



ACCOUNTING

CONTINUING EDUCATION

Peer Review Deficiencies – How to Solve
Them?
(PRD2)

Peer Review Deficiencies – How to Solve Them?

(PRD2)

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PEER REVIEW DEFICIENCIES – HOW TO SOLVE THEM? (PRD2)

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LEARNING OBJECTIVES

After completing this course, participants will gain knowledge related to:

- › Required standards for quality control for a firm
- › Understanding Peer Review process
- › Requirements of Quality Control Standards related to documentation
- › Common Peer Review Issues for reporting, Audit, Review and Compilation
- › Common Peer Review issues related to generally accepted accounting principles
- › Avoiding documentation deficiencies
- › Covid-19 Issues that could impact Peer Review

INTRODUCTION – PEER REVIEW AND QUALITY CONTROL

Peer review has been a requirement in the accounting profession since 1988 when it was approved for firm membership in the AICPA. Most state boards of accountancy or regents require firms with an accounting and auditing practice to have a peer review, generally with satisfactory results every three years, as a condition for licensing. Certain regulatory agencies also require satisfactory peer review results as a condition for reporting to the agency. Therefore, firms must be diligent in their efforts to comply with the quality control standards.

Peer review deficiencies can generally be classified as occurring from one or more of the professional standards that affect financial reporting;

1. Financial Accounting Standards (which deal with the presentation, disclosure and measurement of transactions)
2. Professional Code of Conduct (both AICPA and regulated requirements)
3. Performance Standards, SASs and SSARS (which are concerned with reporting on, performance and documentation of required procedures) or
4. Quality Control Standards

The most common deficiencies for 2019-2020 include failure to:

1. Perform adequate risk assessments.
2. Identify and document threats to independence resulting from non-attest services.

3. Gain an adequate understanding of internal control when assessing client risks.
4. Link responses to identified risks.
5. Assess control risk properly.

Many times, the cause of noncompliance is either that the requirements are being misunderstood, or they are not being identified as applicable by practitioners. Whatever the cause, this deficiency must be considered in a peer review and begins with an MFC (matter for consideration).

Should the matter be a consistent or systemic finding among engagements, the matter will be elevated to a higher level of noncompliance and can cause a firm to receive a peer review report of a pass with deficiencies or possibly a fail. In the current environment of heightened interest in audit and engagement quality, an implementation plan may be suggested or required for the firm to address the issue.

The course issues and deficiencies were compiled from:

- Center for Audit Quality Alerts.
- PCAOB Staff Audit Practice Alerts.
- AICPA Professional Ethics: Most Frequent Violations of Professional Standards in Government and Not-for-Profit Engagements and Employee Benefit Plan Investigations.
- Discussion leaders and participants' actual experience.

The AICPA peer review process has continually noted deficiencies in the adequacy of engagement performance as well as the related, required documentation. As a result, those in public accounting need to develop a heightened understanding of documentation requirements in order to minimize the risk of not complying with professional standards, as well as the need to reduce malpractice litigation risk.

This course will also include discussions of compliance with documentation required by:

- Quality Control Standards and firm's quality control document.
- Audit and Assurance Standards.
- Preparation, Compilation and Review Standards.

The cited deficiencies will be presented as Matters for Further Consideration (MFC). A matter is cited when the peer reviewer evaluates the engagement and questions if a required procedure was

performed and/or documented, or if a transaction was accounted for properly or disclosed in the financial statements in conformity with applicable professional standards.

Participant learning objectives for this course program are to:

1. Identify and highlight the current commonly cited peer review deficiencies.
2. Discuss and review the authoritative guidance for these areas.
3. Provide examples and solutions to eliminate deficiencies.
4. Recognize the importance and significance of timely action to address deficiencies.

The quality control standards require firms to establish a quality control document that establishes its own requirements of performance and documentation that are unique for the firm's practice. These usually go above and beyond the required professional standards.

PRACTICE NOTE: In the context of a peer review, should a required procedure not be documented, the required procedure is considered as not being done. Therefore, this could lead to a nonconforming engagement.

A nonconforming engagement is defined as one that is considered as not being performed or reported on in conformity with applicable professional standards in all material respects.

COMPLIANCE WITH QUALITY CONTROL STANDARDS

MFC #1 Cited Deficiency: Failure to Document the Firm's Quality Control

Statement on Quality Control Standards (SQCS) No. 8 – *A Firm's System of Quality Control*, establishes that an accounting firm must establish and maintain a **system of quality control**. This system of quality control should include policies and procedures addressing each of the following elements:

- Leadership responsibilities for quality within the firm.
- Relevant ethical requirements including independence.
- Acceptance and continuance of client relationships and specific engagements.
- Human resources.
- Engagement performance.
- Monitoring.

Documentation supporting a firm's system of quality control should include policies and procedures:

1. Requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.
2. Requiring retention of documentation for a period of time sufficient to permit those performing monitoring procedures and peer review of the firm to evaluate the firm's compliance with its system of quality control or for a longer period, if required by law or regulation.
3. Requiring documentation of complaints and allegations from firm personnel and responses to them.

A number of provisions in SQCS 8 affect workpaper documentation. Those provisions require the following:

1. **Documentation and communication of the firm's quality control policies and procedures** – These policies and procedures should be documented and maintained for a long enough period of time to perform monitoring activities, to assist the peer reviewer in completing the peer review and to comply with any regulatory or legal requirements. Firms are also required to communicate their quality control policies and procedures to their personnel.
2. **Documentation of client acceptance by the firm** – There are several ways to do this:
 - Tailor the firm's own client acceptance and setup forms to include the procedures performed when evaluating whether or not to accept the client.
 - Prepare a memo to the file on the client acceptance process and approval of the appropriate members of the partner group.
 - Use a standardized form or checklist.

No matter what format is used, the firm must develop criteria for client acceptance, and evaluate the integrity of the client as well as the firm's competence and independence (if required) to perform the engagement.

3. **Documentation of planning the engagement** – SQCS 8 requires a firm to set policies and procedures to provide reasonable assurance that engagements are performed according to professional standards. For example, professional standards for audit, preparation, compilation and review each require an understanding of the client and the industry in which the client operates. This understanding is considered at an appropriate level for the level of service of the engagement. Consequently, this knowledge is part of the planning process. Therefore, documentation of planning can consist of:

- Work program with planning procedures.
- Planning memo – For a compilation, the memo can be short, discussing any changes with the client that would require changes to the “normal” compilation procedures. For example, if the client’s bookkeeper was ill for a period of time and the owner-recorded transactions himself, your compilation procedures might be expanded to consider whether those transactions were recorded properly.
- Understanding of Client Information Form.

NOTE TO PARTICIPANTS: Statement on Quality Control Standards No. 8 requires that the identity and role of the engagement partner be communicated to management and those charged with governance. Most firms provide this communication in the annual engagement letter with the client.

4. **Documentation when consultation has been performed on the engagement**—Quality control standards require that when accounting research is performed for an engagement issue, that research must be documented. This is easier said than done because often auditors or accountants may not recognize the issue.

Another problem is when to document an issue. The standards do not require a memo to the file every time you need to look up something in the authoritative literature. But if judgment or interpretation is required, then a consultation memo should be prepared, even if one individual performs the research without consultation with another party.

When a firm uses an external consultant, the firm should evaluate and document whether the qualifications of the consultant are adequate to perform the required consultation.

Some examples of when a consultation memo should have been prepared:

- A discussion takes place concerning a newly issued accounting or performance standard.
- A discussion takes place with members of a state society’s accounting and auditing technical committee concerning an accounting or auditing issue.
- Whether to book a contingency such as an environmental remediation liability.

Some tips when preparing the consultation memo follow:

- Summarize the pertinent facts.
- Document the research performed – both the authoritative literature and any person with whom you have consulted, as well as their qualifications.
- Be sure that the conclusion reached follows the research performed.

- Date the memo so that if questions arise later on when the literature has changed, the applicable pronouncements as of that date can be determined.

Also, note that there could be differences of opinion within a firm. Statement on Quality Control Standards No. 8 requires differences of opinion and their resolution to be documented.

5. **Documentation that the engagement has been properly supervised and reviewed** – The workpapers need to provide evidence that each person’s work was reviewed. This is again firm policy as the standards do not provide any specific guidance. The techniques commonly used are:

- Sign off of workpapers by the next level reviewer.
- Sign off on the “cover” of each workpaper file by the appropriate reviewer.
- Completion of a technical reviewer’s checklist.

Sign off for any of the above approaches can be done manually or electronically.

Note: Quality control standards require that a firm establish a policy for identifying specific circumstances that would require an engagement be subjected to an additional review pre-issuance. For example, a firm could establish a policy that an Engagement Quality Control Review would be required if the engagement involved a new client, a new industry or a change in level of service to the firm or partner. If an Engagement Quality Control Review (EQCR) is performed, there should be documentation that:

- The required EQCR procedures were performed.
 - The EQCR has been completed before the report was released.
 - The reviewer is not aware of any unresolved issues that would indicate inappropriate engagement conclusions.
6. **Documentation of client continuance** – Often firms perform an annual client continuance evaluation “globally”; that is, a review of all the firm’s clients (small firm) or an office review of clients. In this case, the minutes of the meeting of the client continuance process may be all the documentation that is maintained. When discontinuance decisions are made, then the termination letter to the client will be another form of documentation.
 7. **Documentation of monitoring procedures performed** – Monitoring is an ongoing evaluation of a firm’s quality control policies and procedures. Documentation should include:
 - Planning, including the selection process for engagements.
 - Actual monitoring procedures performed.

- Evaluation of:
 - Compliance with professional standards, and regulatory and legal requirements.
 - Whether the firm’s quality control system has been appropriately designed and effectively implemented.
 - Whether the firm’s quality control policies and procedures have been operating effectively.
- Identification of deficiencies, evaluation of their impact, and if required, recommendations for corrective action.

8. **Written confirmation on independence is required at least annually.**

Firm’s Workpaper Retention and Changes to Documentation

1. **SSARS** – Surprising as it may seem, SSARS does not address workpaper retention requirements. Therefore, workpaper retention for preparations, compilations, and reviews, the rules of the respective State Board of Accountancy governing the accountant should be followed in addition to the firm policies.
2. **Auditing Standards** – AU-C 230, *Audit Documentation*, stipulates that the retention period should not be shorter than 5 years from the **report release date**.

AU-C 230 and SQCS 8 also require the auditor to have controls to ensure documentation is not altered or deleted without the auditor’s knowledge, or is lost or damaged. These controls should:

- Determine if, when and by whom the documentation was created, changed, or reviewed.
- Protect the information during the audit, especially if it is transmitted electronically to others, and allow those on the audit full access to the information they need.
- Prevent unauthorized access.
- In addition, client confidentiality should be protected.

Another addition in AU-C 230 deals with changes to audit files. It:

- Defines two critical dates. The first date is **the date of the auditor’s report**, now defined as a date no earlier than the date the auditor has obtained sufficient evidence to support the opinion. This includes evidence that the documentation has been reviewed, the financials have been prepared and management has taken responsibility for the statements. AU-C 230 says the report date is expected to be close to the report release date (the date the auditor

grants the client permission to use the auditor's report in connection with the financial statements).

The second date is the **documentation completion date**, the date the audit file should be complete. This date should be within **60 days following the report release date**. However, state regulations or firm's quality control system may require a period shorter than 60 days.

Both of these dates govern what changes are permitted to the file.

- Permits the auditor to make the following changes to audit documentation prior to the documentation completion date:
 - Complete and assemble audit evidence.
 - Discard superseded data and collate and cross-reference workpapers.
 - Sign off all checklists.
 - Add information such as originals of faxed or emailed confirmations.
 - Clarify information contained in the file.

When this occurs, the revised documentation should contain all the same information and conclusions as the original superseded documentation. If the information is no longer relevant or valid, then it need not be retained, as long as it is prior to the documentation completion date.

Note: After the documentation completion date, documentation should not be deleted or discarded before the end of the retention period. However, documentation can be added.

- If new information is received **after the report date**, requiring either additional work or possible revision to the financial statements (as per AU-C 560, *Subsequent Events and Subsequent Discovery of Facts*), the auditor can make changes to the workpapers, as long as the documentation includes:
 - Identification of who made the changes and when.
 - When the changes were reviewed.
 - Specific reasons for the changes.
 - Impact, if any, of the changes on the auditor's conclusions.

