a situation in which use of tax-basis financial statements might be warranted, making the answer incorrect.

3. According to the author, which of the following is the engagement of choice when profitability is the goal:
   a. Incorrect. The GAAP audit is the least profitable engagement, and not generally the engagement of choice. First, the engagement is an audit and second, it involves GAAP. Both the audit engagement coupled with use of GAAP makes the engagement very time consuming and least profitable.
   b. Incorrect. The tax basis audit is not the most profitable engagement, and therefore not generally the engagement of choice. Although the fact that tax basis is used, the engagement is still an audit which is very time consuming and costly to complete.
   c. Incorrect. Although a review engagement is profitable, there is additional cost to use GAAP. Therefore, this engagement is generally not the most profitable out of all choices of engagements.
   d. **Correct.** According to the author, the tax-basis review is the most profitable engagement, and in many instances, the engagement of choice. First, the review engagement is the most profitable engagement among the compilation, review and audit engagements. Second, use of tax basis instead of GAAP saves time.

4. Although not authoritative, the author suggests that an accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity:
   a. Incorrect. There are circumstances when consent may be given.
   b. Incorrect. The accountant’s name can be used if the accountant has either compiled or reviewed the financial statements, making the answer incorrect.
   c. **Correct.** The accountant can consent to the use of his or her name if the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them.
   d. Incorrect. The financial statements do not have to be audited for the accountant’s name to be used. The financial statements can also be either reviewed or compiled, making the answer incorrect.

5. ASC 220, as amended by ASU 2011-05, requires that comprehensive income be presented in a format. Which of the following is one of the format options available:
   a. Incorrect. GAAP requires a financial statement format and not just a disclosure of comprehensive income, making the answer incorrect.
   b. **Correct.** One of the two format options is to present one single continuous statement of income and comprehensive income, making this answer correct.
   c. Incorrect. Combining the statement of comprehensive income with the balance sheet is not one of the options available, making the answer incorrect.
d. Incorrect. Presenting comprehensive income as a section within the statement of stockholders’ equity was one of the options previously available. However, ASU 2011-05 amended ASC 220 to eliminate this option. Thus, the answer is incorrect.

6. In reporting on supplementary information, which of the following is a correct option:
   a. Correct. An accountant may compile supplementary information under the SSARSs.
   b. Incorrect. If a compilation report is issued for the financial statements, the supplementary information may not be reviewed. To do so would result in supplementary information being reported on at a higher level (review) than the underlying financial statements.
   c. Incorrect. If a review report is issued for the financial statements, the supplementary information may be disclaimed per SSARS No. 21.
   d. Incorrect. If a review report is issued for the financial statements, the supplementary information may be compiled making the answer incorrect.

7. Which of the following is an example of supplementary information:
   a. Incorrect. Percentages that are presented next to historical numbers are generally not considered supplementary information.
   b. Correct. Under the SSARSs an aging analysis of receivables is considered supplementary information on which the accountant must report.
   c. Incorrect. Budgeted information is supplementary information only once it has expired, and not while it is unexpired.
   d. Incorrect. A legend on each page of the financial statements is not considered supplementary information under the SSARSs.

8. An accountant is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:
   a. Incorrect. The information should not extend beyond the current fiscal year, making the answer incorrect.
   b. Incorrect. The information should be presented with interim historical financial statements for the current year, making the answer incorrect.
   c. Incorrect. The information should be unexpired, not expired information.
   d. Correct. The information should be labeled as budgeted, making the answer correct.

9. A successor accountant may wish to consider making inquiries of the predecessor accountant when:
   a. Incorrect. The information obtained about the prospective client should be limited, not unlimited.
   b. Correct. The fact that the information obtained about the prospective client requires special attention is a factor to be considered in determining whether to make an inquiry of the predecessor accountant.
   c. Incorrect. A factor to consider is whether the change in accountants takes place substantially after the end of (not substantially before) the accounting period, making the answer incorrect.
   d. Incorrect. One factor to consider is that there have been frequent, not infrequent, changes in accountants, making the answer incorrect.

10. Which of the following is correct regarding a successor accountant naming the predecessor accountant in his or her report:
    a. Incorrect. There is nothing in the SSARSs that specifically recommends that the successor identify the predecessor accountant in his report.
b. Incorrect. There is nothing in the SSARSs that requires the successor name to specifically name the predecessor accountant in his report. There is, however, prior guidance that states that a successor accountant may state that there was a predecessor accountant in certain cases, but is not required to name him or her.

c. Correct. Although SSARS No. 21 has eliminated specific guidance involving successor-predecessor accountants, previous guidance does provide a situation in which a successor accountant may recognize the existence of a predecessor accountant in his or her report. The exception only applies if the predecessor’s practice is acquired by, or merged with, that of the successor accountant.

d. Incorrect. Existing SSARS No. 21 does not preclude the naming or recognizing the existing of a predecessor accountant.

