



ACCOUNTING

CONTINUING EDUCATION

Compilation and Review Practice Guide (CRP4)

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(CRP4)

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Compilation and Review Practice Guide (CRP4)
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TABLE OF CONTENTS

UNIT 1	1
Compilation and Review History	1
Learning Objectives	1
Introduction	1
SSARS 1 Through SSARS 25	1
SSARS Codification	3
Services Offered by CPAS	4
Preparation of Financial Statements	5
Program Topics	6
UNIT 2	7
AR-C Section 60—General Principles for Engagements Performed in Accordance with SSARS as Amended by SSARS 25	7
Learning Objectives	7
Introduction	7
Section Objective	8
Definitions	8
Scope	10
Preparation of Financial Statements	10
Requirements for All SSARS Services	11
Common Standards Outside of AR-C Section 60	17
Other Practice Issues	22
UNIT 3	27
AR-C Section 70—Preparation of Financial Statements as Amended by SSARS 25	27
Learning Objectives	27
Introduction	27
Section Objective	29
Issue of Independence	29
Scope of this Section	30
The Preparation Engagement	30
Definitions	30
Requirements of AR-C Section 70	31
Practice Issues	36

UNIT 4	43
AR-C Section 80—Compilation Engagements as Amended by SSARS 25	43
Learning Objectives	43
Introduction	43
Section Objective	45
Scope	45
Definitions	45
Requirements of AR-C Section 80	46
Case Study: JMT, Inc.	56
Case Study: JMT, Inc. – Your Questions	61
Case Study: JMT, Inc. – Suggested Questions	62
The Accountant’s Compilations Report	63
Other Considerations Not Included in AR-C 80	69
SSARS 22—Compilation of Pro Forma Information (See AR-C Section 120)	71
Common Peer Review Issues—Compilations	76
Peer Review Deficiencies—Compilations	77
Potential Causes for Liability—Compilations	80
Case Study: Fleming Products, Inc.	82
Case Study: Fleming Products, Inc. – Your Questions	94
Case Study: Fleming Products, Inc. – Suggested Solution	95
UNIT 5	97
AR-C Section 90—Review of Financial Statements as Amended by SSARS 25	97
Learning Objectives	97
Introduction	97
Section Objectives	100
Scope	100
Definitions	100
SSARS 25, Materiality in a Review of Financial Statements and Adverse Conclusions	104
Requirements of AR-C Section 90	105
Common Peer Review Issues—Review	143
Illustrated review Reports	146
Case Study: JMF, Inc.	154
Case Study: JMF, Inc. – Your Questions	157
Case Study: JMF, Inc. – Suggested Questions	158
Case Study: XYZ Company	159
Case Study: XYZ Company – Your Review Comments	162
Case Study: XYZ Company – Suggested Review Comments	163
Practice Guide: Review Inquiry Questionnaire	164

UNIT 6	177
Special Purpose Frameworks.....	177
Learning Objective.....	177
Introduction	177
History	178
Cash and Modified Cash Basis.....	181
Tax Basis	181
Regulatory Basis.....	184
Contractual Basis.....	186
Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SME).....	187
Practice Guide Reporting	194

NOTES

Unit 1

Compilation and Review History

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ☐ Identify the SSARS standards issued since 1978.
- ☐ Identify the topics in this program.

INTRODUCTION

The Accounting and Review Services Committee (ARSC) was established in 1978 to provide performance guidance for, at that time, the newly created compilation and review levels of service. Before the creation of compilation and review levels of service, the principal accounting and auditing services provided to clients were audited and unaudited services. Un-audits were primarily disclaimers of an opinion with a description of the services provided. Many in the profession at that time believed there should be levels of service below an audit to better meet the changing needs of clients and users alike.

The ARSC is an American Institute of Certified Public Accountants (AICPA) committee designated to issue guidance in connection with unaudited financial statements or other unaudited financial information of non-public entities. Its primary mission is to develop and communicate comprehensive performance and reporting standards as well as practice guidance to enable accountants of private entities to provide high-quality, objective compilation and review services to better serve the public interest. The ARSC issues Statements on Standards and Review Services (SSARS) as well as interpretative guidance associated with SSARS standards.

SSARS 1 THROUGH SSARS 25

Introduction

The following is a list of all 25 SSARS statements issued from 1978 through 2021. These standards have been codified into the SSARS Codification based on the issuance of SSARS 21 (with clarifications in SSARS 22, 23, 24, and 25).

- SSARS 1 – *Compilation and Review of Financial Statements* (1978)
- SSARS 2 – *Reporting on Comparative Financial Statements* (1979)
- SSARS 3 – *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (1981)
- SSARS 4 – *Communications Between Predecessor and Successor Accountants* (1982)
- SSARS 5 – *Reporting on Compiled Financial Statements* (1982)
- SSARS 6 – *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (1986)
- SSARS 7 – *Omnibus Statements on Standards for Accounting and Review Services-1992* (1992)
- SSARS 8 – *Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements* (2000)
- SSARS 9 – *Omnibus Statement on Standards for Accounting and Review Services* (2002)
- SSARS 10 – *Performance of Review Engagements* (2004)
- SSARS 11 – *Standards for Accounting and Review Services* (2004)
- SSARS 12 – *Omnibus Statement on Standards for Accounting and Review Services* (2005)
- SSARS 13 – *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (2005)
- SSARS 14 – *Compilation of Pro Forma Financial* (2005)
- SSARS 15 – *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services* (2007)
- SSARS 16 – *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (2007)
- SSARS 17 – *Omnibus Statement on Standards for Accounting and Review Services* (2008)
- SSARS 18 – *Applicability of Statements on Standards for Accounting and Review Services* (2009)
- SSARS 19 – *Compilation and Review Engagements* (2009)
- SSARS 20 – *Revised Applicability of Statements on Standards for Accounting and Review Services* (2011)
- SSARS 21 – *Statements on Standards for Accounting and Review Services: Clarification and Recodification* (2014)
- SSARS 22 – *Compilation of Pro Forma Financial Information* (2016)
- SSARS 23 – *Omnibus Statement on Standards for Accounting and Review Services* (2016)

- SSARS 24 – *Omnibus Statement on Standards for Accounting and Review Services* (2018)
- SSARS 25 – *Materiality in a Review of Financial Statements and Adverse Conclusions*

SSARS CODIFICATION

SSARS 21 reorganized and codified the SSARS standards. All sections were codified, with the exception of AR Section 120, which was codified in SSARS 23. As was done with auditing and attestation standards, the clarified sections are designated with a “C.” The organization of SSARS is as follows:

- AR-C Section 60 – *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*. This section provides a framework and defines and describes the objectives and elements of compilation and review engagements. This section also describes the meaning of certain terms (unconditional requirements and presumptively mandatory requirements) used in SSARS in describing the professional requirements when accountants are performing compilation and review engagements.
- AR-C Section 70 – *Preparation of Financial Statements*. This section applies when an accountant is engaged to prepare financial statements and is not performing an audit, review, or compilation. The objective of the accountant is to prepare financial statements pursuant to a specified financial reporting framework.
- AR-C Section 80 – *Compilation Engagements*. This section establishes standards and provides guidance on the performance of compilations of financial statements. The accountant is required to comply with the provisions of this section whenever the accountant is engaged to report on compiled financial statements.
- AR-C Section 90 – *Review of Financial Statements*. This section establishes standards and provides guidance on the performance of reviews of financial statements. The accountant is required to comply with the provisions of this section whenever the accountant has been engaged to review financial statements. (Exceptions for interim reviews exist.)
- AR-C Section 100 – *Special Considerations – International Reporting Issues*. The section provides guidance when the accountant has been engaged to perform a compilation or a review of financial statements in accordance with SSARS when the financial statements have been prepared in accordance with a reporting framework generally accepted in another country or an international framework other than IFRS.
- AR-C Section 120 – *Compilations of Pro Forma Financial Information*. This section expands SSARS to apply when an accountant is engaged to report or issues a report on compiled pro forma financial information. (Clarified in 2016 and effective for all reports issued after May 1, 2017.)

The results of the codification efforts include the following:

- **Clarity** – The standards are now easier to read, understand, and apply.
- **Continuity** – All professional literature for audits, reviews, and compilations are now drafted using the same conventions.

- **Introduced “preparation services”** – Perhaps the most significant change in the codification was the introduction of a preparation service that allows the accountant to prepare financial statements without a report even if the financial statements are intended for third-party use, thereby eliminating the “prepare and present” dilemma previously faced by accountants.
- **Minor changes:** These are included in both compilations and reviews primarily related to engagement letters and reporting requirements.