These documentation requirements also apply to any other additions/amendments made to the workpapers **after the documentation completion date**.

3. **State Boards of Accountancy** – Some state boards of accountancy have specified retention periods and what to do with workpaper alterations. California has adopted the strictest rules to date. New York also has fairly restrictive rules. The New York Board of Regents has established a **seven-year** retention period after the date of issuance of the final work product, unless legal requirements mandate a longer period or there is an investigation or disciplinary proceeding against the auditor and his/her firm.

In addition, the Board requires:

- Any alteration made subsequent to the issuance of the final work product should be clearly documented, with a description of the subject, date, and reasons for the alteration. Substantive alterations because of post-issuance reviews should also be documented by an addendum to the workpapers, indicating subject, date, and reasons.
 - A set of workpapers should be completed within **45 days of the issuance of the final work product**.
4. **PCAOB** – The PCAOB has issued Standard No. 3, *Audit Documentation*, which has a **seven-year retention period** and a documentation completion date of **45 days** after the report is released. If additions are made to the workpapers after the documentation completion date, then the date, preparer, and reasons for the changes must be documented. **Note: Deletions are not permitted.**

One problem that must be addressed is **email documentation**. With voluminous emails being sent to and received from clients, firms must set their own criteria by which emails will either be retained or discarded. They must also establish a review process designed to make sure all relevant audit-related documentation is retained. There are companies who are now developing an archive system that will allow auditors to add comments to emails and send them to be reviewed without changing the original content.

PROFESSIONAL CODE OF CONDUCT

MFC #2 Cited Deficiency: Failure to Adequately Consider or Document Auditor Independence When Non-Attest Services are Performed

The AICPA, state boards of accountancy, SEC, PCAOB, DOL, and other agencies each have their own independence rules. All of them must be considered when addressing the independence issue.

Some of the AICPA independence rules apply a team approach, which narrows the pool of those members of a firm who are subject to certain independence requirements by focusing on **covered members**. Covered members are:

- Anyone who participates in the attest engagement.
- Anyone in a position to influence the attest engagement:
 - Evaluates the performance or recommends compensation of the attest engagement partner.
 - Directly supervises or manages the attest engagement partner, including all senior levels above the attest engagement partner through to the firm's CEO.
 - Consults with anyone on the attest engagement team on technical or industry issues related to the attest engagement.
 - Participates in or oversees, at all successively senior levels, quality control activities, including monitoring the specific attest engagement.
- A partner or manager providing non-attest services during the period beginning once he/she provides ten hours of non-attest services and ending the later of the date the firm signs the attest report for the year in which the services were performed or when he/she no longer expects to provide ten hours or more of non-attest services.
- A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement.
- The firm, including the firm's own employee benefits plans.
- Any entity whose operating, financial, or accounting policies can be controlled by any of the above.

Some common considerations in applying independence rules in small employee benefit plan engagements are discussed in the remaining paragraphs of this section.

Non-attest Services

A common concern about meeting independence requirements is the effect of providing non-attest services, such as:

- Bookkeeping services (not allowed by the DOL)
- Financial statement presentation
- Cash-to-accrual conversions
- Actuarial services
- Preparing the Form 5500

The AICPA revised its ethics rules to state that financial statement preparation and cash-to-accrual conversions performed by the member for a client should be considered non-attest services and subject to the requirements of the interpretations of the revision. All such services now should be considered non-attest services, regardless of whether the services are performed as part of an audit.

Auditors still are permitted to assist plan clients with financial statement preparation, but must make certain the requirements outlined in the interpretations of the “Non-attest Services” are followed.

1. “General Requirements for Performing Non-attest Services” interpretation calls for the following safeguards to be met:
 - a. Before performing non-attest services, the auditor should determine that the client has agreed to:
 - i. Assume all management responsibilities as described in the “Management Responsibilities” interpretation [1.295.030].
 - ii. Oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience. The member 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 re-perform the services.
 - iii. Evaluate the adequacy and results of the services performed.
 - iv. Accept responsibility for the results of the services.

- b. The member does not assume management responsibilities (see the “Management Responsibilities” interpretation [1.295.030] of the “Independence Rule”) when providing non-attest services and the member is satisfied that the client and its management will:
 - i. Be able to meet all of the criteria delineated in item a;
 - ii. Make an informed judgment on the results of the member’s non-attest services;
 - iii. Accept responsibility for making the significant judgements and decisions that are the proper responsibility of management.

If the client is unable or unwilling to assume these responsibilities (for example, the client cannot oversee the non-attest services provided or is unwilling to carry out such responsibilities due to lack of time or desire), the member’s performance of non-attest services would impair independence.

- c. Before performing non-attest services, the member establishes and documents in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding:
 - i. Objectives of the engagement.
 - ii. Services to be performed.
 - iii. Client’s acceptance of its responsibilities.
 - iv. Member’s responsibilities.
 - v. Any limitations of the engagement.

2. “Cumulative Effect on Independence When Providing Non-attest Services” [1.295.020].

The above safeguards do not apply to communications that are a normal part of the audit and certain routine activities performed by the member, such as providing advice and responding to the client’s questions as part of the client-member relationship. However, in providing such services, the member must not assume management responsibilities.

Practice Application for Employee Benefit Plans

Plan auditors must take into consideration affiliates of the employee benefit plan when determining whether they are independent with respect to the plan.

Interpretation 1.295 does not specify how the understanding is to be documented, so the auditor has flexibility. The understanding can be documented in a separate engagement letter, in the audit

documentation, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement.

Certain activities performed as part of a non-attest service are considered to be management functions and, therefore, impair independence, regardless of whether the auditor complies with the other requirements of ET Section 1.295. The Interpretation specifically states that performance of the following activities relating to audits of employee benefit plans would impair an auditor's independence:

- Having custody of plan assets.
- Serving as a fiduciary, as defined by ERISA.
- Making disbursements on behalf of a plan.
- Making policy decisions on behalf of plan management.
- When dealing with plan participants, interpreting the plan document on behalf of plan management without first obtaining the concurrence of plan management.

In addition, under Interpretation 1.295, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity.

The Interpretation recognizes that various other regulatory bodies, such as the SEC or the DOL, may have independence rules related to non-attest services that are more stringent than those contained in Interpretation 1.295.

The Interpretation states the failure to comply with the independence requirements of such regulatory bodies constitutes a violation of the Interpretation. Auditors of employee benefit plans should be aware of the independence regulations promulgated by the DOL.

PRACTITIONER NOTE: Performing procedures in connection with an audit that are designed to address audit risk arising from the lack of control activities, such as reconciling carrying amounts of assets and liabilities with amounts reported by third-parties (such as trustees or custodians), would NOT be considered bookkeeping services. Similarly, preparing financial statements as part of an audit would not be considered a bookkeeping service. Neither of those services involve processing the entity's transactions or preparing its accounting records. Proposing audit adjustments of accounting records prepared by the entity also would not be considered a bookkeeping service.

Deficiency Issue: Lack of adequate documentation of **skills, experience, education, or knowledge** of the individual who has been assigned by management to take responsibility for the oversight when non-attest services are performed by the outside auditor. This documentation should be in sufficient

detail that it is clear that there is adequate knowledge of the individual to assume the required responsibilities.

AUDIT ENGAGEMENTS

MFC #3 Cited Deficiency: Failure to Adequately Document Sampling Methodology

AU-C 530 provides guidance on how to perform sampling during an audit engagement. However, if the methodology of the sampling method used is not documented, the overall objective of evaluating appropriate audit evidence may be compromised.

The following documentation is required:

- How the sample size was selected, including consideration of the completeness of the population.
- Which specific items were selected (list specific items tested).
- The audit work performed on each item.
- Identification of any differences between the recorded amount and the result of the test.
- Aggregation of any differences.
- Extrapolation of any differences.
- Conclusions as to whether the extrapolated difference needs to be booked as an adjustment, posted to the Summary of Passed Adjustments, or passed because it is below the amount of tolerable misstatement.

MFC #4 Cited Deficiencies: Failure to Appropriately Document the Risk Assessment. Failure to Link Risk Assessment to Further Audit Procedures

Issue #1: Failure to appropriately document the risk assessment procedures.

The following is a summary of some of the professional requirements related to the performance of risk assessment procedures.

Risk assessment procedures should be performed to provide a basis for identification and assessment of risks of material misstatement at both the financial statement and **relevant assertion levels**.

Risk assessment procedures include:

- a. Inquiries of management and others at the client.
- b. Analytical procedures.
- c. Observations.
- d. Walkthroughs.

Auditors should perform and document risk assessment procedures to support the assessment of the risks of material misstatement. The risk assessment procedures provide the audit evidence necessary to support the risk assessments, which, in turn, drive the nature, timing, and extent of further audit procedures. Thus, the results of the risk assessment procedures are an integral part of the audit evidence obtained to support the opinion on the financial statements.

It is not acceptable to simply deem risk to be "at the maximum" unless such an assessment is supported by the facts, controls and circumstances. By defaulting to maximum risk without an adequate understanding of the internal controls in place, specific risks cannot be determined, nor can the affected assertions be identified.

Are all assertions of accounts payable equally risky? If that were so, extensive tests of existence and valuation would be required as well as the common tests of completeness and accuracy, and this is unlikely to result in an efficient audit. Also, conditions or weaknesses that indicate a fraud risk could be overlooked. Illustrative audit programs may not be sufficient to address all possible engagement risks.

All of the risk assessment procedures (for example, inquiries, analytical procedures, observations, and walkthroughs) are not required for each aspect of the client's internal control or economic environment. However, in the course of obtaining the required understanding about the client, you should consider and perform all the risk assessment procedures. If not performed, consider documenting why the procedures were not considered necessary.

Issue #2: Linking the risk assessment procedures to performance of further audit procedures

Based on the risk assessment performed, the auditor will determine the appropriate **overall** and **specific** responses to the significant risks identified. The specific responses will address significant risks at the relevant assertion level. AU-C 330 refers to these responses as **further audit procedures**. The auditor should be aware that risk at the financial statement level may affect the risk at the assertion level. This would be primarily due to a weak control environment. Bearing this in mind will help the auditor design further audit procedures that are responsive to both levels.

The concept of linkage is emphasized in the risk assessment standards (as well as in AU-C 240). **The understanding of the entity and its environment (including internal control) is linked to the assessment risk and the determination of significant risks.** The assessment of significant risks at the financial statement and relevant assertion level is linked to the design of further audit procedures. These concepts are illustrated below.

EXAMPLE

Although the auditor of BTRW identified numerous risks, after the risk assessment was performed, management override was determined to be a financial statement risk and two items were considered significant risks at the assertion level – related party receivables (completeness, valuation, disclosure) and an environmental liability (valuation, disclosure). Since they were not systematically processed transactions, the auditor had not previously looked at the design of controls or whether controls had been placed in operation, so she performed those procedures. The auditor did not identify any areas where substantive tests alone will not provide sufficient appropriate audit evidence. The auditor now has to determine the overall and specific responses to the significant risks identified and evaluate the evidence obtained.

Overall Responses

Overall responses are used to address the pervasive risks that might be identified at the financial statement level. Usually these risks will be related to issues associated with the entity's control environment, risk assessment, information and communication, and/or monitoring activities. There are several ways the audit team can respond to these risks:

- Emphasize professional skepticism in gathering and evaluating audit evidence.
- Use more skilled staff to perform sensitive audit procedures.
- Provide more supervision.
- Incorporate unpredictability into the audit.
- Use personnel with specialized skills or specialists.
- If issues are related to the control environment, then the auditor could perform more procedures nearer to year end, use more substantive procedures, modify procedures to obtain more persuasive audit evidence or increase the number of locations to be included in the audit scope.

EXAMPLE

A trucking company, a Subchapter S Corporation, has three shareholders. They all participate in the business, one as CEO, and the other two as CFO and COO. The accounting department is very small with one accounting supervisor and a billing clerk. The Company has a board of directors but it consists of the three shareholders, the Company's attorney and one member of the community who knows the owners. Board meetings are rare since the three owners discuss concerns for the company on a day-to-day basis. The Company is required to have an audit as a condition of bank debt.