11. According to SSARS No. 21, which of the following is correct regarding disclosing selected information as required by GAAP:

a. Incorrect. In SSARS No. 21, there is no provision that permits an accountant to issue a review report on financial statements that omit substantially all disclosures.

b. Incorrect. SSARS No. 21 does provide an exception under which an accountant may compile financial statements that omit substantially all disclosures.

c. Correct. According to SSARS No. 21, the accountant may compile such statements provided the omission of substantially all disclosures is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

d. Incorrect. SSARS No. 21 is not silent on this issue. Information that permits an accountant to report on compiled financial statements that omit substantially all disclosures is found in SSARS No. 21.

12. In which of the following situations may an accountant label notes to financial statements: “Selected Information—Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included:”

a. Incorrect. If there are no disclosures, use of the reference “Selected Information—Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States are Not Included” is unnecessary because there are no notes to label.

b. Correct. The identified label is appropriate when there are disclosures about only a few matters in the form of notes to financial statements. Two disclosures would satisfy the “few matters” threshold.

c. Incorrect. Presenting 50 percent of the ten required disclosures is certainly more than “a few matters” so that use of the label “Selected Information…..” is not appropriate.

d. Incorrect. SSARS No. 21 states that when the financial statements include more than a few disclosures, this guidance is not appropriate. Instead, the omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation or review report as a GAAP departure. Thus, the use of the “Selected Information…..” is not appropriate.

13. Which of the following is correct regarding SSARS No. 21 as it relates to development of expectations in analytical procedures:

a. Incorrect. The SSARS No. 21 requirement is nothing new. Since the issuance of SSARS No. 1 in 1979, the requirement to develop expectations in performing analytical procedures has been present.

b. Incorrect. According to peer review results, most accountants have not complied with the requirement to develop expectations in performing analytical procedures.
c. Incorrect. SSARS No. 21 provides little guidance as to how to develop expectations.
d. Correct. SSARS No. 21 does not indicate how to develop expectations, thereby giving the accountant great flexibility in applying the standard.

**Review Questions – Section 3**

1. In which of the following types of engagements must an accountant plan materiality:
   a. Correct. Planning materiality is required for an audit engagement under the SASs.
   b. Incorrect. SSARS No. 21 does not require that an accountant plan materiality in a review engagement although an accountant may do so.
   c. Incorrect. SSARS No. 21 does not require that an accountant plan materiality in performing a compilation engagement.
   d. Incorrect. An agreed-upon procedures engagement does not involve planning materiality because the procedures performed and the scope and materiality threshold are dictated by the responsible party, and not the accountant. Thus, planning materiality is not part of an agreed-upon procedures engagement.

2. A restricted-use report should contain a separate other-matter paragraph that includes all of the following except:
   a. Incorrect. SSARS No. 21 states that a restricted-use report should mention that the report is intended for the use of the specified parties. Thus, this information is included in the report.
   b. Correct. The report is not used for nonspecified parties, so that reference to use by nonspecified parties is not something that should be included in the report.
   c. Incorrect. SSARS No. 21 requires that the restricted-use report identify the specified parties to whom use is restricted, so that there is no risk that a nonspecified party does not rely on the report.
   d. Incorrect. The restricted-use report should include a statement that the report is not intended to be and should not be used by anyone other than the specified parties. By including this statement, there is no confusion as to whether nonspecified parties should use the report.

3. SSARS No. 21 permits an accountant to perform a compilation engagement related to a specified ______ of a financial statement.
   a. Incorrect. A compilation of a component is not part of an engagement under SSARS No. 21.
   b. Correct. SSARS No. 21 offers the accountant the option to perform a compilation engagement on a specified element, account or item of a financial statement, making the answer correct.
   c. Incorrect. SSARS No. 21 does not address issuing a compilation report on a “position,” making the answer incorrect.
   d. Incorrect. SSARS No. 21 does not deal with a “type” of financial statement, making the answer incorrect.

4. Which of the following is correct regarding a review of a specified element, account or item after the effective date of SSARS No. 21:
   a. Correct. SSARS No. 21 now provides authorization for the performance of a review engagement on a specified element, account or item of a financial statement.
b. Incorrect. Authorization for a review engagement of a specified element, account, or item was found in SSAE No. 10 prior to the effective date of SSARS No. 21. Now, that authority is found in SSARS No. 21.

c. Incorrect. The review report on a specified element, account or item provides limited assurance, not positive assurance, making the answer incorrect.

d. Incorrect. A review of a specified element, account or item is permitted by SSARS No. 21, making the answer incorrect.