Each section of the codification also has certain definitions of terms that are included in Appendix A of this program.

SERVICES OFFERED BY CPAS

CPAs offer many services to clients. In the past, anytime the accountant prepared and submitted financial statements they knew would be used by third parties, SSARS applied. Under SSARS 21, this distinction is no longer made. The service offered by CPAs is determined by the terms of the engagement. While SSARS engagements require the terms to be clearly stated in an engagement letter, it is recommended that engagement letters be used for all engagements to avoid misunderstandings. Typical engagements performed by CPAs include the following:

- **Bookkeeping** – These engagements require that the CPA perform bookkeeping services such as data entry, check writing and recording, payroll services, deposit recording, bank/account reconciliations, and journal entries. In a bookkeeping engagement, the accountant is not being engaged to prepare financial statements. It becomes a bit more complex when the accountant inputs information into a software program—such as QuickBooks®—that the client uses to prepare financial statements. In this case, as long as the accountant performs their services inside the software, AR-C 70 will likely not apply (discussed further in Unit 3).

Note: At times, the CPA is engaged to perform bookkeeping or controller-type services for a client. If the CPA generates financial reports (for internal or external purposes), these are non-attest services that would likely impact the independence of the CPA for the performance of attest services the CPA may be engaged to perform.

- **Journal entry assistance** – When a client does its own bookkeeping and the accountant is hired to clean up the records, there could be confusion as to the applicability of SSARS. As in the bookkeeping engagement, the client’s understanding of the role of the accountant is critical.
- **Assistance services** – When the accountant is engaged to assist management in the preparation of financial statements, AR-C Section 70 doesn’t apply, but this can be a slippery slope. The accountant will have to use professional judgment to determine whether the services provided are limited to assisting management or involve actual preparation, in which case AR-C Section 70 is applicable. A carefully worded engagement letter is critical in these situations.

Note: Assume the CPA is running financial reports to show certain expenses or decreases in revenues and profits in conjunction with applications for PPP loans, EIDL grants, EIDL loans, and state and/or local financial assistance lending opportunities that require certain qualifiers pertaining to COVID-19 implications. What level of service applies? Mike Glynn of the AICPA seems to suggest that AR-C Section 70 only applies if it’s a financial statement (not components or extracted segment reports). But it’s in conjunction with a credit application—does that suggest that AR-C 70 would apply?

- **Preparation services** – When the accountant in public practice is engaged to prepare financial statements (or prospective financial statements), AR-C Section 70 applies.
- **Compilation services** – Compilation reports under AR-C Section 80 are only required when the accountant is engaged to compile the financial statements. Accountants may be simultaneously engaged to assist in the preparation of the financial statements or to prepare the financial statements, but such services are separate from and in addition to the compilation services.
- **Review services** – Review reports under AR-C Section 90 are required when the accountant is engaged to review the financial statements. Accountants may be simultaneously engaged to assist in the preparation of the financial statements or to prepare the financial statements, but such services are separate from and in addition to the review services. If such services are provided in addition to the review services the accountant must be careful not to perform management functions due to the review requirement that the CPA remain independent.
- **Tax services** – While tax services are not a financial statement service, the use of engagement letters is a best practice. Accountants often apply bookkeeping and/or journal entry assistance services in conjunction with tax services provided.

PREPARATION OF FINANCIAL STATEMENTS

To some, the use of the word preparation has been confusing. The authoritative literature uses the word in two different contexts:

- **ET 1.295** – Under the Code of Professional Conduct, preparation of financial statements is used in the context of the general act of helping your client prepare financial statements. This could be part of a bookkeeping, consulting, preparation, compilation, review, or audit engagement. This section considers preparation to be a *non-attest* service.
- **AR-C Section 70** – Under SSARS, a preparation service is a *defined service* where the client engages the CPA to prepare financial statements. In this context, it is a service that is distinguishable from a compilation, review, or audit engagement because the prepared financial statements are not the end deliverable. In cases where the compilation or review involves some ET 1.295 preparation (assisting the client in preparation of the financial statements), it is not a preparation service under AR-C Section 70.

Independence Subtopic 1.295 requires that in order for a CPA to perform non-attest services for a client, the CPA must adhere to *the general requirements for performing non-attest services*. Under the general requirements, the CPA must not assume management responsibilities when performing non-attest services. Examples of non-attest services include:

- Advisory services;
- Appraisal, valuation, and actuarial services;
- Benefit plan administration;
- Bookkeeping, payroll, and other disbursements (Note: Although not specifically listed, this will include preparation of financial statements and reconciliations);
- Business risk consulting;

- Corporate finance consulting;
- Executive or employee recruiting;
- Forensic accounting;
- Information systems design, implementation, or integration;
- Internal audit;
- Investment advisory or management; and
- Tax services.

PROGRAM TOPICS

- Unit 1: Compilation and Review History
- Unit 2: AR-C Section 60—General Principles for Engagements Performed in Accordance with SSARS as Amended by SSARS 25
- Unit 3: AR-C Section 70—Preparation of Financial Statements as Amended by SSARS 25
- Unit 4: AR-C Section 80—Compilation Engagements as Amended by SSARS 25
- Unit 5: AR-C Section 90—Review of Financial Statements as Amended by SSARS 25
- Unit 6: Special Purpose Frameworks

Unit 2

AR-C Section 60—General Principles for Engagements Performed in Accordance with SSARS as Amended by SSARS 25

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ☐ Describe the requirements of AR-C 60, General Principles for Engagements Performed in Accordance with SSARS.
- ☐ Describe professional responsibilities when performing an engagement in accordance with SSARS.
- ☐ Recognize best practices for SSARS engagements.

INTRODUCTION

AR-C Section 60, *General Principles for Engagements Performed in Accordance with SSARS*, provides the general principles for any engagement performed in accordance with SSARS.

The following topics are applicable to all levels of service and are discussed in detail in this section of the program:

- Section Objective
- Definitions
- Scope
- Preparation of Financial statements

- Requirements for All SSARS Services:
 - Ethical Requirements
 - Professional Judgment
 - Conduct of the Engagement in Accordance with SSARS
 - Engagement-Level Quality Control
 - Acceptance and Continuance of Client Relationships and Engagements Performed in Accordance with SSARS
 - Determining the Applicability of the Financial Reporting Framework
 - Common Standards Outside of AR-C Section 60
-

TAKE NOTE

Topics in this section apply to all levels of service, including preparation (AR-C Section 70), compilation (AR-C Section 80), and review (AR-C Section 90). Reference to these requirements will be made throughout this program but will not be covered in detail in each section to avoid repetition. If there are new or additional requirements applicable to a level of service, they will be covered in the appropriate section.

SECTION OBJECTIVE

The objective of the accountant is to obtain an understanding of the general principles for engagements performed in accordance with SSARS.

DEFINITIONS

Applicable financial reporting framework. The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the reporting entity and the objective of the financial statements, or that is required by law or regulation.

Designated accounting standard setter. A body designated by the Council of the AICPA to promulgate principles generally accepted in the United States of America pursuant to the “Compliance with Standards Rule” (ET 1.310.001) and the “Accounting Principles Rule” (ET 1.320.001) of the AICPA Code of Professional Conduct.

Engagement partner. The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

Engagement team. All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who perform procedures on the engagement.

Fair presentation framework. See *financial reporting framework*.

Financial reporting framework. A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (e.g., accounting principles generally accepted in the United States of America [U.S. GAAP], International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework).

The term *fair presentation framework* refers to a financial reporting framework that requires compliance with the requirements of the framework and does one of the following:

- a. Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework.
- b. Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in rare circumstances.

A financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgment in (a) or (b) is not a fair presentation framework.

Financial statements. A structured representation of historical financial information, including disclosures, intended to communicate a reporting entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term *financial statements* ordinarily refer to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of the financial statements or in the notes, or incorporated by reference.

The requirements of the applicable financial reporting framework determine the presentation, structure, and content of the financial statements and what constitutes a complete set of financial statements.

Firm. A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in the practice of public accounting.

General purpose financial statements. Financial statements prepared in accordance with a general-purpose framework.

General purpose framework. A financial reporting framework designed to meet the common financial information needs of a wide range of users.

Interpretive publications. Interpretations of SSARs; exhibits to SSARs; AICPA Guide *Preparation, Compilation, and Review Engagements*; guidance on preparation, compilation, and review engagements included in AICPA Audit and Accounting Guides; and AICPA Statements of Position, to the extent that those statements are applicable to such engagements.