The Company's auditor identified these facts during his risk assessment. In prior years, he also noted that the significant estimates (all expense/liabilities) of the company were all at the high end of the range and that the CFO was reluctant to make any entries that would increase the company's income.

Due to the nature of the business, the fact it is closely held without much independence on the board, and the apparent bias on the part of management related to estimates, the auditor decided that an overall response was necessary. He altered the audit plan by assigning a manager to the engagement to test the estimates and supervise the staff on the job. In addition, year-end work was expanded.

Specific Responses

For **material audit risks at the relevant assertion level**, the auditor will design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement. This can be a combination of tests of controls (if the auditor expects that the controls are operating effectively) and substantive tests. **The auditor should perform substantive procedures for all relevant assertions related to each material class of transactions, account balance and disclosure. Tests of controls alone are not sufficient.**

The auditor should obtain audit evidence about the accuracy and completeness of information generated by the client's information system when that information is used in performing audit procedures.

MFC #5 Cited Deficiency: Failure of Audit Documentation to Contain Sufficient, Competent Evidence to Support the Firm's Opinion on the Financial Statements.

AU-C 230, *Audit Documentation*, makes it clear that the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of:

- The work performed (including the nature, timing, extent, and results of audit procedures performed).
- The audit evidence obtained and its source.
- The conclusions reached.

Case Study - Notes Receivable Workpaper

Review the workpaper that the assistant on the audit of Starr Foods prepared for the Notes Receivable.

Starr Foods, Inc.

Notes Receivable

12/31/X5

JMF

2/15/X6

Source: Account 2401 – Notes Receivable

	ABC Note	DEF Note	XYZ Note	PPP Note
Date Issued	1/1/X2	1/1/X3	7/1/X3	7/1/X4
Due Date	1/1/X7	1/1/X8	7/1/X8	7/1/X8
Face Value	\$10,000	\$25,000	\$10,000	\$20,000
Fair Value	None	\$40,000	\$25,000	\$30,000

					Total	
NR Balance at 1/1/X5	\$ 5,200	\$ 17,000	\$ 2,400	\$ 17,000	\$ 41,600	pp
Additions	0	0	0	0	\$ -	
Principle Payments	<u>\$ (2,400)</u>	<u>\$ (5,000)</u>	<u>\$ (1,000)</u>	<u>\$ (4,500)</u>	<u>\$ (12,900)</u>	cr
NR Balance at 12/31/X5	\$ 2,800	\$ 12,000	\$ 1,400	\$ 12,500	\$ 28,700	gl
	✓	✓	✓	✓	✓	

pp – Traced to prior period's works papers

cr – Traced to cash receipts journal

gl – Agreed to general ledger

✓ Downfooted

Required:

1. Identify deficiencies of the workpaper.

2. What effect would this workpaper have on the opinion of the financial statements?

Audit documentation provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally accepted auditing standards and provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

Among other matters, AU-C 230 provides the following:

- The auditor should prepare audit documentation that is sufficient to enable an **experienced auditor**, having no previous connection to the audit, to understand the nature, timing, and extent of the auditing procedures performed to comply with GAAS and applicable legal and regulatory requirements. This includes:
 1. Identifying characteristics of the specific items or matters tested,
 - a. Who performed the audit work
 - b. The dates such work was completed
 - c. Who reviewed the audit work
 - d. The dates of such review
 - e. Clear understanding of the results of the audit procedures performed
 - f. The audit evidence obtained
 - g. Significant findings or issues arising during the audit
 - h. Conclusions reached
 - i. Significant professional judgments made in reaching those conclusions

PRACTICE NOTE: It is not acceptable to only document the errors found. Documentation must consist of all the procedures performed on all the tested items.

- **Verbal explanations** on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but they may be used by the auditor to clarify or explain information contained in the audit documentation.
- The auditor should document **significant findings or issues**, actions taken to address them, and the basis for the final conclusions reached. If for some reason the auditor leaves the assignment before resolving all items, he or she may provide an open item listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- The auditor should **assemble the audit documentation** in an audit engagement file and complete the administrative process of assembling the final audit engagement file on a timely basis – no later than 60 days following the report release date (also known as the documentation completion date). The auditor may need to consider that statutes, regulations, or the audit firm's quality control policies could specify a period of time shorter than 60 days following the report release date in which this assembly process is to be completed.
- Certain matters, such as auditor independence and staff training, which are not engagement specific, may be documented either centrally within a firm or in the audit documentation for an audit engagement.

MFC #6 Cited Deficiencies in Performance of Required Procedures

Issue #1: Failure to appropriately address fraud considerations in an audit.

AU-C 240: *Consideration of Fraud in a Financial Statement Audit* is the primary source of guidance for the CPA and provides the specifics in regards to the consideration of fraud by the auditor. It does not change the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements whether caused by error or fraud. It does build on concepts such as discussions with the engagement team and company management. The objectives of the standard are:

- Identify and assess the risk of material misstatement of the financial statements due to fraud.
- Obtain sufficient, appropriate audit evidence regarding the assessed risk of material misstatement due to fraud by designing and implementing appropriate responses.
- Responding appropriately to fraud or suspected fraud identified during the audit.

In order to meet these objectives, the requirements of AU-C 240 are:

1. Identify risk factors existing at the client for fraudulent financial reporting and/or misappropriation of assets.
2. Determine if these factors require a change in audit strategy – if so, tailor the strategy.
3. Conclude as to whether detected material misstatements may be due to fraud.
4. Document the entire risk assessment process.

In addition, there are three other standards that build on and intertwine certain requirements in AU-C 240 as follows:

1. **AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards** – lays out the overall responsibilities of a CPA when auditing financial statements to meet the following objectives:

- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or **fraud**, allowing the auditor to express an opinion.
- Report on the financial statements and communicate as required by GAAS based on those findings.

The standard also introduces the concepts of professional skepticism and professional judgment, of which both are crucial in determining the possibility of material misstatements from fraud.

2. **AU-C 315: *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*** – builds on concepts such as discussions with the engagement team and company management, as well as identification and assessment of risk of material misstatement.
3. **AU-C 330: *Performing Audit Procedures in Response to Assessed Risk and Evaluating the Audit Evidence Obtained*** – highlights specific audit procedures responsive to assessed risk.

Issue #2: Failure to properly perform and document planning analytics.

The auditor should perform analytical procedures that are designed to:

- Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and
- Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

When performing an analytical procedure, the auditor should use his or her understanding of the company to develop **expectations** about **plausible relationships** that are likely to exist. This understanding can come from a combination of internal information such as the contents of board meeting minutes or external information such as published rates of reimbursement from a payor source such as Medicare.

AU-C 520, Analytical Procedures, provides the current guidance relative to performing analytical procedures in planning, as substantive tests and in the overall review at the end of the audit. AU-C 315 reiterates this guidance, stressing that the auditor, in performing preliminary analytical procedures, should develop expectations about plausible relationships that are reasonably expected to exist. *AU-C 240, Consideration of Fraud in a Financial Statement Audit*, goes one step further and specifies that analytical procedures be performed for the purpose of identifying unexpected relationships in revenue accounts.

All three topics state that analytical procedures performed in planning are generally performed using data that is **aggregated** at a high level so that only broad indications of risk due to error or fraud are likely to result. However, the auditor should consider these results in the risk assessment.

Many auditors perform these preliminary analytical procedures using a fluctuation analysis (i.e., taking the balances from the current period and comparing them to prior periods and explaining any differences that are significant). The problem with this approach is that the implicit expectation with that method is that the current period will be similar to the prior period. But this is not always true. It is the author's view that expectations are better constructed by **factoring anticipated changes into the expectations rather than explaining the differences**.

Since the objective is to identify risk, even with aggregated balances, then a better approach might be to evaluate the fluctuations "**in light of the information the auditor has gained through understanding the external environment, reading the board minutes, etc.**"

The important thing is to make it clear from the narrative provided to supplement the spreadsheet that the auditor was not expecting the current year to look like the prior year, but in examining the fluctuations, took the environmental changes in the entity into consideration.

The auditor may also choose to use a comparison of **budget to actual**. This assumes that the budget is an important document to the entity and there are controls over the budgeting process to ensure that it isn't changed during the period without approval.

Analytical Procedure	Uses and Limitations
<p>Trend analysis – This analytical procedure has an implicit expectation. The auditor would compare the current year object of interest (i.e., revenue, expense line item, etc.) to the prior year.</p>	<p>This method will be less precise than other types of analytical procedures but it is very useful for preliminary analytical procedures.</p> <p>Note that if the auditor uses only one year, this can lead to bias unless it can be substantiated that the environment is that stable. The auditor enhances the procedure by using more years. This method only allows for factoring in one variable.</p> <p>It is not likely that the method will yield a precise enough expectation for a substantive audit procedure (SAP).</p>
<p>Ratio analysis – These analytical procedures have an implicit expectation. Ratio analysis involves a comparison of relationships between financial statement accounts between two periods or over time. This can be the comparison of an account with nonfinancial data (dollars of sales with numbers of sales) or comparison of relationships between financial data and industry statistics such as return on investments compared to market statistics for an investment portfolio.</p>	<p>This method only works when the relationships are stable. It is important to disaggregate data. The method only allows for one variable.</p> <p>This method is very good for preliminary analytical procedures but is not likely to yield a precise enough result for SAPs.</p>

The AICPA's Audit Guide on *Analytical Procedures* gives other examples of types of analytical procedures such as trend analysis and ratio analysis that can be performed in planning to see if expected relationships still exist in the current year based on prior year financial and nonfinancial information (for example, revenue per customers or clients, same store sales per day, etc.). It is important to be sure to evaluate the risk of fraud relating to revenue recognition.

MFC #7 Cited Deficiencies: Communication and Reporting

Issue #1: Failure to communicate and/or document required communication with those charged with governance.

AU-C 260, The Auditor's Communication with Those Charged with Governance, establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. The term "those charged with governance" means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. For entities with a board of directors, the term encompasses the term board of directors or audit committee used elsewhere in generally accepted auditing standards (GAAS).

In accordance with auditing standards, the auditor must communicate with those charged with governance **findings or issues**, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process. The auditor should communicate the following with those charged with governance:

- The auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are prepared, in all material respects, in conformity with the applicable financial reporting framework.
- The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

These responsibilities may be communicated through the engagement letter, or other suitable form of written agreement that documents the terms of the engagement, if the engagement letter or other written agreement is provided to those charged with governance.

The auditor may also consider including additional information in their communications such as:

- An overview of the **planned scope and timing** of the audit.
- **Significant findings** from the audit, including:
 - Auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.
 - Significant difficulties, if any, encountered during the audit.
 - Disagreements with management, if any.
 - Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process, unless all of those charged with governance are involved in managing the entity, the auditor should also communicate the following:
 - **Material, corrected misstatements** that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.
 - **Significant findings or issues**, if any, arising from the audit that were discussed, or the subject of correspondence with management.

- The auditor's views about **significant matters that were the subject of management's consultations** with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.
- **Written representations** the auditor is requesting. The auditor may provide those charged with governance with a copy of management's written representations.
- The auditor should communicate in writing with those charged with governance **significant findings or issues from the audit** if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.

EXAMPLE

Communications with Those Charged with Governance

To the Board of Directors of Loscalzo Training Center:

We have audited the financial statements of Loscalzo Training Center for the year ended December 31, 20X2, and have issued our report thereon dated April 15, 20X3. Professional standards require that we provide you with the following information related to our audit.

Our Responsibility Under U.S. Generally Accepted Auditing Standards

As stated in our engagement letter dated November 5, 20X2, our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities.

Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our meeting about planning matters on December 10, 20X2.

Significant Audit Findings

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by Loscalzo Training Center are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during 20X2. We noted no transactions entered into by the Organization during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

EXAMPLE (CONTINUED)

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management.

The attached schedule summarizes uncorrected misstatements of the financial statements. Management has determined that the effects of the uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Management posted one entry to accrue for management bonuses. This entry was significant and overlooked by management in the closing process. Bonuses that were accrued amounted to \$80,000.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management's Representations

We have requested certain representations from management that are included in the management representation letter dated April 15, 20X3.