5. Ivan the CPA is asked to perform a compilation on a schedule of accounts receivable. Which of the following is correct.
   a. Incorrect. A full set of GAAP (or a special purpose framework) disclosures is required only if there is a full set of financial statements, which is not the case in this example.
   b. Correct. Disclosures are only required if financial statements are issued, not schedules. Thus, the answer that no disclosures are required is correct.
   c. Incorrect. There is no requirement for any disclosures including disclosures of the schedule of accounts receivable. However, if disclosures were to be included, they would be limited to those related to receivables because that is the subject matter of the financial statements.
   d. Incorrect. There is no requirement that disclosures be limited to the summary of significant accounting policies. In fact, no disclosures are required if a schedule, and not a financial statement, is presented.

6. Sarah CPA is issuing a review report on a single financial statement, a balance sheet on a GAAP basis. Sarah is determining whether there should be disclosures. Which of the following is correct.
   a. Incorrect. Disclosures related to the balance sheet are required per ASC 235.
   b. Incorrect. A full set of GAAP (or a special purpose framework) disclosures is required if there is a full set of financial statements which there is not in this example.
   c. Correct. ASC 235 states that disclosures are required only for the information that is given, which is limited to the balance sheet.
   d. Incorrect. ASC 235 does not limit disclosures to the summary of significant accounting policies.

7. Which of the following should be the date of a management representation letter for a review engagement:
   a. Incorrect. The date should not be the last day of the fiscal year being reviewed because the accountant may not have been hired at that date. The date of the letter is the date on which the letter is presented and signed by the client.
   b. Correct. The letter should be dated on the date on which it is presented and signed by the client. If the client does not sign it on that date, the date should be the date on which the letter is presented (faxed, emailed or mailed) to the client.
   c. Incorrect. The date of the accountant’s review report, is the date on which representations within the letter are made. It is not the date of the letter.
   d. Incorrect. The last date that the accountant and the client had contact has nothing to do with the date on the representation letter.

8. If a current owner/manager refuses to sign a representation letter for a period of time during which management was not present:
   a. Correct. If the current owner/manager refuses to sign the letter because he or she was not present during the period of time during which the representations apply, SSARS No. 21 states that a review report may not be issued.
b. Incorrect. The accountant may not step down to a compilation engagement if current owner/manager refuses to sign the letter.

c. Incorrect. Nothing found in SSARS No. 21 requires that the accountant should notify shareholders of the current owner/manager’s refusal to sign the letter.

d. Incorrect. There is no authority found in SSARS No. 21 or the SASs that would permit the accountant to step up to an audit if there is a refusal to sign the letter. Moreover, if there is a refusal to sign a review representation letter, one would assume that the same owner/manager would refuse to sign an audit representation letter.

9. Which of the following is not an example of a circumstance when an accountant should consider obtaining an updated representation letter from management for a review engagement:

a. Incorrect. The fact that the review report is not issued for a significant period of time after the original management representation letter was obtained, is an example of a circumstance where an updated representation letter should be obtained.

b. Incorrect. If a material subsequent event occurs after obtaining the original representation letter, the accountant should obtain an updated representation letter that includes the additional subsequent event in the representations.

c. Incorrect. One example where an updated representation letter might be needed is if the predecessor accountant is asked to reissue his or her financial statements.

d. Correct. A change in the format of the representation letter due to the issuance of a new SSARS would not be an example of a situation in which an updated letter would be required. A change in format due to a new SSARS would impact the letter format prospectively thereby not requiring a change in an already issued letter.

10. Ralphie CPA is performing a review on the financial statements of XYZ Company. Under AR-C 90, Ralphie must obtain evidence that:

a. Incorrect. There is no requirement that the accountant reconcile the general ledger to the trial balance.

b. Correct. A new requirement in AR-C 90 is that the accountant must obtain evidence that the financial statements agree or reconcile with the accounting records. In general, accounting records means the general ledger or trial balance.

c. Incorrect. Although an accountant should make sure the notes agree with the financial statements, there is no explicit requirement for the accountant to reconcile them.

d. Incorrect. AR-C 90 does not require that supplementary information reconcile with the financial statements, although it would be good practice to ensure that such information does, in fact reconcile with the financial statements.

Review Questions – Section 4

1. Which of the following is correct regarding ASC 274, Personal Financial Statements:

a. Incorrect. Assets must be stated at their estimated current values, not fair value.

b. Incorrect. Liabilities must be stated at their estimated current amounts, not liquidation value.

c. Incorrect. The cost of the disposal of assets, if material, should be deducted in computing current values.

d. Correct. ASC 274 states that the Statement of Net Worth (statement of financial condition) is required, but the Statement of Changes in Net Worth is optional.
2. Which of the following is a prescribed form if it is submitted to a bank:
   a. Incorrect. A GAAP financial statement is not a prescribed form because the financial statement is not a preprinted form.
   b. Incorrect. A tax return is not a prescribed form. The reason is because the tax return will be submitted to the bank and not the body that designed it (the IRS).
   c. Correct. A financial statement on a bank’s preprinted form is a prescribed form.
   d. Incorrect. Instructions to a form do not meet the definition of a prescribed form as they will not be prepared.