Other preparation, compilation, and review publications. Publications other than interpretive publications.

Professional judgment. The application of relevant training, knowledge, and experience, within the context provided by SSARs, accounting, and ethical standards, in making informed decisions about

the courses of action that are appropriate in the circumstances of the preparation, compilation, or review engagement (specifically referenced in AR-C Section 90).

Prospective financial information. Any financial information about the future. The information may be presented as complete financial statements or limited to one or more elements, items, or accounts.

Special purpose financial statements. Financial statements prepared in accordance with a special purpose framework.

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

- Cash basis
- Tax basis
- Regulatory basis
- Contractual basis
- Other basis (FRF for SMEs)

SCOPE

This section is intended to help accountants better understand their professional responsibilities when preparing an engagement in accordance with SSARS. Additional sections in the SSARS Codification have been established to set forth specific performance and reporting requirements. Such additional requirements are based on the general principles provided by this section, and any requirements created by this section also have been incorporated into additional sections.

The financial statements subject to the engagement performed in accordance with SSARS are those of the reporting entity. SSARS do not impose responsibilities on management and do not override laws and regulations that govern their responsibilities.

PREPARATION OF FINANCIAL STATEMENTS

Financial Statements

Preparation and fair presentation require the following:

- The identification of the applicable financial reporting framework (This determines the form and content of the financial statements in the context of any relevant laws or regulations.)
 - A general-purpose framework (e.g., GAAP, IFRS)
 - A special purpose framework (e.g., tax, cash)
- The preparation and fair presentation of the financial statements based on the financial reporting framework

- The inclusion of an adequate description of the framework in the financial statements

The preparation and fair presentation of the financial statements requires management to exercise judgment when making accounting estimates that are reasonable in the circumstances as well as when selecting and applying appropriate accounting policies. These judgments are made based on the provisions of the applicable financial reporting framework.

The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of a reporting entity. For example, a complete set of financial statements might include a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements.

An accountant may be engaged to prepare, compile, or review a complete set of financial statements or an individual financial statement. The financial statements may be for an annual period or for an interim period based on management's needs.

REQUIREMENTS FOR ALL SSARS SERVICES

Ethical Requirements

Accountants must comply with all relevant ethical requirements contained in the AICPA Code of Professional Conduct (and rules of applicable state boards of accountancy and other applicable regulatory agencies) throughout the engagement, including:

- Responsibilities,
- The public interest,
- Integrity,
- Objectivity and independence,
- Due care, and
- Scope and nature of services.

Quality control standards used by firms (QC Section 10, *A Firm's System of Quality Control*), should set out their responsibilities to establish and maintain a system of quality control around SSARS engagements and establish policies and procedures that enable the firm to have reasonable assurance that they comply with these requirements, including requirements related to independence.

Due care requires the accountant to fulfill professional responsibilities with competence and to have the appropriate capabilities to perform the engagement.

Professional Judgment

Professional judgment is essential to any engagement because interpretation of all the requirements around ethics and SSARS, and the ability to make informed decisions throughout the engagement, cannot be made without it. Therefore, there are some distinguishing factors associated with professional judgment, including the following:

- The accountant has relevant training, knowledge, and experience that enable him/her to make informed decisions using reasonable judgment. This includes reaching out to others within the engagement team, or others within or outside the firm on difficult or contentious matters.
- The accountant displays competence in the application of SSARS and accounting principles by making judgments that are appropriate and consistent based on the facts and circumstances that are known throughout the engagement, including:
 - Any knowledge acquired from prior period engagement experience;
 - The accountant's understanding of the reporting entity and its environment, including its industry, accounting systems, and financial reporting framework; and
 - The extent the preparation and presentation of financial statements require judgment by management or the accountant.
 - The use of professional judgment throughout the engagement must be appropriately documented in accordance with the guidance for each level of service.
 - Lastly, professional judgment cannot be used to justify decisions that are not supported by the facts and circumstances of the engagement or evidence obtained (in a review engagement).

Conduct of the Engagement in Accordance with SSARS

The accountant must perform review, compilation, or preparation engagements in accordance with SSARS. An exception to this rule is certain reviews of interim financial information (generally 10-Q reviews performed for SEC registrants). Regarding the conduct of the overall engagement, accountants are responsible for the following:

- Complying with the sections relevant to the engagement
 - A section is relevant when it is in effect and the circumstances being addressed exist.
 - The accountant should understand the entirety of the section to understand the objectives and requirements.
 - The accountant should only represent compliance with SSARS in reports to which they have complied with the appropriate requirements of the applicable section.

- Complying with relevant requirements of each section, unless circumstances of the engagement are not relevant because they are conditional, and the condition does not exist
- Complying with requirements in SSARS, of which there are two categories with specific definition that describe the degree of responsibility that is imposed on accountants. The two categories are:
 - **Unconditional requirements** – The words *must* or *required* are used to indicate an unconditional requirement. Unconditional requirements require the accountant to comply in all cases whenever the circumstances apply.
 - **Presumptively mandatory requirements** – Presumptively mandatory requirements are indicated by the word *should*. These requirements also require the accountant to comply if the circumstances apply. However, in rare cases, when the accountant departs from these requirements, the accountant is required to document the justification for the departure, along with how other performed procedures meet the objectives of the standard.
 - Here's an example of when a presumptively mandatory requirement would not be required: The review standards indicate certain inquiries that the accountant should make of management. One of the inquiries is to ask about the status of uncorrected misstatements identified during the previous engagement. If there were no uncorrected misstatements in the past, this inquiry would be unnecessary, but the accountant would document why the inquiry was not made.
 - Procedures enumerated in the *Preparation, Compilation, and Review Engagements* guide should be considered as a level of authority. Considering these procedures or actions is presumed to be required; however, the considered action itself is not presumed to be required.

REMINDER

The accountant must document (a) the justification for not performing a presumptively mandatory procedure, and (b) how the alternative procedures performed were sufficient to achieve the intent of that presumptively mandatory requirement.

- Being familiar with the contents of the AICPA Guide—*Preparation, Compilation, and Review Engagements*—an interpretive publication issued under the authority of the ARSC. Pursuant to AR-C Section 60, an accountant should consider applicable interpretive publications in the performance of his or her engagement in accordance with SSARSs. If the accountant does not apply the guidance in this interpretive publication, the accountant should document how the requirements of SSARS were complied with in the circumstances addressed by such guidance. Accordingly, the referenced guide is considered authoritative.
- Considering other interpretive publications, other preparation, compilation, and review publications that are not SSARS and are not authoritative but are recommendations on the application of SSARS in specific circumstances (industry-specific). In application of any of this non-authoritative material the accountant needs to exercise professional judgment and assess the relevance and appropriateness of the guidance to the engagement circumstances.

Engagement Level Quality Control

An engagement partner is responsible for all engagement-related activities for an engagement performed in accordance with SSARS. This responsibility includes assuring that the engagement team performing the services complies with the firm's system of quality control.

In an engagement performed in accordance with SSARS, the engagement partner should take responsibility for the following:

- The overall quality of each engagement to which the partner is assigned
- The direction, supervision, planning, and performance of the engagement in compliance with professional standards and applicable legal and regulatory requirements
- The accountant's report being appropriate in the circumstances
- The engagement being performed in accordance with the firm's quality control policies and procedures

When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation;
- Understanding of professional standards and applicable legal and regulatory requirements;
- Technical expertise, including expertise with relevant information technology and specialized areas of accounting and attest services;
- Knowledge of relevant industries in which the client operates;
- Ability to apply professional judgment; and
- Understanding of the firm's quality control policies and procedures.

The firm's system of quality control should ensure:

- Competence of engagement team personnel through their recruitment and formal training;
- Independence of personnel, if applicable;
- Maintenance of client relationships through effective acceptance and continuance processes; and
- Adherence to regulatory and legal requirements through effective monitoring.

Other areas that should be considered by the engagement partner include the following:

- **Additional considerations after the engagement is accepted** – If the partner becomes aware of anything that would have caused the firm to decline the engagement had information been available earlier, the partner should communicate that promptly to the firm.

- **Compliance with relevant ethical requirements** – The partner should remain alert to possible non-compliance by the team.
- **Monitoring** – The firm should have a process that provides it with reasonable assurance that the quality control system is relevant, adequate, and effective.

Acceptance and Continuance of Client Relationships and Engagements Performed in Accordance with SSARS

As mentioned above, quality control systems require maintenance of client relationships via effective processes and procedures that involve accepting new engagements and continuing with existing relationships. It is important to be selective in this exercise to ensure that new and existing clients meet the firm's quality standards and ethical obligations.