Management's Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Organization's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to our retention as the Organization's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

This information is intended solely for the use of the Board of Directors and management of Loscalzo Training Center and is not intended to be, and should not be, used by anyone other than these specified parties.

Issue #2: Failure to communicate internal control matters identified in an audit.

Of the peer review matters identified in audit and attest engagements, many relate to **internal control matters identified in an audit** including the following:

- Failure to note the auditor's responsibility for communicating internal control matters identified in the audit in the engagement letter.
- Failure to complete or inaccurate completion of the internal control matters section of the firm's audit work programs in accordance with quality control policies and procedures.
- Failure to identify internal control matters during the planning stage of the engagement.

AU-C 265, Communicating Internal Control Related Matters Identified in an Audit, requires that deficiencies identified during the audit and evaluated as significant deficiencies or material weaknesses should be communicated in writing to those charged with governance on a timely basis. Such significant deficiencies or material weaknesses include those that were remediated during the audit.

Management may already know of the existence of significant deficiencies or material weaknesses, and the existence of these deficiencies may represent a conscious decision by management, those charged with governance, or both, to accept that degree of risk because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. Auditors are responsible for communicating significant deficiencies and material weaknesses, regardless of management's decisions.

The **written communication of significant deficiencies and material weaknesses** should include:

- The definition of the term *material weakness* and, where relevant, *significant deficiency*.
- A description of the significant deficiencies and material weaknesses and an explanation of their potential effects.
- Sufficient information to enable those charged with governance and management to understand the context of the communication.
- A restriction regarding the use of the communication to management, those charged with governance, and others within the organization, and any governmental authority to which the auditor is required to report.

To enable those charged with governance and management to understand the context of the communication, you should also include the following elements:

- The purpose of the audit was for the auditor to express an opinion on the financial statements.
- The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.
- The auditor is not expressing an opinion of the effectiveness of internal control.
- The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

In some circumstances, the reviewer may include additional statements in the communication regarding:

- The general inherent limitations of internal control, including management override of controls.
- The specific nature and extent of your consideration of internal control during the audit.

A client may ask you to issue a written communication indicating that no material weaknesses were identified during the audit of the financial statements. You are not precluded from issuing such a communication, provided it includes the matters required under AU-C 265.

EXAMPLE

Sample Template for an AU-C 265 Communication

In planning and performing our audit of the financial statements of XYZ Company (the "Company") as of and for the year ended December 31, 20X9, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses, and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses [and other deficiencies that we consider to be significant deficiencies].

EXAMPLE (CONTINUED)

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. [We consider the following deficiencies in the Company's internal control to be material weaknesses:]

[Describe the material weaknesses that were identified.]

[A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company's internal control to be significant deficiencies:]

[Describe the significant deficiencies that were identified.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

Issue #3: Failure to properly date the audit report. The reports were dated significantly earlier than the date of the review of workpapers and the release date, and the management representation letters were dated after the report letter date.

Under AU-C 230, *Audit Documentation*, the auditor's report should not be dated any earlier than the date that the audit documentation has been reviewed, the financial statements, including footnotes, have been drafted, and management has accepted responsibility for the financial statements. AU-C 230 goes on to say that this will ordinarily be close to the report release date.

AU-C 580, *Written Representations*, says that the management representation letter should be dated as of the date of the auditor's report.

REVIEW ENGAGEMENTS CITED DEFICIENCIES

Cited Deficiencies

Issue #1: Failure to obtain an engagement letter or failure to have all the required elements included within the engagement letter.

The accountant must agree with the client on the terms of the review engagement. This agreement must be documented in a signed engagement letter by both parties including the following:

- The objective of the engagement.
- The responsibilities of management.
- The responsibilities of the accountant.
- The limitations of the engagement to prepare financial statements.
- Identification of the applicable financial reporting framework for the preparation of financial statements.
- The expected form and content of the accountant's review report and a statement that there may be circumstances where the report may differ from its expected form and content.

Because there can be misunderstandings with the client between the accountant's responsibilities and those of the client, AR-C 90 requires the accountant to obtain a signed, written engagement letter in a review.

The engagement letter should include the following statements:

1. **The objective of a review is to obtain limited assurance that no material modifications are required in order for them to be in compliance with the applicable financial reporting framework.**
2. The preparation and fair presentation of financial statements are management's responsibility.
3. It is management's responsibility to design, implement, and maintain adequate internal controls over the financial statement process.
4. The prevention and detection of fraud are management's responsibility.
5. Management is responsible for compliance with applicable laws and regulations.
6. All financial records and information are given to the accountant.

7. **Management will provide the accountant with certain written representations made during the review.**
8. The engagement will be performed in accordance with SSARS issued by AICPA.
9. **A review consists primarily of the accountant making inquiries and performing certain analytical procedures.**
10. **A review is substantially less in scope than an audit which requires the accountant to express an opinion on the financial statements.** A review does not contemplate:
 - Obtaining an understanding of internal controls.
 - Assessing fraud risk.
 - Testing accounting records through confirmation, inspection, observation, etc.
 - Performing any other audit procedures, such as looking at bank checks or images.
 - That the accountant will express an opinion on the financial statements as a whole.
11. The engagement cannot be relied on to discover errors, fraud, or illegal acts.
12. The accountant will inform the appropriate management level if any errors, fraud, or illegal acts come to the accountant's attention except for illegal acts that are clearly inconsequential. The client and the accountant can agree as to what is considered inconsequential.

The engagement letter should discuss, if applicable, material departures and supplementary information.

While it was always a best practice, SSARS 21 now requires the client to return a signed engagement letter to the accountant.

EXAMPLE*Sample Review Engagement Letter*

To the Board of Directors or Stockholders:

You have requested that we prepare the financial statements of Finnigan 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 understanding of this engagement 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 and
- 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 engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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; 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 any evidence or information that comes to our attention during the performance of our review procedures that indicates fraud may have occurred. In addition, we will 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.

EXAMPLE (CONTINUED)**Your Responsibilities**

The engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to prepare 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 SSARS:

- 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.
- 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.
- The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements.
- The prevention and detection of fraud.
- To ensure that the entity complies with the laws and regulations applicable to its activities.
- To make all financial records and related information available to us.
- The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement.
- To provide us with unrestricted access to persons within the entity of whom we determine it necessary to make inquiries.
- 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.

EXAMPLE (CONTINUED)**Our Report**

We will issue a written report upon completion of our review of Finnigan Company's financial statements. Our report will be addressed to the board of directors of Finnigan 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.

Other Relevant Information

Our fees for these services...

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 Finnigan Company by:

[Signed]

[Name and Title]

[Date]

Issue #2: Failure to obtain appropriate management representation letters (all representations required, appropriate dating, appropriate financial statement periods).

SSARS requires that the accountant must obtain written representations from management for all financial statements and periods covered by the accountant's review report. As such, **the representation letter should:**

- Cover all of the financial statement periods being reported on. Thus, if the financial statements are comparative, the representations should be comparative.
- Be signed by current management, even if they were not there for the entire period being reported on.

The specifics of the representation letter will depend on the circumstances of the engagement and, therefore, tailoring the letter is critical. Ordinarily, the representations confirm information given to the accountant both verbally and in writing (the engagement letter) as well as reduce any misunderstanding as to what is being represented all the while documenting the continuation and appropriateness of the representations. The accountant should ask for the following, in writing:

- Contain management's acknowledgement that they are responsible for the preparation and fair presentation of the financial statements in conformity with the applicable framework and that the financial statements do present fairly the financial statements, including reasonable assumptions and values.
- Acknowledge management's responsibility to design, implement, and maintain relevant internal control.
- Acknowledge management's responsibility to prevent and detect fraud, as well any knowledge of fraud or suspected fraud affecting the entity involving management or others where that fraud could have a material effect on the financial statements.
- State that management has responded fully and truthfully to all inquiries.
- State that all information is complete.
- State whether there were any subsequent events.

EXAMPLE

Sample Management Representation Letter

(To Accountant)

(Date)

This representation letter is provided in connection with your review of the financial statements of Finnigan 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, as of (date of accountant's review report) the following:

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 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.
- 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.

EXAMPLE (CONTINUED)

- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole.
- 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 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 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 laws or regulations 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 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.

EXAMPLE (CONTINUED)

- 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 agree with the adjusting journal entries that you have recommended, and they have been posted to the company's accounts.

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

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

Issue #3: Review reports were not updated for current language in SSARS 21 or had inappropriate titles that did not reflect the proper financial reporting framework.

If financial statements are reviewed, a report **should** be issued. The purpose of a review report is to prevent any misunderstanding regarding the level of responsibility being taken by the accountant for the financial statements. The report should identify the financial statements, the financial reporting framework, and conclude that no material modifications are required based on the planned procedures. A standard review report should include the following:

- A **title** such as “Independent Accountant’s Review Report.”
- The accountant’s report should be **addressed to the appropriate party** such as stockholder, owner, board of directors, etc.
- The **introductory paragraph** in the accountant’s report should:
 - a) Identify the entity being reviewed;
 - b) State that the financial statements have been reviewed;

- c) Identify the title of each statement. The report would use the exact financial statement titles used;
 - d) Specify the date or period covered by the financial statements;
 - e) Include a statement that a review includes primarily applying analytical procedures to management's or owners' financial data and making inquiries of company management or owners;
 - f) Include 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.
- A section with the **heading** "Management's Responsibility for Financial Statements" that includes an explanation that **management or owners are responsible** for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement.
 - A section with the **heading** "Accountant's Responsibility" that includes the following:
 - The **accountant's responsibility** is to conduct the review in accordance with SSARS issued by the AICPA.
 - A statement that SSARS requires the accountant to **perform review procedures** to obtain limited assurance that there are no material modifications that should be made to the financial statements.
 - A statement that the accountant believes that the results of the accountant's procedures provide a **reasonable basis** for the report.
 - A statement that based on the accountant's review, the accountant is **not aware of any material modifications** that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report.
 - A manual or printed signature.
 - Accountant's city and state.
 - The date of the review report.

Each page of the financial statements should bear the legend "See Accountant's Review Report."

PRACTICE NOTE: The accountant's review report should be dated when all required procedures of the review have been performed and definitely not earlier than the date on which the accountant has gathered sufficient review evidence.

Issue #4: Failure to report on supplementary information presented with the financial statements and the accountant's review report.

In a review of financial statements that are accompanied by supplemental information, the accountant can either review or not review the information. If reviewed, clearly indicate in either the report (other-matter paragraph) or a separate report accompanying the supplemental information that:

1. The supplemental information is presented only for additional analysis purposes and is not a required part of the financial statements.
2. The supplemental information is the representation of management.
3. 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 conformity with the applicable framework.
4. The accountant has not audited the supplementary information and, accordingly, does not express an opinion on such information.

EXAMPLE

Supplementary Information – Other-Matter Paragraph/Reviewed

The [supplemental information included] is presented for the purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. We have reviewed the information, and, based on our review, 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 framework]. We have not audited the information, and, accordingly, we do not express an opinion on such information.

If the accountant did not review the information, the other-matter paragraph/separate report, would include above items 1 & 2, would not include 3, and 4 would be modified as follows:

EXAMPLE

Supplementary Information – Other-Matter Paragraph/Not Reviewed

The [supplemental information included] is presented for the purposes of additional analysis and is not a required part of the basic financial statements. The information is the representation of management. We have not audited or reviewed the information, and, accordingly, we do not express an opinion, a conclusion nor provide any assurance on such information.

Cited Deficiencies In Documentation of Analytical Procedures: Failure to Document Expectations or the Comparison of Expectations to Recorded Amounts for Analytical Procedures

The purpose of analytical procedures is:

- To identify fluctuations and the existence or absence of relationships that are different than those expected,
- To serve as the basis for making additional inquiries of management as to why they differ from those expected, and
- To provide the review evidence that will be the basis for the limited assurance given to the accountant's review report.

SSARS does not require the accountant to substantiate management's explanations. However, if management is unable to provide an explanation or the explanation is unreasonable based on the accountant's understanding of the business or the client's operations, the accountant will generally be required to tailor and perform additional procedures.