3. Harry CPA is performing a compilation engagement on personal financial statements in a bank’s prescribed form. The prescribed form does not include an estimated tax liability which is required by GAAP. Which of the following is correct:
   a. Incorrect. The AICPA Guide states that in a prescribed form, there is a presumption that the information in the form is sufficient for the body’s form. Thus, the departure is not referenced.
   b. Incorrect. The AICPA Guide does not state that the accountant should reference the GAAP departure in the disclosures but not the report. Moreover, the prescribed form does not have separate disclosures outside the form.
   c. Correct. The AICPA Guide states that because there is a presumption that the information in the prescribed form is sufficient, there is no requirement that the issuer of the form be notified of the departure from GAAP or another framework.
   d. Incorrect. There is guidance to address the issue found in the AICPA Guide.

4. Harold Brown CPA is asked to prepare a personal financial statement for Angie Jolie on the tax-basis of accounting. Which of the following is a title that Harold may use for one of the financial statements.
   a. Incorrect. The title is incorrect for two reasons. First, under the personal financial statement provisions, the statement of financial condition should be issued. Second, SSARS No. 21 requires that there be a description of the basis (tax basis) and not fair value basis.
   b. Correct. SSARS No. 21 requires that the title include a description of the non-GAAP basis (tax basis) which is presented in this case. The statement of financial condition is an appropriate title for a personal financial statement. Adding “tax basis” to it satisfies the requirement of SSARS No. 21 with respect to titles of a special purpose framework, such as tax basis.
   c. Incorrect. A statement of cash flows is not a typical statement for personal financial statements. Further, there must be a description of the basis used, such as “tax basis.”
   d. Incorrect. Although the title “statement of financial condition” is correct, it lacks a description at the end such as “tax basis.”

5. Which of the following is correct regarding financial statements submitted electronically:
   a. Incorrect. SSARS No. 21 is applicable to financial statements submitted electronic as if they were submitted manually.
   b. Incorrect. Financial statements may be submitted electronically in any format including PDF, Word, or other, making the answer incorrect.
   c. Incorrect. A hard copy of the financial statements and accountant’s report does not have to be submitted in addition to the electronic submission.
   d. Correct. SSARS No. 21 permits financial statements to be signed by the accountant manually or electronically.
Review Questions – Section 5

1. Which of the following is one of the two types of peer reviews under the AICPA peer review program:
   a. Correct. The system review is one of the two types of peer reviews with the other being an engagement review.
   b. Incorrect. Document review is not one of the two. A firm might perform its own internal document review but it is not one of the two types of peer reviews.
   c. Incorrect. A findings review is not one of the two types of peer reviews. Findings represent the results of a review but is not one of the names of the reviews.
   d. Incorrect. Under the peer review program, a report review is not one of the two types of reviews. A report review was a type of review under the previous AICPA peer review program but is not under the current program.

2. A system review focuses on which of the following:
   a. Incorrect. Working paper documentation is the focus of an engagement review, not a system review.
   b. Incorrect. Obtaining a management representation letter is an effort that a peer reviewer would consider in an engagement review and not a system review.
   c. Incorrect. The accountant’s effective use of inquiry and analytical procedures is an integral part of an engagement review and not a system review.
   d. Correct. A system review encompasses opining of whether a firm is in compliance with its own quality control policies and procedures.

3. Firms that only perform compilation engagements on financial statements that omit substantially all disclosures________:
   a. Incorrect. A system review is required for firms that perform engagements under the SASs and/or examinations of prospective financial information under the SSAEs. A compilation engagement is not covered under the SASs or SSAEs so that a system review does not apply.
   b. Correct. Under the current AICPA peer review program, a compilation engagement on financial statements that omits substantially all disclosures falls under an engagement review.
   c. Incorrect. A report review is no longer one of the types of reviews provided by the current AICPA peer review program.
   d. Incorrect. Firms that perform any compilation engagements must participate in the peer review program, making the answer incorrect.

4. Under the AICPA peer review program, which of the following engagements would require an engagement review to be performed assuming no other engagement is performed by the firm:
   a. Correct. A review engagement would require a firm to be subject to an engagement review.
   b. Incorrect. A governmental audit elevates the firm to the requirement that it be subject to a system review and not an engagement review.
   c. Incorrect. An examination under SSAE No. 10, elevates the firm to the requirement that it be subject to a system review and not an engagement review.
   d. Incorrect. An audit, which is performed under the SASs, elevates the firm to the requirement that it be subject to a system review and not an engagement review.
5. In a peer review, if there is one or more findings, a peer reviewer may conclude that the finding(s) rise to the level of which of the following:
   a. Incorrect. A matter is an item that warrants further consideration and is not a finding.
   b. Correct. A finding(s) may result in either a deficiency or a significant deficiency.
   c. Incorrect. The peer review program does not use the term “violation.”
   d. Incorrect. Fraud is used as a term in an audit but is not referenced in the AICPA peer review program.