In order to accept an engagement to be performed based on SSARS (including a preparation engagement), the accountant should do the following:

- Determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable. Consider the following:
 - The purpose of the financial statements. Are they prepared to meet the needs of many users? Who are the intended users?
 - Whether law or regulation prescribes the applicable reporting framework
- Obtain the agreement of management that it acknowledges and understands its responsibility for the following:
 - The selection of the financial reporting framework to be applied in the preparation of financial statements
 - The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to error or fraud, unless the accountant decides to accept responsibility for such internal control

Note: SSARS 24, *Omnibus Statement on Standards for Accounting and Review Services—2018*, makes clear that, although the accountant may accept responsibility for the design, implementation, and maintenance of internal control, such an activity is a management responsibility and, as such, impairs independence if performed for an attest client. If an accountant accepts such responsibility, the accountant is precluded from performing a review of financial statements and from performing a compilation if the report does not include a communication of non-independence.

- Preventing and detecting fraud
- Ensuring that the reporting entity complies with laws and regulations applicable to its activities

- The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments provided by management for the preparation of financial statements
- Providing the accountant with:
 - Access to all relevant information
 - Additional information that the accountant may request from management for the purpose of the engagement
 - Unrestricted access to persons within the reporting entity of whom the accountant determines it necessary to make inquiries

At the end of the day, the engagement partner must decide whether the conclusions reached regarding the acceptance and continuation of client relationships are appropriate. Additional information and activities that could be considered in this determination include the following:

- The integrity of owners, management, and those charged with governance
 - Interview the prospective or existing client
 - Review/read previous financial statements
 - Gain a preliminary understanding of the accounting system and supporting staff
 - Understand the purpose of the statements and the intended users
- The competence of the engagement team (including time allotted and resources available)
- Whether the firm can meet their ethical requirements (i.e., independence in a review)
- Any issues or findings that have been identified in past or current engagements that could give rise to increased risk in accepting an engagement (if you knew then what you know now)
 - Consider communication with predecessor accountant, if any
 - Consider communication with other third parties familiar with the prospective or exiting client
 - Evaluate past and current experience with the performance of services for existing clients

Overall, the accountant should not accept an engagement if:

- The accountant has reason to believe that relevant ethical requirements cannot be satisfied, including independence in a review engagement;
- The accountant's preliminary understanding of the engagement circumstances indicates that information needed to perform the engagement is likely to be unavailable or unreliable; or

- The accountant has cause to doubt management's integrity and its impact on the performance of the engagement.

When performing any engagement under SSARS, the accountant is required to obtain the agreement of management on its responsibilities regarding the financial statements. Many times, particularly in smaller companies, management may not be aware of what it is responsible for versus what the accountant is responsible for. In fact, a good percentage of professional liability claims arise because the client made assumptions that the accountant was providing much more than the accountant was engaged to perform.

In addition, the preparation service requirements of AR-C 70 have caused a lot of additional confusion in the industry as to when they are applicable. Therefore, a well-written engagement letter is crucial to minimize any confusion about mutual responsibilities.

Determining the Applicability of the Financial Reporting Framework

Factors that are relevant to the accountant's determination of the acceptability of the financial reporting framework selected by management to be applied to the preparation of the financial statements include the following:

- The nature of the reporting entity
- The purpose of the financial statements
- The nature of the financial statements
- Whether law or regulation prescribes the applicable financial reporting framework

In accordance with this section, the accountant is required to obtain the **agreement of management** on management's responsibilities in relation to the financial statements as a condition precedent to accepting the engagement.

COMMON STANDARDS OUTSIDE OF AR-C SECTION 60

AR-C Section 60 contains the general principles applicable to all SSARS engagements. In addition to these general principles, there are other areas that are discussed separately in each section of SSARS. These areas include:

- Agreement on engagement terms;
- The accountant's knowledge and understanding of the reporting entity's financial reporting framework;
- Preparing the financial statements (any level of service); and
- Independence.

Agreement on Engagement Terms (Any SSARS Engagement)

Engagement letters are essential to a practice and should be utilized for every service provided, regardless of the extent of the service or the length of time that the firm has known the client. The

terms of the agreement should be documented in an engagement letter or other suitable form of written agreement and should include the following:

- The objective of the engagement
- The responsibilities of management, including the following:
 - The selection of the financial reporting framework to be applied in the preparation of their financial statements
 - The design, implementation, and maintenance of internal controls that are relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error
 - Preventing and detecting fraud
 - Ensuring compliance with applicable laws and regulations
 - The accuracy and completeness of all information, including significant judgments made in preparing the financial statements
 - Providing the accountant with:
 - Access to all relevant information
 - Additional information, when requested
- 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

SSARS 21 established the requirement that both parties must sign the engagement letter.

TAKE NOTE

Each section of SSARS contains additional requirements based on the level of service. Those additional requirements are addressed in the following sections, along with basic examples.

TAKE NOTE

In the unusual situation that the accountant decides to accept responsibility for the design, implementation, and maintenance of internal controls of the business, such accepted responsibility would impair independence and preclude the accountant from performing a review engagement. Further, the accountant should list such control responsibilities under the responsibilities section of the engagement letter, rather than management's responsibilities.

While not listed in the professional standards, the following are some **engagement letter best practices** often cited by insurance carriers and practitioners:

- **Be specific as to the services being performed** – This is especially true when performing bookkeeping services. For example, what specific bookkeeping services are being performed? Does it mean posting the cash receipts, reconciling the checkbook, preparing payroll, preparing the 941s, et cetera?
- **To avoid confusion, discuss services you are not performing** – It is important to include not only those services that you have been engaged to perform, but also those services that you are specifically not providing. For example, if you are being engaged to perform a compilation:

“We will not audit or review such financial statements. We will not review or evaluate internal controls, confirm receivables or other balances with third parties, or observe physical inventory.”

- **Use annual engagement letters** – Some attorneys believe that by using an annual engagement letter, the timing of the engagement is spelled out so that the statute of limitations might start when the financial statements are delivered. In addition, if the letter is prepared annually, it is more likely that changes in client services will be incorporated and changes in client economic situation and performance results can be appropriately documented.
- **Indemnification clauses** – A limitation of liability provision and a consequential damage provision in an engagement letter may not always be enforceable. Nonetheless, many insurance carriers believe they offer several benefits, such as the following:

- Courts are accepting them with more frequency as they are enforceable in many instances
- An accepted limitation provision that could act as a deterrent in pursuing litigation when a client or his attorney understands that challenging the enforceability is an obstacle

In some cases, indemnification clauses were determined to be an impairment of independence because they have the client assume liability for the CPAs expenses. It is important that CPAs carefully review the clause and discuss it with legal counsel. Due to the complex legal issues, the AICPA has offered no guidance in this area.

Practitioners should be aware that some states have had court rulings about these clauses/waivers or have anti-indemnification statutes that may prohibit the inclusions of additional insured provisions in contracts. Again, practitioners should check with their legal counsel and insurance carrier prior to including these clauses/waivers in engagement letters.

- **Fees** – Specify what the fee for the service will be and when it is to be paid. Consideration should be given to retainers for new or slow-paying clients. Most insurance companies and attorneys recommend against fixed fees because of the possibility that a firm might take shortcuts if it starts to run over budget. It is recommended that fees be based on hourly billing rates with a fixed dollar estimate, with a clause that states:

“If additional time is expected, the client will be notified prior to incurring the additional time.”

- **Work stoppage** – Unfortunately, some jurisdictions do not believe that nonpayment of fees is a reason for stopping work, unless there is an agreement to that effect. The author recommends that the following clause be included:

“Fees are due and payable (state firm policy). If fees are not paid as agreed, we reserve the right to discontinue work.”

- **Fraud detection** – Despite the fact that detection of fraud is not even required in an audit (although auditors must assess the risk of fraud), there is an expectation on the part of clients that accountants will find fraud if it exists. Therefore, any responsibility for fraud detection should be specifically excluded from the engagement.
- **Completion of engagement** – Because there may be confusion over what the accountant’s responsibility may be if errors are found that the client is unwilling to correct, or if additional procedures are required under professional standards, the following language should be considered:

“We reserve the right to discontinue our services and not issue a report if the engagement cannot be completed in accordance with professional standards.”

- **Specify users** – Because the issue of privity varies from state to state, an accountant may limit exposure by stating who the intended users of the financial statements will be. For example:

“The financial statements are for the use of XYZ Bank in order to comply with its loan covenant. We are not aware that the financial statements are intended to be used by anyone other than management and XYZ Bank.”