Analytical procedures may be performed at either the financial statement level or the account level, and the nature, extent and timing of analytical procedures should be determined based on the accountant's professional judgment, with appropriate documentation. How disaggregated the analytical procedures is a matter of professional judgment. For example, cost of sales for an accounting firm would consist of labor hours at a standard billing rate whereas the cost of sales for a manufacturer may vary widely, based on the type of product sold.

Although the selection of the extent, type and appropriateness of analytical procedures requires judgment (risk awareness), the following may influence the accountant's decision:

- The materiality of the items being tested.
- The probability that errors might exist. Analytical procedures are designed to detect unknown potential errors. If you already suspect that the amounts are likely incorrect, you should request that the client correct the errors before performing analytical procedures.
- Prior experience with the client. Errors discovered in previous engagements should be used as a guide in the selection of analytical procedures in the current engagement.
- The qualification of the client's accounting staff and the integrity of the underlying financial data.
- Whether the amounts being tested are subject to manipulation by management.

SSARS identifies the following sources for developing expectations:

1. Comparison of current amounts to prior periods.
2. Comparison of actual amounts to budgeted or forecasted amounts.
3. Consider changes in the business and the business economic conditions.
4. Identifying appropriate interrelationships of accounts.
5. Comparison of operating results to industry standards.
6. Comparison of financial to non-financial data.
7. Comparison to similar clients.
8. Scanning the general ledger.

The documentation of an analytical procedure is a matter of preference and judgment. However, the documentation should include the following:

- The **expectation** and how it was developed.
- Results of comparing expectation to actual.
- An acceptable deviation from the expectation. For example, how much could the resultant analytical procedure vary from the expectation before the accountant would make additional inquiry?
- The results of any additional inquiry (i.e., management's response) or additional procedures performed.

COMPILATION ENGAGEMENTS

Cited Deficiencies

Issue #1: Engagement Letters – Failure to update for current SSARS language, identify lack of independence, and identify the financial reporting framework being utilized by management (especially when employing a special purpose framework)

NOTE TO PARTICIPANTS: Findings in past peer reviews refer to revisions in language that were not adopted. The compilation and review guidance should be consulted each year for changes.

The accountant must agree with the client on the terms of the compilation engagement. This agreement **must be documented in a signed engagement letter by both parties** including the following:

- The objective of the engagement.
- The responsibilities of management.
- The responsibilities of the accountant.
- The limitations of the engagement to compile financial statements.
- Identification of the applicable financial reporting framework for the preparation of financial statements.
- The expected form and content of the accountant's compilation report and a statement that there may be circumstances where the report may differ from its expected form and content.

While SSARS has always recommended obtaining an engagement letter to document the understanding with the client as to what services the accountant was performing for the client and the limitations on those services, obtaining a signed engagement letter is now required. Engagement letters are one of the best ways for an accountant to limit their liability. The following statements should be included in written engagement letters.

The engagement letter should include the following statements:

1. The objective of a compilation is assisting management in presenting financial information in the form of financial statements.
2. The accountant is not giving any type of assurance that the accountant will find material modifications to the information that is management's representation.
3. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
4. It is management's responsibility for designing, implementing and maintaining adequate controls over the financial statement process.
5. The prevention and detection of fraud is management's responsibility.
6. Management is responsible for identifying and ensuring the entity's compliance with laws and regulations.
7. Management is responsible for making all financial information available to the accountant.

8. The engagement will be performed in accordance with SSARS.
9. A compilation is different from an audit or review in that a compilation does not contemplate:
 - Performing inquiry, analytical or other review procedures.
 - Obtaining an understanding of internal controls.
 - Assessing fraud risk.
 - Testing accounting records through confirmation, inspection, observation, etc.
 - Performing any other audit procedures, such as looking at bank checks or images.
 - That the accountant will not express any assurance, opinion, or other conclusion on the financial statements.
10. The engagement cannot be relied on to discover errors, fraud, or illegal acts.
11. The accountant will inform the appropriate management level if any material errors, fraud, or illegal acts come to their attention, except for illegal acts that are clearly inconsequential. The client and the accountant can agree as to what is considered inconsequential.
12. The effect of any lack of independence.

AR-C 80 also indicates that if applicable, the following items should also be included in the engagement letter:

- Material departures from the financial reporting framework and that the effects may not be disclosed.
- Substantially all disclosures have been omitted.
- Reference to supplementary information.

If management is adopting a new GAAP-Private Company Counsel (PCC) private company standard, reference this in the engagement letter (see TIC .32, .33 and .34).

While it was always a best practice, SSARS 21 now requires the client to return a signed engagement letter to the accountant.

EXAMPLE

Sample Compilation Engagement Letter

To the appropriate representative of management of Finnigan Company:

You have requested that we prepare the financial statements of Finnigan 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 engagement by means of this letter.

Our Responsibilities

The objective of our engagement is to:

- Prepare financial statements in accordance with accounting principles generally accepted (or special purpose framework) in the United States of America based on information provided by you, and
- 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 compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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 to prepare financial statements in accordance with accounting principles generally accepted in the United States of America and 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 SSARS:

- The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America.
- The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements.
- The prevention and detection of fraud.

EXAMPLE (CONTINUED)

- To ensure that the entity complies with the laws and regulations applicable to its activities.
- To make all financial records and related information available to us.
- The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement.

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 the services performed and accepting responsibility for such services.

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.

Other Relevant Information

Our fees for these services....

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 Finnigan Company by:

[Signed]

[Name and Title]

[Date]

Issue #2: Report Letter – Several cited deficiencies related to the required language related to the compilation report, including:

1. Updating for current language in SSARS.
2. Using appropriate titles.
3. Reporting on supplementary information.

4. Noting that substantially all disclosures are omitted.
5. Citing a lack of independence, when appropriate.

The Accountant's Compilation Report

The purpose of issuing a compilation report is to ensure that the intended users of the financial statements do not misunderstand the nature of management's responsibilities versus those of the accountant. The standard compilation report should be in writing and include the following:

- Include a statement that management (owners) is responsible for the financial statements.
- Identify the financial statements that have been compiled.
- Identify the entity whose financial statements have been compiled.
- Specify the date or period(s) covered by the financial statements.
- Include a statement that the accountant performed the compilation engagement in accordance with SSARS issued by the ARSC Committee.
- Include a statement that the accountant did not audit or review the financial statements.
- Include a statement that the accountant is not required to perform any procedures to verify the accuracy or completeness of the information provided by management.
- Include a statement that the accountant does not express an opinion, a conclusion, nor provide any assurance on the financial statements.
- Include the manual, printed, or digital signature of the accountant or the accountant's firm.
- Include the city or state where the accountant practices. This may be indicated on letterhead stationery that contains the issuing office's city and state.
- Include the date of the report, which should be the date that the accountant has completed the procedures required by AR-C 80.

EXAMPLE

*Accountant's Compilation Report**

Management is responsible for the accompanying financial statements of Finnigan Company, which comprise the balance sheets as of December 31, 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 in accordance with accounting principles generally accepted in the United States of America. We have performed compilation engagements 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 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.

(Signature of accounting firm or accountant, as appropriate)

(Accountant's city and state)

(Date of the accountant's report)

*Note: SSARS 21 removed the requirement for the compilation report to have:

1. A report title (e.g., Independent Accountant's Compilation Report)
2. Address/Salutation
3. Separate paragraphs

An accountant is permitted in the accountant's report to **emphasize a matter** (EOM) that is discussed in the financial statements, including the notes. These matters should be matters of importance such as:

- A going concern issue.
- Subsequent events.
- Related party transactions.

SSARS 21 added a requirement that an emphasis of matter paragraph be included for compilations and reviews when a Special Purpose Framework (Tax, Cash, Regulatory, Contractual, or FRF for SMEs) is used.

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

An accountant can compile financial statements for a client that omits substantially all disclosures provided that:

1. The accountant does not believe that the disclosures were omitted in an attempt to mislead expected users.
2. The financial statements are prepared in accordance with the applicable financial reporting framework.

When the client wishes to issue financial statements while omitting substantially all disclosures, the compilation report must be modified to alert the user to this circumstance. These modifications include:

- A statement that management has elected to omit substantially all disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework.
- 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.
- A statement that, accordingly, the financial statements are not designed for those who are not informed about such matters.

EXAMPLE

Accountant's Compilation Report – Omits Substantially All Disclosures

Management is responsible for the accompanying financial statements of Finnigan Company, which comprise the statements of assets, liabilities, and equity – tax basis as of December 31, 20X2 and 20X1 and the related statements of revenues and expenses – tax basis and cash flows for the years then ended, and the related notes to the financial statements 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 compilation engagements 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 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.

The financial statements are prepared in accordance with 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 of 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)

PRACTICE NOTE: Just because the engagement omits substantially all disclosures, it does not mean that some items should not be disclosed. If the CPA believes a disclosure of an item is necessary in order to prevent the financial statements from being misleading, or if the CPA believes the additional information is important to the known users of the financial statements, the accountant should consider making the disclosure, or else reconsider the engagement. One viable solution might be by utilizing the “selected disclosure” option discussed below.

If the client wants to make certain disclosures but still omits substantially all disclosures, or if the accountant believes that a particular disclosure is significant and necessary information that should be conveyed to the users of the financial statements, the financial statements should include them as “*Selected Information – Substantially All Disclosures Required by Generally Accepted Accounting Principles (or other applicable framework) Are Not Included.*”

Selected information should be limited to significant information, such as a going concern, subsequent events, or event of default, etc., in order to avoid a user, assuming that it is the most important disclosure when, in fact, other more important disclosures may have been omitted. Additionally, the accountant should consider whether management’s election to include only selected information causes the financial statements to be misleading. If so, the accountant should request that the financial statements be revised to include the omitted disclosures, probably requiring a full disclosure report engagement.

ACCOUNTING STANDARDS

Cited Accounting Standard Deficiencies

These are not new nor have there been recent changes in guidance but the opportunity for continued noncompliance still exists for the following issues.

Issue #1: Failure to include adequate disclosures for related party transactions.

Topic 850, Related Party Disclosures, deals exclusively with related party issues. Paying special attention to related party transactions in an audit is crucial as there are two distinct areas that auditors must be concerned: fraud detection and disclosures. Because these types of transactions are the direct result of the relationship and may otherwise not have taken place, the disclosures surrounding these transactions are necessary for a proper understanding of the financial statements. Inadequate disclosures often result in misleading financial statements. The auditor’s concern is identifying the relationships and evaluating the adequacy of the related disclosure.

Whenever a *material* transaction occurs between related parties, the following disclosures are required:

- a. Nature of the Relationships – The related party need not be identified by name, but the nature of the relationship should be clear. Terms such as *officer, stockholder, affiliate, parent company, or subsidiary* fulfill this requirement.

- b. Description of the Transactions – For each period presented, disclosures should describe the nature of all related party transactions and any information needed to understand their effects on the financial statements. For example, it should be clear whether transactions involved loans, guarantees, leases, sales of goods or services, chargebacks for expense allocations, etc. This is required even if no dollar amounts are involved, such as providing free services.

If there is a pervasive relationship between related parties, the nature of the relationship should be disclosed even if there were no transactions between them. This is because the control relationship may still impact results of operations. For example, the author worked with two affiliated companies that had overlapping product lines; the owners decided which company would fill customer orders. Although this involved no intercompany transactions, the relationship could impact results of operations depending on how orders were assigned.

- c. Dollar Amounts of Transactions – For each period presented, the dollar amount of transactions during each period must be disclosed – not just year-end balances. For example, if a company makes numerous sales totaling \$500,000 to an affiliate, and the balance receivable at year end is \$200,000, both the total sales and the balance must be disclosed. Groups of similar transactions with one type of related party may be combined and disclosed in total.
- d. Effect of Any Changes in the Terms of the Transactions – If the terms of any related party transactions have changed from the prior period, the change should be disclosed to clarify the effect on comparability. This would apply, for instance, if the stated rate of interest were changed or eliminated on a loan due from a stockholder.
- e. Balances, Terms and Settlement of Related Party Receivables and Payables – For each balance sheet presented, amounts due to and from related parties must be disclosed. ASC 310, *Receivables*, requires that notes or accounts receivable due from officers, employees or affiliated companies be shown separately. This is typically done on the face of the balance sheet. In addition, if the terms and settlement provisions are not obvious, these, too, must be disclosed.