6. With respect to the AICPA peer review program, which of the following is correct regarding the firm’s representation letter:
   a. Incorrect. The reviewed firm must provide a signed representation letter to the reviewer that includes certain representations.
   b. Incorrect. The representation regarding compliance is stipulated as negative assurance rather than positive assurance.
   c. Incorrect. A firm’s refusal to furnish the written representation letter to the reviewer constitutes a limitation of the peer review.
   d. Correct. The firm is required to make a representation that all client engagements were provided to the reviewer, making the answer correct.

7. The due date of a firm’s initial peer review is:
   a. Incorrect. Three years is not identified within the peer review standards.
   b. Correct. A firm’s due date is 18 months from the date it enrolled in the program.
   c. Incorrect. The three years and six months date only applies to peer reviews subsequent to the initial review.
   d. Incorrect. The standards do not mention a period of one year of receiving notice from the state licensing board.

8. Specific financial statement deficiencies noted in peer reviews related to the Statement of Income include all of the following except:
   a. Incorrect. The summary of deficiencies noted includes the fact that there are no income tax provisions found in interim financial statements, while requires such a provision.
   b. Incorrect. In the summary of deficiencies, one deficiency found is that the reporting period of the statement of income was not clearly defined. GAAP obviously requires that the period be defined.
   c. Incorrect. Although GAAP requires that the significant components of income tax expense (current and deferred components) be disclosed, one of the deficiencies noted was that such a disclosure was not included in the notes or statement of income.
   d. Correct. Errors in the calculations of totals is not a significant deficiency noted by peer reviewers regarding the Statement of Income.

9. Which of the following is not a deficiency listed for engagements subject to government auditing standards:
   a. Incorrect. One of the deficiencies noted regarding engagements subject to government auditing standards is that there were missing reports on internal control or compliance.
   b. Incorrect. Governmental auditing standards require that the auditor perform compliance testing, which is one of the deficiencies noted regarding engagements subject to government auditing standards.
   c. Correct. Inadequate titles used on reports is not a listed deficiency regarding engagements subject to government auditing standards.
d. Incorrect. The results of peer reviews noted that auditors were using inadequate and outdated reference materials in performing their engagements.

10. Which of the following is an example of authoritative GAAP guidance:
   a. Incorrect. An accounting textbook is part of non-authoritative GAAP regardless of how prominent the author may be.
   b. Correct. Rules and interpretive releases of the SEC under federal securities laws are sources of authoritative GAAP for SEC registrants.
   c. Incorrect. Pronouncements of professional associations or regulatory agencies are non-authoritative GAAP.
   d. Incorrect. Technical Practice Aids are part of non-authoritative GAAP.

Review Questions – Section 6

1. Most changes required by GAAP:
   a. Incorrect. Generally, GAAP changes are not useful for smaller nonpublic businesses.
   b. Incorrect. Implementing GAAP changes can be costly for the practitioner of smaller nonpublic businesses, with little or no added value.
   c. Correct. Generally, most of the changes required by GAAP have little usefulness to smaller nonpublic businesses, such as goodwill and other intangibles amortization, consolidation of real estate leasing entities, and depreciation.
   d. Incorrect. Many GAAP changes are not as significant to a smaller nonpublic business for whom the issuance of financial statements is nothing more than a necessity to satisfy a bank or third party user.

2. Which of the following is not one of the four most common GAAP departures that can simplify engagement time:
   a. Incorrect. The author states that amortizing goodwill and indefinite-lived intangible assets is one of the most common GAAP departures that can reduce an accountant’s engagement time.
   b. Correct. This is not a GAAP departure that is recommended for simplifying engagement time. The reason is because the statement of cash flows is an important statement that most third-party users want included in financial statements even though its exclusion would save the accountant time.
   c. Incorrect. The author notes that one way to simplify engagement time is to use one depreciation schedule for both book and tax depreciation.
   d. Incorrect. The author suggests that engagement time can be reduced if deferred income taxes are not recorded.

3. Per the author, how many GAAP departures can generally be included in a compilation or review report without including an additional “significant and pervasive” paragraph:
   a. Incorrect. Departures from GAAP are permitted without it being considered so “significant and pervasive” that the additional paragraph is warranted.
   b. Correct. In the author’s opinion, in most cases, one or two GAAP departures will generally not distort the financial statements, notwithstanding the fact that one significant departure could by itself be significant.
c. Incorrect. According to the author, when the number of GAAP departures is elevated to three, maybe four, the accountant may wish to consider whether the financial statements are so distorted, they are misleading and no longer purport to be GAAP. In such a case, an additional paragraph can be inserted into the report or the accountant should withdraw from the engagement.

d. Incorrect. At some point, there are some many GAAP departures that the financial statements are distorted. Thus, the answer “limitless” is not correct.