In order to be effective, this clause should be accompanied with an indemnification clause.

- **Do not sell services** – The engagement letter should stand on its own. If additional services are to be provided, they should be provided pursuant to a revised engagement letter. This can be accomplished by stating the following:

“This letter encompasses all of the terms of this professional engagement. If additional services are requested, they will be provided for in a separate engagement letter.”

- **Peer review** – The AICPA Code of Professional Conduct also requires that an accountant keep client information confidential. Although the standards carve out certain exemptions, and many believe peer reviewers are covered by these exemptions, as a precautionary measure, the author recommends the following:

“We subscribe to a program of peer review for maintenance of quality control in our firm. As part of this program, this engagement may be selected for review by other accountants under strict rules of confidentiality. Your acceptance below constitutes your agreement for disclosure under the program.”

- **Outsourcing** – The AICPA Code of Professional Conduct Ethics Interpretation 1.150.040, *Use of a Third-Party Service Provider*, states that a member should disclose to a client, preferably in writing, that s/he may use a third-party service provider before disclosing confidential client information to the provider. This does not apply if the third-party provider is performing administrative support functions such as authorizing e-file tax transmittal services, storing records, or software application hosting.

- This can be addressed by adding the following:

The firm may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information, and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, the firm will remain responsible for the work provided by any such third-party service providers.

- **Selection of services** – The client is required to take responsibility for the financial statements and understand the accountant’s role. In order to document that the client understands the service provided, the author recommends the following language be included:
 - “You understand that our firm performs audit, review, compilation, and preparation services. Furthermore, you have determined that a _____ service most appropriately meets your needs.”

All SSARS engagements require an engagement letter. Since the services differ, the contents of the letter will differ. Customization to the individual client and services is crucial. There are examples of letters in each section of this manual.

The Accountants Knowledge and Understanding of the Reporting Entity’s Financial Reporting Framework¹

The accountant should obtain an understanding of the financial reporting framework adopted by management that is intended to be used in the preparation of financial statements as well as the significant accounting policies adopted by management.

For new clients, an accountant can gain this understanding by considering:

- AICPA guides;
- Specific publications applicable to the client’s industry;
- Financial statements of other entities in the industry, if available;
- Textbooks, periodicals, industry trade journals, and CPE programs; and
- Other individuals in the firm who are knowledgeable about the industry.

Financial statements may be prepared based on management’s entity-specific financial reporting framework, as long as those financial statements are not misleading. If this is the case, the accountant needs to make sure that it is clear to the client and user what the basis of accounting is for such financial statements.

¹ AR-C 70, 80 and 120; AR-C 90 contains sections requiring an Understanding of the Industry, and Knowledge of the Entity which effectively incorporate knowledge and understanding of the entity’s FRF.

Preparing the Financial Statements (Any Level of Service)

The financial statements should be based on management's records, documents, explanations, and other information. If management fails to provide complete and accurate information and this comes to the attention of the accountant, the accountant should request correct information, or if not provided, withdraw from the engagement.

Independence

Independence is defined in Topic ET 1.200 of the AICPA Code of Professional Conduct. The definition of independence is the same for all levels of service. It is very important to note that the rules are not relaxed for SSARS engagements. Thus, the accountant is subject to the same rules for preparation, compilation, and review as for audits. However, the accountant's consideration of independence varies based on the level of service offered.

- **Preparation** – The accountant is not required to evaluate independence.
- **Compilation** – The accountant must evaluate independence. If independence is impaired, the compilation report must be modified and include a statement about the lack of independence.
- **Review** – The accountant must be independent when performing review services.

OTHER PRACTICE ISSUES

SSARS 21 greatly reduced guidance in common financial statement situations. While these areas are no longer directly referenced in the standards, the standards give general guidance that can be applied to most of the areas. In some cases, the issues have been addressed in the following AICPA publications:

- Preparation, Compilation, and Review Engagements Guide
- Developments in Preparation, Compilation, and Review Engagements Alerts
- Center for Plain English Accounting (newsletters, reports, and alerts)

Examples of these topics include:

- Personal financial statements,
- Prescribed forms, and
- Interim reports.

There is guidance in AR-C Section 90 for review engagements that is absent from AR-C Section 80 on compilations. When engaged to compile financial statements, many practitioners nevertheless consider, as a best practice, the guidance in AR-C Section 90 dealing with:

- Communication with management and those charged with governance
- Understanding the industry (discussed below)

- Knowledge of the reporting entity (discussed below)
- Using the work of other accountants
- Communicating to management and others regarding fraud or non-compliance with laws and regulations
- Reporting on the financial statements
 - Comparative financial statements
 - Emphasis-of-matter and other-matter paragraphs
 - Known departures from the applicable reporting framework
 - Alert that restricts the use of the accountant's report
 - The accountant's consideration of a reporting entity's ability to continue as a going concern
 - Subsequent events and subsequently discovered facts
 - References to the work of other accountants
 - Change in engagement from audit to review

Specifically, understanding the industry and knowledge of the reporting entity consists of the following:

Understanding the Industry

An accountant should possess an understanding of the industry. This understanding can be obtained through related client experience, formal training programs, reading financial statements of other companies in the same industry, and reading the AICPA accounting guides or other literature pertaining to the industry. Accordingly, the accountant is not precluded from accepting an engagement in an industry in which the accountant has no previous experience, provided the accountant obtain that knowledge and understanding prior to the issuance of the accountant's report.

This understanding should be sufficient for the accountant to determine that the client has selected the appropriate accounting practices and principles used, as well as the appropriate financial statement format used in a particular industry.

Understand an industry includes any appropriate GAAP or SPF accounting pronouncements that relate to the industry in which the client operates. Examples include the following:

- The required supplemental schedules for a Common Interest Realty Association (CIRA)
- The fact that the Department of Labor requires a comparative statement of net assets for a 401(k) plan
- A condo developer is renting unsold units and must test carrying value for impairment

- A not-for-profit client must break out with donor restrictions and without donor restrictions assets on statement of financial position
- Economic problems within the industry that might affect the client's business or operational results
- New accounting pronouncements or reporting requirements
- Positive or negative industry trends that can impact the risks of material misstatements in the financial statements

Knowledge of the Entity

An accountant should obtain knowledge about the client's business and the accounting principles and practices used by the client. The accountant should also obtain a general understanding of the following about the client:

- Organization and operating characteristics. For example:
 - Is it a C corporation that would require deferred taxes?
 - Is it a pass-through entity?
 - Is there a board of directors (those charged with governance) that might require additional communication?
- Nature of its assets, liabilities, revenues, and expenses. For example:
 - Would the client be expected to have inventory?
 - Does the client have a loan agreement that requires certain compliance tests?
 - Are sales subject to a right of return?
 - How does the client select the appropriate accounting principles? If they are not capable of doing so, how would this affect your reporting?
 - Find out whether newly issued accounting standards going into effect are appropriately known, applied, and disclosed.
- The technology used by the client's accounting systems and related records documentation trail, as well as the personnel responsible for that technology.
- How the client's practices may differ from appropriate industry practices. For example:
 - Recording a factoring of accounts receivable as a sale when the conditions of sales do not exist
 - Recognizing revenue because the sale proceeds are non-refundable

- Classifying certain operating items such as gain/loss on sale of fixed assets, owner's salary, depreciation, etc., as non-operating
- Not properly straight-lining rents when the client's lease calls for increases in future rental payments

NOTES

Unit 3

AR-C Section 70—Preparation of Financial Statements as Amended by SSARS 25

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ☐ Apply the requirements of AR-C 70, Preparation of Financial Statements.
- ☐ Identify practitioner matters to consider when agreeing to perform preparation engagements.

INTRODUCTION

The *Preparation of Financial Statements* is a 2015 addition to the SSARS Codification. Due to their small size, many private companies with limited third-party users, or limited accounting expertise, are unable or unwilling to invest in experienced accounting personnel for their businesses. As a result, they engage accountants to assist with both preparing financial accounting information and *presenting* financial statements.

Before SSARS 21, when an accountant was associated with or responsible for the submission of financial statements to a client, the accountant was required to issue either a compilation or review report on the financial statements. SSARS defined this as an **attest service**. SSARS 19 defined **submission** as “presenting to management financial statements that an accountant has prepared.” Based on this definition, compilations were required when either of the following two circumstances existed:

1. Client engages the accountant to perform a compilation (retained in SSARS 21)
2. Accountant submits financial statements to a client (eliminated by SSARS 21)

The audit literature, most state statutes, and the AICPA’s Code of Professional Conduct define the preparation of financial statements as a **non-attest service** falling under the guidance of Code of Professional Conduct Independence Subtopic ET 1.295, *Nonattest Services*. The conflict of those

definitions with the belief that compilations were attest services was extensively discussed. Ultimately, it was decided that the designation of compilations as attest was irrelevant since SSARS standards would have to be followed. SSARS no longer designates compilations as attest services.