The following notes illustrate a variety of disclosures for related party transactions:

EXAMPLES

NOTE 5: RELATED PARTY TRANSACTIONS

During 20X9 and 20X8, the Company made unsecured, non-interest-bearing demand loans to the President of the Company totaling \$55,000 and \$125,000, respectively.

NOTE 6: RELATED PARTY TRANSACTIONS

The Company provides administrative support at no charge to a company affiliated through common ownership.

NOTE 7: RELATED PARTIES

The major stockholders of the Company also own an affiliate that produces similar products. Customer orders may be assigned to either company, without regard to their impact on earnings.

Issue #2: Cash Flow Statements – Incorrect classifications, netting amounts and non-cash transactions.

Classification of Cash Flows

Cash flow increases and decreases are required to be presented in the cash flow statement as operating, investing, or financing cash flows.

Statement of Cash Flows (ASC 230)

- **Operating activities** involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that generate net income.
- **Investing activities** include making and collecting loans and acquiring and disposing of debt or equity instruments as well as property, plant, and equipment and other related productive equipment.
- **Financing activities** include obtaining resources from owners, borrowing and repaying amounts borrowed, and obtaining and paying for other resources obtained from long-term creditors.

ASC 230 identifies what cash flow increases and decreases should be classified as operating, investing and financing.

Operating Cash Flows:

- Cash receipts from the sale of goods and services whether for cash or on credit.
- Cash receipts from interest and dividends.

- Cash payments to acquire materials for resale.
- Principal payments on both short-term and long-term notes payable to suppliers of raw materials.
- Cash payments to other suppliers and employees for other goods or services.
- Cash payments to governments for taxes, fines, and other fees or penalties.
- Cash payments to lenders and other creditors for interest.
- Cash payments made to settle an asset retirement obligation.
- All other cash receipts and payments that do not fall into the investing or financing classifications such as lawsuit settlements/payments, proceeds from insurance settlements, payments for charitable contributions, or cash refunds to customers.

Investing Cash Flows:

- Gross cash receipts and payments for purchases, sales, and maturities of available-for-sale securities.
- Cash receipts from collections or sales of loans.
- Cash receipts from sales of equity instruments of other entities.
- Cash receipts and payments for the sale or purchase of property, plant, and equipment and other productive assets.
- Cash receipts from sales of loans that were acquired as investments not specifically acquired for resale.
- Cash payments for loans made by the entity and payments to acquire debt instruments of other entities.
- Cash payments to acquire equity instruments of other entities (other than trading).

Financing Cash Flows:

- Cash receipts from issuing equity instruments.
- Cash receipts from issuing bonds, mortgages, notes, and from other short- or long-term borrowings.

- Cash receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving PP&E or establishing or increasing a permanent endowment or term endowment.
- Cash receipts/payments received/paid for derivative instruments that include financing elements at inception.
- Cash retained as a result of the tax deductibility of increases in the value of equity instruments under share-based payment arrangements that are not included in the cost of goods sold.
- Cash payments for dividends or other distributions to owners, including payments to reacquire the entity's equity instruments.
- Cash repayments for amounts borrowed.
- Other cash principal payments to creditors who have extended long-term credit.
- Cash payments for debt issue costs.

Netting Cash Inflows and Outflows

Generally, ASC 230 requires separate presentation of gross cash inflows and outflows. This is true for both direct and indirect methods. Exceptions are permitted for:

- Exchanges between cash and cash equivalents.
- Financial instruments with quick turnover, short maturities, and large amounts of cash inflows and outflows (line of credit borrowings, notes receivable, certain short-term investments).
- Changes of assets and liabilities associated with operating activities (operating cash flows on indirect method, reconciliation on direct method).

Presentation of Non-Cash Transactions

ASC 230 requires non-cash financing and investing activities to be **excluded** from cash flows and **disclosed** as supplemental information on the face of the statement or in the footnotes. This is relevant for both the direct and indirect methods.

Two points should be emphasized to clarify this requirement:

- a. Treatment of these transactions differs from the “all-inclusive” approach used years ago in the statement of changes in financial position, which showed such transactions as both a source and use of working capital or cash.

- b. The required presentation for non-cash activities is an example of “required supplemental disclosure”, and while common practice is to include it on the face of the statement, inclusion in the notes is also acceptable.

In practice, this disclosure is often missing or the amounts are erroneously included in cash flows.

EXAMPLE

During 20X2, Farber Co. acquired a building for \$1,200,000, paying \$200,000 and obtaining a \$1,000,000 mortgage.

Proper treatment is to show the \$200,000 as an investing cash outflow to purchase property. The \$1,000,000 borrowing is excluded from both financing and investing cash flows and is disclosed as follows:

Non-Cash Financing and Investing Activities:

Property acquired with a mortgage payable \$1,000,000

TPA 1300.21 states that if the check from the lender is written directly to the borrower and the borrower as payee signs it over to the seller, the transaction should be grossed up to a \$1,200,000 cash investing and a \$1,000,000 financing activity.

Subsequent payments on the mortgage would be shown as cash outflows with financing activities.

Note that any time a capital lease is first recorded, a non-cash asset acquisition has occurred and the guidance herein applies.

Issue #3: Failure to properly classify long-term debt – Debt continues to be classified as long-term even though the debt’s maturity debt is less than 12 months or a debt covenant violation has occurred causing the debt to be due on demand.

Long-Term Debt (ASC 470)

ASC 470, *Debt*, clarifies the classification of obligations, as follows:

- a. Due on demand – current.
- b. Due on demand within one year from the balance sheet date, even if liquidation is not expected within the year – current.
- c. Long-term debt callable by the creditor because of a violation of the debt agreement. In this case, the debt should be classified as current unless the creditor has waived or subsequently lost the right to demand payment.

Note that the ASC 470 states that long-term debt should be classified as noncurrent unless both of the following two conditions exist:

- There is a loan violation at the balance sheet date or a violation would have occurred if the loan was not modified, and
 - It is probable that the default would not be cured or a covenant would not be complied with at measurement dates within the next twelve months (or the operating cycle).
- d. Long-term debt that will be callable by the creditor if a violation is not cured within a specified grace period. Here, the debt should be classified as current unless it is probable that the violation will be cured during the grace period. If the debt is classified as noncurrent, then the circumstances of the classification should be disclosed.
- e. ASC 470 allows short-term debt to be classified as long-term if management has both the intent **and** the ability to refinance this debt. The following conditions must be met:
- The company **intends** to refinance on a long-term basis.

AND

- The company has the ability to refinance, as evidenced by:
 - Post-balance sheet issuance of debt or equity securities – issuance must be prior to the date the financial statements are issued.

OR

- Entering into a financing agreement that allows financing on a long-term basis and that:
 - Does not expire within one year from the balance sheet date.
 - Is not cancelable except for a violation of a provision that can be objectively determined; for example, working capital ratios, debt to equity ratios, etc.
 - Has not been violated prior to the issuance of the statements. However, if a waiver has been obtained, this criterion is met.
 - Can be honored because of the financial capability of the lender.

The amount that can be reclassified cannot exceed the actual amount refinanced or the amount specified in the agreement. If the amount in the agreement fluctuates, then an estimate of the minimum amount to be available should be made. If an estimate cannot be made, then none of the debt should be reclassified. Keep in mind that if you actually pay off debt after the balance sheet date

and replace the funds used by issuing new long-term debt, you cannot reclassify the debt as long-term.

Issue #4: Failure to adequately disclose GAAP departures.

With the ever-increasing complexity of U.S. GAAP, many private companies are opting to take GAAP departures in areas such as variable interest entities, impairments, fair values and derivatives to name a few. The challenge in disclosing these departures is there are no practice aids or publications that provide guidance or examples; instead, they focus on the audit report required with a GAAP departure.

The objective in the note should be to add to, rather than replace, the information in the GAAP departure paragraph in the accountant's report. In some instances, there may be overlap between the note disclosure and audit report.

Occasionally, there may be no need for a note because the description in the report paragraph "says it all." For example, if there is a GAAP departure in reviewed financial statements because the Statement of Cash Flows was not presented, there is nothing more to say in a note. However, in most cases, the report paragraph will refer the reader to the note or notes where the GAAP departure is described in more detail.

Some **general guidelines** that may be followed in drafting notes for GAAP departures include:

- The effects of the departure on the financial statements should be disclosed to the extent they are known. Otherwise, include a statement that the effects are undetermined. (There is no requirement for the accountant to determine the effect of a departure, but if management has determined the effect, it should be disclosed.)
- The disclosure may be placed in a separate note for GAAP departures, or within the note that deals with the related topic. For example, if a company has not consolidated a related party VIE, the GAAP departure could be disclosed in a separate note or in the note where the transactions with the VIE are described.
- When GAAP rules are not followed, the notes should include informative disclosures that best represent the spirit and intent of the standards involved. For example, if a company has an interest rate swap and fails to apply proper accounting for derivatives, the notes should still describe the structure of and rationale for entering the swap. (Note that this presumes a knowledge of GAAP sufficient to understand what the entity *failed* to do!)
- A description of the policies used should be included, with the phrase "which is a departure from generally accepted accounting principles."

- Management's rationale for using a non-GAAP method may be described; in client situations, this tends to "soften the blow," but should not be worded in a manner that implies that a failure to apply GAAP is "correct."

EXAMPLE

Failure of Accounting for an Interest Rate Swap as a Derivative

NOTE 5: LONG-TERM DEBT (in part)

During 20XX, the Company entered into an interest rate swap with its primary lending bank, in order to lock in a fixed rate of interest on its long-term borrowings. As a result, the borrowings now carry an effective interest rate of 5.2% in place of the previous floating rate of LIBOR plus 3% (4.7% at the commencement of the swap).

Under generally accepted accounting principles, the interest rate swap should be accounted for as a hedging activity with the fair value of the swap reflected in the asset or liability accounts of the Company, and a corresponding credit or charge in Other Comprehensive Income, a component of Stockholders' Equity. As interest payments are made, this equity component would be reclassified to earnings.

The Company has not applied these provisions, which is a departure from generally accepted accounting principles. The accompanying financial statements reflect interest expense at the effective rate of 5.2%, and include no balance sheet effects for the swap arrangement.

This departure has no effect on reported earnings. The effects of not reflecting the fair value of the contract on the balance sheet have not been determined.

EXAMPLE

Failure of Consolidating Related Lessor (VIE)

NOTE 3: RELATED PARTY LEASE AND DEPARTURE FROM GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Commencing in July 20X1, the Company rents its primary facility from a company affiliated through common ownership under a lease accounted for as an operating lease. The lease provides for an initial five-year term with annual rents of \$80,000, plus three additional five-year renewal options, each with 5% rent increases. Under this agreement, the Company is obligated to pay property taxes and insurance on the real estate.

Through June 20X1, the Company was paying \$10,000 per month plus executory costs determined monthly. Rents were \$97,150 and \$120,000, respectively, for 20X1 and 20X0; related executory costs were \$25,500 in 20X1 and \$8,100 in 20X0. Rent expense was offset in part for chargebacks to affiliates of \$14,400 in 20X1 and \$15,000 in 20X0 to allocate occupancy costs.

Under generally accepted accounting principles, companies are required to consolidate related lessors that qualify as variable interest entities because they receive subordinated financial support. Under these provisions, the Company is required to consolidate the accounts of its leasing affiliate. However, to permit lenders and stockholders to continue receiving financial statements of the Company on a standalone basis, management has decided not to consolidate this entity, and rent expense is being recorded as paid, without regard to scheduled rent increases. This is a departure from generally accepted accounting principles and the impact on earnings has not been determined.

Summary financial information (tax basis) for the affiliate as of December 31, 20X1 is as follows:

Total assets	\$366,500
Total liabilities	\$20,000
Net worth	\$346,500
Net income for the year ended December 31, 2010	\$66,500

At December 31, 20X1, scheduled rents under the long-term lease, including renewal periods but exclusive of executory costs, are as follows:

20X2	\$80,000
20X3	80,000
20X4	80,000
20X5	80,000
20X6	82,000
Thereafter	<u>1,282,000</u>
Total	<u>\$1,684,000</u>

The Company is a guarantor on mortgage debt of the affiliated lessor in the event of default; however, such debt is considered to be adequately collateralized by real estate. At December 31, 20X1, the outstanding principal balance of \$20,000 is payable in monthly installments of \$2,500 plus interest at prime (3.25% at December 31, 20X1) through August 20X2.