4. Which of the following would be the type of general ledger account that could be set up with an imprest balance:
   a. Incorrect. A fixed asset account does not work well for being set up with an imprest balance because it is not a recurring prepaid or accrual account.
   b. Incorrect. A long-term debt account is not an account that should be set up on an imprest balance because it is not a recurring prepaid or accrued item account.
   c. Incorrect. Because cash or a cash equivalent is not an accrual or prepaid account and therefore is not recommended to be set up with an imprest balance.
   d. Correct. The author suggests that imprest balances can be set up for recurring accrued and prepaid items, one of which is accrued commissions.

5. Under pre-SSARS No. 21 rules, an engagement letter ________________.
   a. Incorrect. Prior to the application of SSARS No. 21, the rules found in SSARS No. 19 did not require that the letter be signed by anyone.
   b. Incorrect. Under the pre-SSARS No. 21 rules, a client was not required to sign an engagement letter.
   c. Incorrect. Under the pre-SSARS No. 21 rules, the accountant was not required to sign an engagement letter.
   d. Correct. Under the pre-SSARS No. 21 rules, SSARS No. 19 required that the understanding be in writing, but the engagement letter did not have to be signed by anyone.

6. Which of the following provisions should be in every engagement letter:
   a. Incorrect. SSARS No. 21 does not address whether a provision that limits the amount of damages should be in the engagement letter. Although this provision is recommended by the author, it is not addressed in SSARS No. 21 or in the sample engagement letter found in SSARS No. 21.
   b. Correct. SSARS No. 21 states that one of the elements that should be in every engagement letter is language as to management’s responsibility.
   c. Incorrect. SSARS No. 21 does not require language regarding the record retention policy although such language is highly recommended.
   d. Incorrect. Language about ownership of records and confidentiality of information should be in every engagement letter. However, SSARS No. 21 does not mention it.

7. Which of the following should be included in an engagement letter:
   a. Correct. Most attorneys believe the inclusion of a mediation clause in the engagement letter assists the accountant in resolving any conflict before litigation. Mediation is not binding on either party.
   b. Incorrect. Generally, arbitration clauses are dangerous with respect to a professional engagement. It is legally binding and the process can restrict the accountant from proving his or her case. Most insurance carriers state that an arbitration clause should be avoided and can be included only with respect to fee disputes, and not malpractice cases.
c. Incorrect. Both mediation and arbitration clauses should not be included. Although a mediation clause is recommended, an arbitration clause is dangerous and should be avoided.

d. Incorrect. One of the two clauses, the mediation clause, should be included, making the answer incorrect.

8. Which of the following is correct regarding engagement risk:
   a. Incorrect. Nothing could be further from the truth. The courts are lined with cases against accountants who performed compilation or bookkeeping services for their clients.
   b. Incorrect. Client can and do sue accountants who performed bookkeeping services for their clients, making the answer incorrect.
   c. Correct. Because clients and third parties misunderstand the different levels of accounting services, the courts tend to hold accountant’s to a higher level of service than contracted for in, for example, bookkeeping services.
   d. Incorrect. Accountants are not required to obtain an engagement letter in a bookkeeping engagement but are encouraged to do so.

9. Which of the following is correct with respect to the comparison of a financial statement to a trial balance:
   a. Incorrect. A financial statement does combine similar general ledger accounts making the answer incorrect.
   b. Incorrect. A trial balance typically does not include financial statement titles making the answer incorrect.
   c. Incorrect. Typically, a trial balance does not have a net income caption at the bottom
   d. Correct. A financial statement nets contra accounts while a trial balance maintains the balances on a gross basis.

10. Facts: Johnny CPA submits a tax return to a client. Which of the following is correct:
    a. Incorrect. Because a tax return is not a financial statement, there are no reporting requirements under SSARS No. 21.
    b. Incorrect. SSARS No. 21 permits an accountant to issue a compilation or review report on a tax return.
    c. Correct. Under SSARS No. 21, there is no reporting requirement with respect to a tax return although an accountant may elect to perform a compilation or review engagement report on that tax return and issue a report thereon.
    d. Incorrect. SSARS No. 21 is not silent as to whether an accountant is permitted to report on a tax return and permits an accountant to perform a compilation or review engagement on the tax return.