The primary purpose of AR-C Section 70 is to create consistency within the performance standards for the definition of the preparation of financial statements. Accordingly, AR-C Section 70 has replaced the previous SSARS 8 guidance on management use only financial statements.

The objective of this section is to prepare financial statements pursuant to the financial reporting framework adopted by management. Because it is based on management needs, there is more flexibility as to the information that is presented. In addition to GAAP and special purpose frameworks, the information can be:

- A management financial reporting framework,
- Management-use financial statements,
- Financial statements presented for analysis purposes,
- Non-GAAP information, and
- Partial financial statements.

AR-C Section 70 provides requirements and guidance when an accountant is engaged to prepare financial statements for a reporting entity but has not been engaged to perform a compilation, review, or audit on those financial statements.

AR-C Section 70 requires that when the accountant is engaged to perform a preparation service, the accountant would follow the requirements and guidance in AR-C Section 70. Thus, applicable performance standards are engagement driven. For example, when the accountant is engaged to perform a compilation of financial statements, the accountant would follow the requirements and guidance in AR-C Section 80, *Compilation Engagements*, not the preparation guidance in AR-C 70.

A *preparation service engagement* could consist of preparation of any of the following:

- Financial statements
- Specified elements, accounts, or items of a financial statement
- Supplementary information (required and not required)
- Pro forma financial information
- Prospective financial information

These financial statements would be generally prepared on plain paper or on client stationery; they would not be prepared on firm stationary. The preparer's name may, or may not be, present in the *no assurance is provided* legend required on each page.

The following topics are in detail in this section of the program:

- Section Objective
- Issue of Independence
- Scope of This Section
- The Preparation Engagement
- Definitions
- Requirements of AR-C Section 70:
 - Acceptance and Continuance of Client Relationships and Engagements to Prepare Financial Statements
 - Agreement on Engagement Terms
 - The Accountant’s Knowledge and Understanding of the Reporting Entity’s Financial Reporting Framework
 - Preparing the Financial Statements
 - Financial Statements that Omit Substantially all the Disclosures Required by the Applicable Financial Reporting Framework
 - Documentation in a Preparation Engagement
- Practice Issues

SECTION OBJECTIVE

The objective of the accountant is to prepare financial statements pursuant to a specified financial reporting framework.

ISSUE OF INDEPENDENCE

An engagement to prepare financial statements is a non-attest service and does not require an accountant’s report, nor does the accountant have to consider independence when engaged to prepare financial statements, even if the financial statements are expected to be used by or provided to a third party.

TAKE NOTE

It is important that the accountant consider independence when assisting in the preparation of financial statements when done in conjunction with compilation, review, or audit services since those services require an assessment of independence. Although it is not required that the accountant evaluate independence in a preparation engagement, it is important that independence is maintained if an engagement requiring independence may be possible. To safeguard against this, accountants should

consider the guidance contained in the audit literature and the AICPA's Code of Professional Conduct Subtopic 1.295, Non-attest Services.

SCOPE OF THIS SECTION

The accountant is not required to verify the accuracy or completeness of the information provided by management, nor is the accountant required to gather evidence to express an opinion or a conclusion on the financial statements.

This section does not apply when an accountant prepares financial statements or prospective financial information:

- And is engaged to perform an audit, review, or compilation of those financial statements;
- Solely for submission to taxing authorities;
- For inclusion in written personal financial plans prepared by the accountant;
- In conjunction with litigation services that involve pending or potential legal or regulatory proceedings; or
- In conjunction with business valuation services.

The determination about whether the accountant has been engaged to prepare financial statements or merely assist in preparing financial statements (which is a bookkeeping service that is not subject to this section) is determined based on services the client requests the accountant to perform and requires the accountant to apply professional judgment.

THE PREPARATION ENGAGEMENT

An engagement to prepare financial statements in a non-attest service and does not require a determination about whether the accountant is independent of the reporting entity.

In addition, an engagement to prepare financial statements **does not require** the accountant to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements or otherwise report on the financial statements.

DEFINITIONS

Management. The person(s) with executive responsibility for the conduct of the reporting entity's operations. For some entities, management includes some or all of those charged with governance (e.g., executive members of a governance board or an owner-manager).

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

REQUIREMENTS OF AR-C SECTION 70

AR-C Section 70 engagements require the AR-C Section 60 requirements be followed.

Acceptance and Continuance of Client Relationships and Engagements to Prepare Financial Statements

If the accountant is not satisfied with any of the matters set out in Section 60 as preconditions for accepting an engagement to prepare financial statements, the accountant should discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the accountant about those matters, the accountant should not accept the proposed engagement.

Agreement on Engagement Terms

- The written agreement on engagement terms should include that which is required by AR-C Section 60 Paragraphs 1-6, plus:
 - The objective of the engagement
 - The responsibilities of management
 - The agreement of management that each page of the financial statements will include a legend indicating that no assurance is provided on the financial statements. If management does not agree to the placement of such a legend on each page of the financial statements, the accountant will be required to perform an engagement necessitating the writing of an accountant's report, or issue a disclaimer (see guidance following) making it clear that no assurance is provided on the financial statements
 - 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 financial statements are to contain a known departure(s) from the applicable financial reporting framework or omit substantially all disclosures required by the applicable financial reporting framework.

FIGURE 3.1: Illustrative 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 and changes in stockholders' equity. These statements will not include a statement of cash flows and related notes to the financial statements, as required by accounting principles generally accepted in the United States of America. We are pleased to confirm our acceptance and our understanding of this engagement to prepare the financial statements of Finnigan Company by means of this letter.

Our Responsibilities

The objective of our engagement is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you. We will conduct our engagement in accordance with Statements on Standards for Accounting and Review Services (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 or provide any assurance on the financial statements.

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

Management Responsibilities

The engagement to be performed is conducted on the basis that management acknowledges and understands that our role is to prepare financial statements in accordance with accounting principles generally accepted in the United States of America. Management has the following overall responsibilities that are fundamental to our undertaking the engagement to prepare your financial statements in accordance with 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 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*
- *The prevention and detection of fraud*
- *To ensure that the entity complies with the laws and regulations applicable to its activities*
- *The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement to prepare financial statements*
- *To provide us with:*
 - *Access to all information of which you are aware that is relevant to the preparation and presentation of the financial statements, such as records, documentation, and other matters*
 - *Additional information that may be requested for the purpose of the preparation of the financial statements*
 - *Unrestricted access to persons within Finnigan Company of whom we determine necessary to communicate*

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

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

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

Other Relevant Information

Our fees for these services...

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

Please sign and return the attached copy of this letter to indicate your acknowledgement of an agreement with the arrangements for our engagement to prepare the financial statements described herein, as well as 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]

TAKE NOTE

Although not in the sample engagement letter presented in SSARS 21, best practices recommend an additional bullet under Management Responsibilities stating:

“The selection of the [identify the financial reporting framework] to be applied in the preparation of the financial statements.”

TAKE NOTE

It is considered a best practice that an engagement letter is obtained at least annually. The engagement letter can cover multiple services and address attest and non-attest services—for example, an engagement to prepare monthly financial statements and perform a compilation engagement on the annual financial statement for an entity.

The Accountant's Knowledge and Understanding of the Reporting Entity's Financial Reporting Framework

The accountant should obtain an understanding of the financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements.

Preparing the Financial Statements

- The accountant should ensure that a statement is included on each page of the financial statements, indicating (at a minimum) that “no assurance is provided” on the financial statements. If the accountant is unable to include a statement on each page of the financial statements, the accountant should do one of the following:
 - Issue a disclaimer that makes clear that no assurance is provided on the financial statements.
 - Perform a compilation engagement in accordance with AR-C Section 80.
 - Withdraw from the engagement and inform management of the reasons for withdrawing.

DISCLAIMER EXAMPLE

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date]

ARSC Observation and Suggestion

The issuance of a disclaimer is intended to be used when the accountant is engaged to prepare financial statements but either cannot include the required legend on each page of the financial statements or there is another reason that the inclusion of the legend is not practical. For example, if the accountant is engaged to prepare financial statements but management's software is not compatible with the inclusion of a legend, the accountant can perform the preparation engagement and issue the disclaimer. However, if at the outset of the engagement, the client's desire is that the accountant will issue a report to be used by management or third parties, the accountant will likely perform a compilation engagement on the financial statements the accountant prepared.