Note: The above example also includes GAAP disclosure for the debt guarantee. In addition, note subtle wording explaining that the company is not “straight-lining” scheduled rent increases.

ASU 2014-07 obviates the need for a GAAP departure for certain leases between related parties. In such a case, the note disclosure might look more like the following:

EXAMPLE

Note 3: Related Party Lease

Commencing in July 20X1, the Company rents its primary facility from a company affiliated through common ownership under a lease accounted for as an operating lease. The lease provides for an initial five-year term with annual rents of \$80,000, plus three additional five-year renewal options, each with 5% rent increases. Under this agreement, the Company is obligated to pay property taxes and insurance on the real estate.

Through June 20X1, the Company was paying \$10,000 per month plus executory costs determined monthly. Rents were \$97,150 and \$120,000, respectively, for 20X1 and 20X0; related executory costs were \$25,500 in 20X1 and \$8,100 in 20X0. Rent expense was offset in part for chargebacks to affiliates of \$14,400 in 20X1 and \$15,000 in 20X0 to allocate occupancy costs.

At December 31, 20X1, scheduled rents under the long-term lease, including renewal periods but exclusive of executory costs, are as follows:

20X2	\$80,000
20X3	80,000
20X4	80,000
20X5	80,000
20X6	82,000
Thereafter	<u>1,282,000</u>
Total	<u>\$1,684,000</u>

The Company is a guarantor on mortgage debt of the affiliated lessor in the event of default; however, such debt is considered to be adequately collateralized by real estate. At December 31, 20X1, the outstanding principal balance of \$20,000 is payable in monthly installments of \$2,500 plus interest at prime (3.25% at December 31, 20X1) through August 20X2.

EXAMPLE

Failure to Record Asset Impairment

NOTE 4: PROPERTY (in part)

The Company holds an office building under construction in central Florida that it has decided to sell “as is” rather than complete, due to market conditions. The amount realized on this sale is expected to be at least \$1,000,000 less than its recorded cost of \$2,800,000. Because the sale process cannot be predicted with certainty, management has not reflected any loss or impairment of value for this property in the accompanying financial statements. This is a departure from generally accepted accounting principles, which require that property held for sale be written down to its estimated fair value less costs to sell, with a corresponding loss included in income from operations.

Because the fair value of the property is not known, the effects of this departure on the financial statements have not been determined.

COVID-19 ISSUES THAT MAY IMPACT PEER REVIEW

Potential Financial Reporting

Introduction

At the time of this writing, March 2020, the country is pretty much in an economic lockdown due to the coronavirus. As a result, significant financial reporting consequences are a likely possibility in a variety of accounting and disclosure areas. Reporting entities and their auditors/accountants will need to be alert for the economic and financial impact of the actions taken by both the federal and state governments to curtail the coronavirus. This Appendix addresses some of these financial reporting impacts/consequences to serve as a memory jogger for practitioners and reporting entities to consider when preparing their 2019 and 2020 financial statements.

To highlight the significance of these financial reporting impacts/consequences, please review the following J&J Snack Foods press release issued on March 22nd, 2020 and summarized in the Courier-Post on March 24th, 2020¹:

J&J Snack Foods Corp. has predicted that the impact of the coronavirus on its finances will be worse than originally predicted.

The Pennsauken N.J. firm on Sunday said government shutdown orders have closed or curtailed foodservice venues that account for about two-thirds of its \$1.2 billion in annual revenue. J&J on March 12th had estimated the virus would affect only about one-third of its revenues. J&J sells soft pretzels, frozen beverages, and other snacks.

The Company's initial statement predicted it would lose sales in part due to "anticipated lower attendance and traffic" at foodservice venues like schools, stadiums, movie theaters, and amusement parks.

J&J's new statement says the financial impact has increased due to government-ordered shutdowns "over the past 10 days". The shutdowns are intended to curb the spread of the virus by reducing interactions between people.

¹<https://www.courierpostonline.com/story/news/2020/03/23/jandj-snack-foods-pennsauken-coronavirus-gerald-shreiber/2897900001/>

In its statement, J&J said it expects higher sales at grocery stores, and other retailers, but that the overall impact will be “decidedly negative”. The Company which previously reported record sales for 48 years, said it could not estimate the financial impact but predicted that it would be “material.”

Subsequent Events

Topic 855, Subsequent Events, discusses the two types of subsequent events that can impact financial statements and disclosures:

1. An event or transaction occurring after the balance sheet date but before financial statements are issued (or available to be issued) that confirms a fact that existed at the balance sheet date. These events are called **recognized subsequent events** because they are recorded in the accounts. The key is that the event must be the culmination of conditions that existed on or before the balance sheet date.
2. An event or transaction occurring after the balance sheet date but before the financial statements are issued (or available to be issued) that relates to events occurring after the balance sheet date. These events are called **non-recognized subsequent events**. Such events would not cause a change in the accounts but, if material, are disclosed in the notes.

The potential economic and financial impact of the coronavirus meets the criteria to be a non-recognized subsequent event that will **require disclosure** for financial reporting periods ending before January 20, 2020, the date the virus became known. Those required disclosures include:

A reporting entity should disclose the following:

- The nature of the event
- An estimate of its financial effect, or a statement that such an estimate cannot be made.

If the non-recognized subsequent event (coronavirus) has a significant impact/consequence on the reporting entity’s financial statements, the reporting entity should also consider supplementing the historical financial statements with pro forma financial data. Such data should give effect to the event as if it had occurred on the balance sheet date. In some situations, a reporting entity should also consider presenting pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

Revenue

In Topic 606, Revenue from Contracts with Customers, a contract with a customer does not exist if it is probable that the reporting entity will not collect substantially all of the consideration to which it will be entitled - assessing probability is made based on the customer’s ability and intent to pay the amounts when due. If a significant change in facts and circumstances takes place after the sale has been

recognized, such as the customer being unable to pay due to the consequences of the coronavirus, the contract may no longer be probable of collection, and therefore, a customer contract no longer exists. If that is the case the reporting entity cannot recognize the revenue from the transaction. Any prior recognized revenue as a result of the transaction should be reversed out of earnings.

Topic 606 defines **variable consideration** as the amount of consideration to which a selling entity will eventually become entitled that may be uncertain in whole or in part due to:

- Potential returns, allowances, rebates, refunds, discounts, or other credits to the customer's account
- Performance incentives, penalties, or price concessions
- Consideration contingent on the occurrence or non-occurrence of a future event

A reporting entity must include in the transaction price some or all of an amount of variable consideration that is estimated to the extent that it is **probable** that there will not be a significant reversal in the amount of cumulative revenue recognized when the uncertainty associated with the variable consideration is subsequently resolved.

Due to the coronavirus, variable consideration may have to be reassessed in future reporting periods. At the end of each reporting period, the estimated transaction price (including any variable consideration) should be updated to present any changes in circumstances. Any changes that have occurred should be accounted for as a change in the transaction prices as a change in estimate.

Receivable Impairments (Credit Losses)

Topic 310, Receivables, addresses measurement, presentation, and disclosure requirements for financing receivables, including trade receivables, and loans receivable. Topic 450, Contingencies, addresses losses from uncollectible receivables.

ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments was issued to provide financial statement users with more decision-useful information about a reporting entity's 1) **expected credit losses** on financial assets and 2) other commitments to extend credit. ASU 2016-13 is effective for public business entities for fiscal years beginning after December 15, 2019, early adoption is permitted.

The scope of Topic 326 includes:

- Loans receivable
- Debt securities
- Trade receivables

- Net investment in leases
- Off-balance sheet credit exposure
- Reinsurance receivables

2019 Financial Statements

If a public reporting entity adopts ASU 2016-13 earlier than 2020, the related current expected credit loss (CECL) framework should be applied for estimating credit losses in 2019 financial statements. If ASU 2016-13 is not early adopted, Topic 310, Receivables, applies for the recognition of impairments for receivables that may result from the coronavirus in 2019 public company financial statements. For 2020 reporting periods, ASU 2016-13 applies to public business entities and unless a non-public reporting entity early adopts ASU 2016-13 in 2020, Topic 310 will apply.

Assuming Topic 310, Receivables and Topic 450, Contingencies, applies for both public and non-public reporting entities for 2019 financial statements, an estimated loss from a loss contingency (such as impaired receivables due to the coronavirus) should be accrued by a charge to income if both of the following conditions are met:

1. Information available before the financial statements are issued or available to be issued indicates that it is **probable** that a receivable had been impaired, and
2. The amount of the loss can be reasonably estimated

Disclosure of the impairment should be made if there is at least a **reasonable possibility** that a loss or an additional loss may have been incurred.

Disclosure of an impairment loss arising after the date of the reporting entity's financial statements but before those financial statements are issued may be necessary to keep the financial statements from being misleading if a loss accrual is not required. If disclosure is deemed necessary, the financial statements should include both of the following:

- The nature of the impairment loss
- An estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made

2020 Financial Statements

Public business entities are required to apply ASU 2016-13's credit loss guidance to their 2020 financial statements. This guidance requires public business entities to record a current expected credit loss (CECL) (if any) for receivables measured at amortized cost or net realizable value over the receivables' life. Because this is a forward-looking measurement, it is based on forecasts of future economic conditions. This CECL model requires if losses exist, the carrying value of the receivable should equal

its amortized cost minus an allowance for credit losses, that is, the amount expected to be collected. In estimating credit losses, all relevant information should be considered:

- Past events
- Current conditions
- Reasonable, supportable forecasts

NOTE: The *Coronavirus Aid, Relief, and Economic Security Act* passed in March of 2020, provides financial institutions optional temporary relief from troubled debt restructurings and impairment accounting requirements for certain loan modifications related to the coronavirus. A financial institution may elect to suspend the application of Topic 310's guidance for troubled debt restructurings and loan impairments.

In addition, the Act also provides optional temporary relief to insured depository institutions from compliance with Topic 326's guidance for credit loss accounting when estimating allowances for credit losses.

Valuation of Inventory

Topic 330, Inventory, states the basis of accounting for inventories is cost. According to Topic 330, costs for inventory purposes may be determined under one of several cost flow assumptions including FIFO, average, or LIFO. The primary objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

FIFO and average cost basis inventory are subsequently measured at the lower of cost or **net realizable value**. LIFO is subsequently measured at the lower of cost or market. Reduced demand for inventory due to the coronavirus may require loss recognition.

Fair Value Measurements

Fair value is defined in Topic 820, Fair Value Measurement, as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date.

When the market approach is used for fair value measurements, the approach uses observable prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. It includes observable market prices, as well as business valuation models such as earnings multiples. The effects of the coronavirus are causing market volatility that may impact the measurement date for fair value measurements. Assuming this volatility is based on orderly transactions, market prices should be recognized in the financial statements at the measurement date.

Significant fair value disclosures are also required reflecting the valuation techniques utilized for the fair value measurements.

Goodwill Impairments

Goodwill and indefinite-lived intangibles are not currently amortized for public entities, so their original cost remains on the balance sheet indefinitely. As a result, an impairment of value is of greater concern over time, and Topic 350, Intangibles-Goodwill and Other, requires that the possibility of impairment be addressed at least annually (more often if there are **triggering events**.)

Note that a simplified alternative approach for goodwill is now available to non-public entities since the issuance of ASU 2014-02, Accounting for Goodwill. This alternative results in goodwill being amortized and tested for impairment only when there are **triggering events**.

Topic 350 permits a qualitative analysis to be performed to determine if goodwill is impaired. This qualitative analysis first evaluates **qualitative events and circumstances** to conclude whether it is **more likely than not** (“MLTN”) the reporting unit’s carrying value exceeds its fair value. If this qualitative assessment results in a conclusion that it is not MLTN, then a quantitative impairment test based on quantitative data is not required. This approach is an option rather than a requirement and may be used in some reporting periods but not others. A reporting entity can always choose to go directly to the **quantitative** test and forego performing this qualitative analysis. Conversely, when the quantitative test is employed, the qualitative analysis need not also be performed.