Review Questions – Section 7

1. Facts: Mary CPA is hired to review the financial statements of Company Y for the year ended December 31, 20X4. Mary performed nonattest services including controllership services for Y in 20X2 during a year during which Mary reviewed the financial statements. Which of the following is correct:
    a. Incorrect. Mary’s independence for 20X4 is impaired because Mary performed a review during the year (20X2) during which the nonattest services were performed.
b. Incorrect. The fact that Mary’s performed controllership services in 20X2 is not the key reason why her independence is impaired in 20X4. Instead, the reason is because Mary performed a review in 20X2, a period during which the nonattest services (controllership) were performed.
c. Correct. Mary’s independence for 20X4 is impaired because Mary performed a review for Y in 20X2, a period during which Mary performed nonattest services.
d. Incorrect. There is an ethics ruling that addresses the performance of nonattest services during a prior period, making the answer incorrect.

2. Which of the following is considered an attest service:
   a. Incorrect. Financial statement preparation is a nonattest service considered outside the scope of an attest engagement.
   b. Incorrect. Reconciliations, such as cash, accounts receivable and payables, are considered a nonattest service.
   c. Incorrect. Cash-to-accrual conversions are considered a nonattest service per ET 1.295.
   d. Correct. Review engagement procedures are an attest function as a review engagement is, by definition, an attest engagement.

3. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client regarding all of the following critical elements except:
   a. Incorrect. The engagement letter should address the objectives of the engagement per ET 1.295.
   b. Incorrect. The understanding should include language that the client accepts certain responsibilities with respect to the nonattest engagement.
   c. Incorrect. The member’s (accountant’s) responsibilities should be agreed to by both parties.
   d. Correct. Although the cost of the service is important, it is not a critical element that should be in any written document.

4. Which of the following is not true regarding the documentation requirement for nonattest services:
   a. Incorrect. The documentation requirement does not become effective until the client becomes an attest client.
   b. Incorrect. The method of documentation is not as important as the content of the documentation.
   c. Correct. ET 1.295 states that the failure to prepare the required documentation would not impair independence provided the member did establish an understanding with the client.
   d. Incorrect. If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member’s billing or correspondence files.

5. For tax services, which of the following is not one of the skills, knowledge or experience a designated individual for a client should possess to be considered competent:
   a. Correct. The individual does not need to understand the tax law to be competent. Otherwise, there would be no need to hire the accountant for the tax services.
   b. Incorrect. In order to be competent, the individual should at least have a generally understanding of the company’s tax situation.
   c. Incorrect. Being competent includes a basic requirement that the individual have a general understanding of how the amounts on the return were determined even though there is no technical knowledge of tax law required.
   d. Incorrect. It is critical that the designated individual, on behalf of the client, assume all management responsibilities which including making all decisions regarding the significant tax
positions taken on the tax return. Typically, the mere signing of the tax return does, in fact, result in the individual accepting such responsibility for tax positions.

6. The key factor in determining whether the performance of bookkeeping services impairs the accountant’s independence is:
   a. Incorrect. The cost of services is not the key factor in dealing with independence.
   b. Correct. In order to maintain his or her independence, an accountant must not assume management responsibilities with respect to the nonattest service (bookkeeping services) performed. Instead, the client must assume such management responsibilities.
   c. Incorrect. The time spent performing the services is not the key factor in independence making the answer incorrect.
   d. Incorrect. There is no authority found in the ethics rules that suggests that the level of experience of the accountant is a key factor in determining an accountant’s independence.

7. Which of the following is correct regarding the performance of nonattest services as part of a compilation engagement:
   a. Incorrect. The written documentation requirement (Safeguard 3) applies to compilation engagements that do not lack independence. It doesn’t apply when there is a lack of independence in a compilation engagement.
   b. Correct. The same issues regarding independence apply to a compilation engagement as they do an audit or a review engagement, meaning that independence would be impaired if an accountant assumes management responsibilities in performing a nonattest service.
   c. Incorrect. Preparing source documents is one of the tasks for which he or she would have to disclaim independence in the compilation report. The reason is because the accountant would be assuming management responsibilities by preparing such source documents.
   d. Incorrect. ET 1.295 does not require the accountant to document the client’s understanding in writing in a compilation engagement letter.

8. With regard to tax compliance services performed on an attest client, the accountant should:
   a. Incorrect. The accountant may not assume management’s responsibilities as they relate to the tax return or other tax compliance services.
   b. Incorrect. The client, not the accountant, should evaluate the adequacy and results of the nonattest tax services. The reason is because the client, and not the accountant, is responsible for the nonattest services performed by the accountant.
   c. Correct. The accountant should establish and document in writing his or her understanding with the client with respect to the objectives of the nonattest tax engagement, the nonattest tax services to be performed, the client’s acceptance of its responsibilities, the member’s responsibilities, and any limitations of the engagement.
   d. Incorrect. The client, not the accountant, should accept responsibility for the results of the nonattest tax services. If the accountant accepts responsibility, the accountant would taint his or her independence.