When the accountant prepares financial statements based on a special purpose framework (or qualifying selected management framework), the accountant should include a description of the financial reporting framework on the face of the financial statements. Typically, this statement is somewhere in the title but can be placed anywhere, (e.g., in a footer).

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

If the accountant prepares financial statements that contain a known departure(s) from the applicable financial reporting framework, including inadequate disclosures, the financial statements should disclose the misstatement(s) either on the face of the financial statements or in the notes.

If the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, used in the preparation of the financial statements are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information. If management fails to provide such additional or corrected information, the accountant should disclose a material misstatement or misstatements in the financial statements or withdraw from the engagement and inform management of the reasons for withdrawing.

Financial Statements that Omit Substantially all the Disclosures Required by the Applicable Financial Reporting Framework

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

The accountant should not prepare financial statements that omit substantially all disclosures required by the financial reporting framework if, in the accountant's professional judgment, such financial statements would be misleading to users of the financial statements.

Financial statements may be misleading if the applicable financial reporting framework includes the premise that the financial statements are prepared on the going concern basis of accounting and undisclosed uncertainties exist regarding the reporting entity's ability to continue as a going concern. If the accountant becomes aware that uncertainties exist regarding the reporting entity's ability to continue as a going concern, the accountant may suggest additional disclosures concerning the reporting entity's ability to continue as a going concern in order to avoid the financial statements being misleading.

Note: Disclosure of items, such as an uncertainty, is not required in the financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted. Of course, if significant adverse matters are taking place, such as the coronavirus, the accountant will have to determine if the financial statements would be misleading without disclosure of these matters.

Documentation in a Preparation Engagement

Documentation in the preparation engagement – Documentation should contain sufficient detail to provide a clear understanding of the work performed by the accountant. At a minimum, documentation should include a copy of the engagement letter and a copy the financial statements prepared.

An accountant may also consider including documentation about significant consultations or judgments made.

REMINDER

As required by AR-C 60, if an accountant departs from a presumptively mandatory requirement, documentation that includes a description of how the alternative procedure(s) performed were sufficient to achieve the intent of the mandatory requirement, is required.

ARSC Observation and Suggestion

Although management is responsible for the selection of the financial reporting framework to be applied in the preparation of financial statements, in many smaller entities' management will seek the advice of the accountant in the selection of the framework. The accountant is permitted to provide such advice, and this provides the accountant with an opportunity to help management understand the various frameworks that may be applicable, including U.S. GAAP, modified cash basis, tax basis, or the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs). The accountant may also help assess the needs of third-party users of financial statements, such as bankers or owners.

PRACTICE ISSUES

Introduction

The vast majority of questions brought to the AICPA since the issuance of SSARS 21 address AR-C Section 70. Some confusion arises because, as previously noted, the term *preparation* is used in two completely different contexts in the professional literature: one in SSARS and the other in independence interpretations of the Code of Professional Conduct (the Code), namely ET 1.295 (previously Interpretation 101-3).

- Subtopic 1.295 provides guidance on maintaining independence when an accountant is asked to perform non-attest services for an attest client. Non-attest services include bookkeeping, tax return preparation, valuation services, litigation support, and various consulting engagements that are performed in addition to the attest engagement. As part of the 2014 revision of the Code, preparation of financial statements, along with cash-to-accrual conversions and reconciliations, are considered to be non-attest services outside the attest engagement.

Under ET 1.295, management must agree to take responsibility for all non-attest services by assigning an employee (or qualified designee) with adequate knowledge to oversee the accountants' work and then reviewing and approving the results. These terms must be agreed to in a written engagement letter. Otherwise, the accountant is performing management functions, and independence is impaired.

If the accountant prepares financial statements as part of the work on an attest engagement (compilation, review, or audit), it is a non-attest service performed on an attest engagement and must meet the requirements of Subtopic 1.295. It is not a SSARS 21 preparation engagement. In fact, SSARS 21 explicitly excludes this service from the scope of AR-C Section 70.

This confusion is exacerbated by the suggested wording in SSARS 21 for compilation and review engagement letters, which begins with:

You have requested that we prepare the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income and cash flows for the year then ended and the related notes to the financial statements, and perform a review [compilation] with respect to those financial statements.

The term “prepare” in this context means a non-attest service under Subtopic 1.295. Accordingly, a paragraph further down in the sample engagement letters states:

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.

This wording is intended to ensure that the preparation service complies with ET 1.295.

- A SSARS 21 preparation service under AR-C Section 70 applies when the accountant is hired, or engaged, to perform a preparation. This happens when the accountant and client have decided that this service best meets the client’s needs. Even if the accountant performs all the necessary steps to prepare (and even deliver) financial statements, it is not a preparation engagement unless the accountant was hired to do one.

In the past, accountants would not provide financial statements to a bookkeeping or tax client to avoid triggering a SSARS engagement. This is no longer what dictates a SSARS engagement. The critical point to be made here is that you get the correct engagement letter. If one of the things the client is engaging you to do is to prepare the financial statements, follow AR-C 70.

TAKE NOTE

A recent AICPA Guide—*Preparation, Compilation, and Review Engagements*—provides some clarifying guidance:

- To be *engaged* does not mean to obtain an engagement letter. Instead, it is what the accountant is hired to do, regardless of whether it is specified in the engagement letter. The engagement letter is then a required procedure after the accountant has been engaged. The understanding with the entity as to what the accountant is engaged (i.e., hired) to do is paramount in determining whether AR-C Section 70 applies.
- As part of the accountant’s bookkeeping services, the accountant may provide certain financial presentations to the client (e.g., a trial balance) that do not constitute a financial statement. As such, while the accountant may apply—adapted as necessary—the provisions of AR-C Section 70 to the preparation of a trial balance, the accountant is not required to do so.

The implication is that if financial reporting information has the characteristics and appearance of a financial statement, AR-C Section 70 will most likely apply. If the characteristics and appearance were more along the lines of a trial balance or general ledger listing, then it would likely be outside the scope of AR-C Section 70.

Finally, the guide indicates or clarifies that an accountant in public practice who provides a client with controllership, outsourced CFO, or other management services, and is engaged to prepare or provide financial statements as a part of those controllership, CFO, or management services would be subject to AR-C Section 70.

Additional Practice Issues

Determining the Type of Service to be Provided

SSARS 21 is built on a model that is engagement driven rather than submission driven. The engagement the CPA should perform is the service the client hired the CPA to perform. There is a presumption that the client's needs (including how the financial statements are to be used) and expectations will drive the type and level of service.

Consequently, the engagement is no longer defined by what the accountant did; it is determined by what the accountant was hired to do. For example, the services provided to three clients could be virtually identical, with one structured as a bookkeeping engagement, another as a preparation engagement, and the last as a compilation engagement—determined by which service best meets the client's needs. Of course, once the type of service is agreed upon, all of the relevant professional standards must be followed.

TAKE NOTE

Preparation vs. bookkeeping: The 2016-17 Alert, *Developments in Preparation, Compilation, and Review Engagements*, provides some clarifying guidance.

There is certainly a level of professional judgment necessary in assessing whether he has been hired to prepare financial statements or to assist management in preparing its own financial statements (as aided by the accounting software) and discern whether the accountant's preparation of financial information is a by-product of another non-attest service (such as the financial basis from which the tax return will be prepared). So while most non-attest services don't require an engagement letter, it might be advisable to document the services to clarify what the accountant is hired to do and perhaps add language in the non-attest service engagement letter, such as, 'This engagement does not contemplate us preparing financial statements,' to specify that the accountant is not hired to prepare financial statements (if that is the intent).

Perhaps it goes without saying that the accountant should be doing what the accountant was hired to do—not more, not less, not something different—and an appropriate engagement letter should have been obtained specifying the scope of work. If the scope of work changes, the accountant should obtain a new engagement letter.

Note that SSARS 21 does not restrict client or third-party distribution or use of prepared financial statements under any circumstances. As one member of the ARSC said, "These are the client's financial statements, and the accountant shouldn't be restricting their use."

This makes a well-designed engagement letter for all types of engagements critical.

As a practical matter, most firms will continue to provide the same service as before, with the following exceptions:

- If a compilation was performed in the past solely because it was triggered by the submission provision, and the client has no need for a compilation report, the firm might consider going to a preparation service instead.
- If a management-use-only compilation (SSARS 8, which is now eliminated from the SSARS) was performed in the past, the client will have to be consulted about how to replace it.