Rather than prescribe a methodology or “bright line” cutoffs for the qualitative analysis, it provides a **list of potential adverse events and circumstances** that should be considered to assess the likelihood that the carrying value of a reporting unit exceeds its fair value, and then describes in general terms how they should be weighted in terms of their significance, combined with factual data from prior periods or any other relevant data, and examined in conjunction with positive or mitigating factors to form a MLTN conclusion.

Potential Adverse Events and Circumstances

- Macroeconomic factors – deterioration in general economic conditions, access to capital, or foreign exchange rates, or other changes in equity and credit markets
- Industry/market factors – increased competition, industry downturn, change in the market for a company’s products or services, decline in market-dependent multiples or metrics affecting valuation, adverse regulatory actions
- Cost factors – increased costs for materials, labor, etc., that adversely affect profitability or cash flows
- Financial performance – negative or declining cash flows, declines in actual or projected revenue or earnings compared with actual and projected results for prior periods
- Entity-specific – changes in management or key personnel, strategy, or customer base; litigation; consideration of filing for bankruptcy

- Assets – actual or contemplated major disposals; significant asset classes tested for impairment due to triggering events, recognition of goodwill impairments in subsidiaries of the reporting unit
- Share price – sustained decrease in share price (on a standalone basis or in relation to comparable companies)

All of these factors can be impacted by the economic or financial results of the coronavirus and the coronavirus should be considered a **triggering event** for goodwill impairment testing.

For each goodwill impairment loss recognized Topic 350 requires the following **disclosures**:

- A description of the facts and circumstances leading to the impairment
- The amount of the impairment loss and the method of determining the fair value of the associated reporting unit
- If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons therefor and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.
- The caption in the Income Statement or the Statement of Activities in which the impairment loss is aggregated
- If applicable, the segment in which the impaired intangible asset is reported

Property, Plant & Equipment Impairments

Topic 360, Property, Plant and Equipment impairment tests are performed on depreciated (or amortized) assets that are held and used only upon the occurrence of **triggering events** that suggest the assets may be impaired. When performed, the tests are "cash-flow based," i.e., impairment exists when carrying values exceed undiscounted cash flows expected from those assets during their remaining economic life.

This approach is appropriate for both fixed assets and definite-lived intangibles. It makes sense that impairment is addressed only when there are adverse events because these assets' carrying values already decline as they are depreciated or amortized.

Property, plant, and equipment that is classified as held-for-sale is a special case. When these assets become classified as held for sale, an impairment loss is required if their carrying values exceed expected net proceeds from the sale ("fair value less costs to sell.") These write downs are the only ones that may not be permanent; recovery in value is allowed to be recorded.

Definite-lived assets are reviewed for impairment only when certain **triggering events** occur that indicate their values are likely to be impaired. Consequently, any "test" for impairment is not a

routine evaluation performed annually or at each balance sheet date, but one “triggered” by events such as:

- Significant decrease in the market value of an asset (coronavirus)
- Significant change in the way an asset is to be used
- Significant changes in the business or legal environment (coronavirus)
- Significant cost overruns incurred for self-constructed assets
- Continued (or anticipated) operating losses and/or cash flow deficiencies associated with identifiable assets (coronavirus)
- A current expectation that it is more-likely-than-not the asset will be sold or otherwise disposed of before the end of its useful life.

The Impairment Analysis for Property, Plant and Equipment is a 2-step Approach

1. Determine if Impaired

An asset is impaired under Topic 360 when net future cash inflows expected to be generated by the asset (undiscounted and without subtracting any related interest charges) are less than the carrying value of the asset. Note that comparing these two amounts yields a “yes or no” determination of impairment; it does not measure the amount of impairment loss.

2. Determine Amount of impairment loss

Required Disclosures for Impaired Assets Held and Used

- A description of the assets impaired and the facts and circumstances leading to the impairment
- The amount of the impairment loss and how fair value was determined along with the caption in the income statement (or statement of activities) which includes the impairment loss, if the loss is not separately disclosed
- How fair value was determined (i.e., Level 1, 2 or 3)
- If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons why and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.
- The business segments affected, if applicable

EXAMPLE

Note 5: Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted expected future cash flows from the use and eventual disposition of the asset. If the carrying amount of the asset is determined not to be recoverable, a write-down to fair value is recorded. The Company reviews long-lived assets for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

In 2020, due to operating losses and declining market demand due to the coronavirus, the Company determined that the value of its manufacturing plant was impaired. Based on an independent appraisal of the property, the Company recorded an impairment loss of \$3,000,000 in income from continuing operations.

EXAMPLE

Note 4: Asset Impairments:

During 2020, the following impairment losses were recorded on assets of the Company and included in income from continuing operations:

As a result of decreased utilization of certain distribution facilities due to the coronavirus, long-lived assets held and used with a carrying amount of \$525,000 were written down to their fair value of \$375,000, resulting in an impairment loss of \$150,000. The estimate of fair value is based on having the facilities fully utilized as a distribution center, which is their highest and best use.

Also, due to increased competition and decreased demand for the products of Subsidiary X due to the coronavirus, goodwill with a carrying amount of \$300,000 was written down to its implied fair value of \$200,000, resulting in an impairment loss of \$100,000.

In connection with its restructuring plan, the Company's operations in Bangor, Maine were moved to a facility in Worcester, Massachusetts. The vacated facility is currently held for sale, and has been written down from its carrying value of \$600,000 to its fair value of \$400,000 less estimated costs to sell of \$50,000, resulting in a loss of \$250,000.

Breach of Debt Covenants

Classification of assets and liabilities as current or long-term provides important information to users in assessing liquidity and **compliance** with loan covenants, and is actually one form of disclosure. While the general rule for classification as current liabilities is straight-forward (due within one year or operating cycle, whichever is longer), certain situations can complicate this assessment.

Topic 470, Debt, requires current **classification for liabilities** that are:

- a. Due on demand.

- b. Due on demand within one year, even if liquidation is not expected within the year.
- c. Long-term debt that is callable by the creditor because of a **violation of the debt agreement**, unless the creditor has waived or subsequently lost the right to demand payment.

Topic 470 does not distinguish between substantive versus non-substantive violations. Therefore, “tripping” a minor covenant (such as a deadline for submitting financial statements or other documents) triggers the due-on-demand clause in a loan agreement just as major violations do.

Financial reporting issues associated with long-term debt due to the coronavirus include:

- Reclassification of the debt as current (on demand) due to a violation (breach) of the debt covenant agreements
- Potential modifications or extinguishment of debt necessary to address debt covenant violations
- A conclusion must be reached as to whether any debt restructuring is a troubled debt restructuring

Deferred Taxes

In Topic 740, Income Taxes, deferred tax assets are recognized for future deductible amounts, as well as operating loss and tax credit carryforwards. These assets are reduced by a **valuation allowance** if it is more likely than not that all, or a portion of the future tax benefits will not be realized.

Factors to Consider when Determining the Need for a Valuation Allowance Are:

1. Is there income in the current or prior years available to absorb a carryback of tax benefits?
2. Are there net taxable amounts from temporary differences available for offset with net deductible amounts? This factor really means that deferred tax assets can be recognized to the extent there are deferred tax liabilities available for offset.
3. Is taxable income expected?
4. Are there tax planning strategies available to assure realization of future tax benefits?

Due to the economic and financial impact of the coronavirus, reporting entities may have to evaluate whether recorded deferred tax assets will be realizable in the future if the reporting entity has net operating loss carryforwards expiring in the next few years.

Hedging Relationships

Note that in Topic 815, Derivatives and Hedging, hedging unrealized gains and losses are recorded in accumulated other comprehensive income until the forecasted transaction impacts net income or becomes probable of occurring. Due to the economic and financial impact of the coronavirus, it is possible that the hedged transaction will not occur as expected in the original time period and this will cause the amounts in accumulated other comprehensive income to be reclassified to net income.

SEC Reporting - Risk Factors

SEC Regulation S-K Item 105, Risk Factors, requires a discussion of the most significant factors that make an investment in the company or offering speculative or risky. Material risks to a company resulting from the coronavirus should be disclosed in this section. This would include any current trends or uncertainties that could have a negative impact on revenue or net income.

The SEC noted in March of 2020, that all companies will need to provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments. The SEC also encouraged all companies and other related persons to consider their activities in light of their disclosure obligations under federal securities laws. For example, where a company has become aware of a risk related to the coronavirus that would be material for investors, it should refrain from engaging in securities transactions with the public and to take steps to prevent directors and officers from initiating such transactions until investors have been appropriately informed about the risk.

Going Concern

Topic 205, Presentation of Financial Statements, requires management of public and non-public reporting entities to evaluate and disclose whether there is **substantial doubt** about a company's ability to continue as a going concern. Management's assessment would be similar to the one auditors are required to make today. Topic 205 defines "substantial doubt" by incorporating a likelihood component and using the term "probable." "Substantial doubt" is defined in Topic 205 as:

Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

Topic 205 requires management of every reporting entity to:

- Evaluate uncertainties about the entity's going concern presumption at each annual and interim reporting period, and
- Include specific, relevant disclosures if certain conditions are met.

The impact of the coronavirus with mandatory shutdowns of businesses, may cause substantial doubt to the reporting entity's ability to continue as a going concern or may generate operational and/or financial risks requiring additional related disclosure.

When management determines that there is a substantial doubt about a reporting entity's ability to continue as a going concern, they must disclose the following;

- The substantial doubt about the reporting entity's ability to continue as a going concern
- The principal conditions and events giving rise to the substantial doubt
- Management's evaluation of the significance of those conditions and events
- Any mitigating conditions and events, including management's plans

When and if substantial doubt is mitigated by management's plans, the reporting entity must disclose this fact and also disclose:

- The principal conditions and events that initially raised the substantial doubt
- A description of management's plans that alleviated the substantial doubt

EXAMPLE

Note X: Going Concern

The Company has sustained operating losses in 2020 due to the coronavirus, resulting in a net stockholder's deficiency. In addition, the Company is currently in default on certain of its loan agreements. These conditions lead management to believe that there is substantial doubt about the Company's ability to continue as a going concern.

Management is currently negotiating with its bank to restructure outstanding loans. In addition, the Company's owners have agreed to defer any salary during 2020 and 2021 and to contribute existing stockholder loans to the equity of the Company (see Note L). While management believes the expected success of these actions will allow the Company to continue operations for the foreseeable future, there is no assurance that these actions will permit the Company to continue as a going concern in the long-term. The financial statements do not include any adjustments that might result if the Company cannot continue as a going concern.

EXAMPLE*Going Concern Mitigated*

Note 4: Financing Arrangements

The Company has sustained operating losses in 2020 due to the coronavirus, resulting in a stockholders' deficiency. In addition, the Company is currently in default on certain of its loan agreements at December 31, 2020.

In March 2021, the Company finalized a royalty agreement with a third-party manufacturer to produce and sell its new robotic orthopedic surgery components. The revenue from this contract is expected to achieve a return to profitable operations and cure violations of debt covenants.

COVID-19 AUDIT CONSIDERATIONS

Introduction

Managing an audit in a remote environment will require being flexible, available, setting normal policies and procedures, and maintaining constant communication. Audits will still need to maintain high audit quality and consideration should continue to be made to ensure accuracy, completeness, relevance, and reliability. There are a few areas to highlight when performing an audit after the impacts of the changes to accounting and reporting in light of the coronavirus.

Risk Assessment

Auditors should maintain skepticism – be alert for the effect of the impacts on the financial statement accounts, as detailed in the Financial Reporting section above.

Consideration should be made with respect to independence when assisting management with their assessment of going concern or SBA loans related to the CARE Act.

Pay special attention to the following areas:

- Management bias and override because of incentives for survival
- Related party transactions
- Fraud

Inquiries

When conducting inquiries – focus changes or design of procedures to specifically address the effect of the virus on the business. Make sure the focus is on CURRENT CONDITIONS.

Management's assessment of mitigating circumstances for going concern should be considered carefully.

Inquiries should include whether there have been changes in internal control especially due to the effect of remote working environments and social distancing.

Documentation

Documentation standards still apply. Consider how evidence will be obtained from the client. Be mindful of independence rules when in the possession of client data. Storage should be owned by management or contracted by management with a third party; this requirement has not changed.

Security of data should be heightened. Be aware of cyberattacks.

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