9. Which of the following impairs an accountant’s independence related to payroll services:
   a. Correct. Authorizing and approving payment of payroll and payroll taxes is considered assuming management responsibilities, and therefore impairs the accountant’s independence.
   b. Incorrect. Processing client payroll and generating unsigned checks would not impair the accountant’s independence if the client approved the payroll time records and the client signs the checks. The key is that the accountant must not assume management responsibilities.
c. Incorrect. If the payroll tax returns and the tax payments are approved by the client, the accountant can transmit them to the proper agencies. In doing so, the accountant is not deemed to assume management responsibilities.
d. Incorrect. Reviewing the client’s payroll tax returns for errors would not impair independence because the accountant would not be assuming management responsibility for the payroll tax returns.

10. Harry Callahan, CPA, reviews the financial statements of Company X for December 31, 20X1. During 20X1, Harry was a signatory of one of X’s bank accounts solely in the capacity as a backup signatory which Jimmy Jacobs, X’s sole owner, is on vacation. Harry did not actually sign any checks in 20X1. Which of the following is correct:
a. Incorrect. Because Harry was a signatory during 20X1, he had custody of an asset (cash) and therefore impaired his independence with respect to X.
b. Incorrect. Harry’s independence is impaired because he was a signatory of X’s bank account. Therefore Harry is not permitted to perform his review engagement.
c. Correct. Harry’s independence is impaired because he had custody of X’s cash account even though he actually did not sign checks.
d. Incorrect. Whether Harry’s independence is impaired is based on whether Harry actually had custody of the cash account, and not whether he signed any checks during 20X1.

11. Which of the following valuations would generally not impair independence:
a. Incorrect. An accountant’s independence is impaired if he or she performs a valuation on a business combinations because such a service requires a significant degree of subjectivity.
b. Incorrect. An accountant generally cannot perform appraisals of assets and liabilities because they require a significant degree of subjectivity and thus, impairs independence.
c. Incorrect. An accountant generally cannot perform valuations on ESOPs because they require a significant degree of subjectivity and impair independence.
d. Correct. A valuation service that typically does not impair independence is where the service typically produces reasonably consistent results without significant degree of subjectivity. One example of such a valuation is an actuarial valuation of a client’s pension or postemployment benefit liability.

12. Which of the following would impair an accountant’s independence with respect to litigation services:
a. Incorrect. As a fact witness, the accountant’s role is to provide factual testimony to the trier of fact. Answering questions in such a capacity would not impair independence.
b. Incorrect. If the accountant is not making any decisions on behalf of the parties, but instead is acting as a facilitator by assisting the parties in reaching their own agreement, he or she can serve as a mediator without impairing independence.
c. Correct. If an accountant provides litigation consulting services and complies with the three general safeguard requirements under ET 1.295 for providing nonattest services for an attest client, then independence would not be impaired. If the accountant provides litigation consulting services, and subsequently agrees to serve as an expert witness, independence is impaired.
d. Incorrect. An accountant would not impair independence if: the attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim; no attest client within the group is designated as the “lead” and no attest client has the sole decision-making power to select or approve the expert witness.
13. Which of the following services can an accountant perform for a client without impairing independence with regard to hiring personnel:
   a. Correct. The accountant cannot assume management responsibilities. By interviewing a candidate to provide feedback to management (who makes the final decision) would not be acting in the capacity of management.
   b. Incorrect. Negotiating compensation or benefits would clearly be acting in the capacity of management and would, therefore, impair independence.
   c. Incorrect. Making the final hiring decision would be acting in the capacity of management, and would therefore impair independence.
   d. Incorrect. If an accountant makes any decision on behalf of the client, such decision-making impairs the accountant’s independence.

14. Under which of the following is the accountant exempt from responsibility to third parties unless the accountant has a contract with the third party:
   a. Correct. The privity (contract) standard states the “Accountant’s liability is limited to those third parties with whom the accountant has a contractual relationship.”
   b. Incorrect. The near-privity standard allows a third party who does not have a contractual relationship to sue the accountant if three conditions are met.
   c. Incorrect. Under the restatement approach, the accountant cannot be held liable to a third party unless the accountant expressly knows the third parties will be provided with the financial report, or the third parties are members of a limited class of persons to whom the accountant knows the financial report will be given.
   d. Incorrect. Under the foreseeability approach, the accountant is liable to any “reasonably foreseeable” third-party recipient of the accountant’s financial report provided the third party relies on the report for its proper business purpose. The accountant is not required to know the third party.

15. According to ET sec. 1.400.200, Records Requests, which of the following must be returned to a client, even if there are unpaid fees due:
   a. Correct. Client-provided records in the member’s custody or control should be returned to the client.
   b. Incorrect. Member-prepared records should be provided to the client, except when there are fees due the member for the specific work product.
   c. Incorrect. Member’s working papers belong to the member and should not be distributed to the client.
   d. Incorrect. Member work products should be returned to the client except in certain circumstances on of which is if there are fees due to the member for the specific work product.