No Assurance Legends and Other Required Disclosures

There is a requirement that each page of financial statements prepared pursuant to AR-C 70 contains a statement that no assurance is provided on the financial statements. This is usually accomplished through the use of a legend on the face of each page of the statements.

There is also a requirement to disclose other matters such as omitted disclosures, use of special purpose frameworks (e.g., tax basis), known departures, etc. These requirements have resulted in some confusion over how this is best accomplished.

The following list addresses some of the more common issues:

- Although a disclaimer is mentioned as an alternative to a legend, the intent is to use the legend whenever possible.
- The wording of the legend is flexible, so long as it clearly states “no assurance.” Consequently, the simplest example would be, “No assurance is provided on these financial statements.”
- The wording in the legend may be customized to name the firm—for example, “No assurance is provided by ABC CPAs on these financial statements.”
- The wording of the legend may also be customized to state the services that were NOT performed—for example, “These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them.”
- The wording may also refer to compliance with SSARS, such as, “ABC CPAs adhered to Statements on Standards for Accounting and Review Services issued by the American Institute of CPAs in the preparation of these financial statements. No assurance is provided on these financial statements.”
- Although most legends are expected to appear at the bottom of each page, they may be placed anywhere.
- Matters required to be included in a special compilation report paragraph must also be disclosed in prepared financial statements. These include:
 - Omitted disclosures (including the statement of cash flows),
 - Departures from GAAP or any other framework used, and
 - Use of a special purpose framework (such as income tax basis).

However, these disclosures need not be added to the legend; they can be presented in any manner that makes sense (e.g., the financial statement titles may be modified, or the *selected disclosures* option may be used to communicate these issues).

For example:

- If all disclosures are omitted, titles could be changed (i.e., “Balance Sheet—Substantially All Disclosures Required by GAAP Have Been Omitted”);

- If the income tax basis is used, the titles could include “*Income Tax Basis*”; or
- If there is a framework departure, it could be described in a footnote. If disclosures were omitted, this one note would be on page with the title “*Selected Information—Substantially All Disclosures Required by GAAP Have Been Omitted.*”

Peer Review Status for Preparation Engagements

After some initial confusion, current AICPA guidelines exempt from peer review firms that only provide preparation services and no compilation or attest work (unless licensure or other regulations require it). However, some states require peer review for all licensed firms performing engagements falling under SSARS (e.g., Massachusetts).

For firms performing both preparation services and attest services, preparation engagements *will* be subject to selection for peer review.

Practitioner Matters to Consider

- While AR-C Section 70 contains fewer requirements than AR-C Section 80, there is still a lot of due diligence and due professional care that must be applied. Accordingly, members should not promote the service as a significant financial savings to the client.
- For tax clients, an AR-C Section 70 preparation service would provide a good intermediary step to teach the client better bookkeeping and accounting before the client might, by growth or other expansion, need a future higher level engagement reporting service.
- If a client is currently receiving a compilation report, before discussing or promoting an AR-C Section 70 preparation, ensure that, if the client has a banking covenant, the bank would modify the loan covenant and accept a financial statement without an accountant’s report.
- For practitioners that provide outsourced CFO or controllership services, the practitioner should consider whether the client expects a financial statement as a deliverable to be provided by the accountant—which would be an indication that the accountant would be responsible for following AR-C Section 70.
- While the client or management is responsible for the selection of the financial reporting framework to be applied in the preparation of financial statements, the accountant is permitted to provide advice about viable framework options and the benefits and challenges of alternatives. The accountant should consider the needs of the client/management and the expectations of third-party users when advising a client about services to be performed.
- Practitioners should discuss management’s future plans. If management expects to grow with the future need for GAAP financial statements, perhaps a current engagement based on a special purpose framework would not be the best for transition.
- Once the framework has been selected, the accountant may also assist the client in maintaining the applicable measurement and presentation principles of the financial reporting framework, making sure that framework accounting is understandable and meaningful to the owner and other users of the financial statements.

- An accountant may assume the responsibilities for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of financial statements. Such assumption is a non-attest service that, under the *management participation* threat, would preclude the accountant from being independent. However, this non-attest service would not preclude the accountant from providing bookkeeping or an AR-C Section 70 preparation.

NOTES

Unit 4

AR-C Section 80—Compilation Engagements as Amended by SSARS 25

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ☐ Apply the requirements of AR-C Section 80, *Compilation Engagements*.
- ☐ Apply the requirements of AR-C Section 120, *Compilation of Pro Forma Financial Information*.
- ☐ Identify common peer review issues in compilation engagements.

INTRODUCTION

AR-C Section 80 applies when an accountant is engaged to perform a compilation of financial statements, prospective financial information, pro forma financial information (see also AR-C Section 120), or other historical financial information. Compilation engagements may be performed for both historical and prospective financial information.

The objective of the accountant in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements and reports in accordance with AR-C Section 80 without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework.

AR-C Section 80 may be applied—or adapted—as necessary in the circumstances to other historical financial information, such as specified elements, accounts, or items of a financial statement; supplementary information; required supplementary information; and on financial information contained in a tax return.

Compilations may be performed even if the accountant is not independent, as long as the lack of independence is disclosed in the compilation report.

Prior to SSARS 21, many believed that the allowance for lack of independence, as well as the fact that most state statutes do not define a compilation as an attest service, should preclude a compilation from being considered an attest engagement, as they were defined in the standards.

After lengthy discussions, ARSC ultimately believes it does not matter whether compilations are an attest service. The statement that compilations are attest services has been removed from the SSARS.

Note: Depending on the needs of those in charge of governance, compilation engagements may be performed without full disclosures or may not include a statement of cash flows.

The following sections are in detail in this section of the program:

- Section Objective
- Scope
- Definitions
- Requirements of AR-C Section 80:
 - General Principles for Performing and Reporting on Compilation Engagements
 - Independence
 - Acceptance and Continuance of Client Relationships and Compilation Engagements
 - Agreement on Engagement Terms
 - The Accountant’s Knowledge and Understanding of the Reporting Entity’s Financial Reporting Framework
 - Compilation Procedures
 - The Accountant’s Compilation Report
 - The Accountant’s Compilation Report on Financial Statements Prepared in Accordance with a Special Purpose Framework
 - Reporting when the Accountant Is Not Independent
 - Reporting on Financial Statements That Omit Substantially all the Disclosures Required by the Applicable Financial Reporting Framework
 - Reporting Known Departures from the Applicable Financial Reporting Framework
 - Supplementary Information That Accompanies Financial Statements and the Accountant’s Compilation Report
 - Required Supplementary Information

Documentation in a Compilation Engagement

- Other Considerations Not Included in AR-C 80
- SSARS 22—Compilation of Pro Forma Financial Information
- Common Peer Review Issues—Compilations
- Potential Cause of Liability—Compilations

SECTION OBJECTIVE

The objective of the accountant in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with this section without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework.

SCOPE

Section 70 applies when the accountant is engaged to perform a compilation of financial statements, prospective financial information, pro forma financial information, or other historical financial information.

DEFINITIONS

Basic financial statements. Financial statements excluding supplementary information and required supplementary information.

Generally accepted accounting principles (GAAP). Reference to *generally accepted accounting principles* in SSARs means generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the “Compliance With Standards Rule” (ET sec. 1.310.001) and the “Accounting Principles Rule” (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

Management. The person(s) with executive responsibility for the conduct of the reporting entity’s operations. For some entities, management includes some or all of those charged with governance (e.g., executive members of a governance board or an owner-manager).

Misstatement. A difference between the amount, classification, presentation, or disclosure of a reported financial item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the accountant’s professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

Required supplementary information. Information that a designated accounting standards-setter requires to accompany the reporting entity’s basic financial statements. Required supplementary

information is not part of the basic financial statements; however, a designated accounting standards-setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

Supplementary information. Information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the financial statements subjected to the compilation engagement or separate from the financial statements subjected to the compilation engagement.

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

REQUIREMENTS OF AR-C SECTION 80

The requirements of AR-C Section 80 are listed in the following categories:

- General principles for performing and reporting on compilation engagements
- Independence
- Acceptance and continuance of client relationships
- Agreement on engagement terms
- The accountant's knowledge and understanding of the reporting entity's financial reporting framework (covered in Section 2, AR-C Section 60 – *General Principles for Engagements Performed in Accordance With SSARS*)
- Compilation procedures
- The accountant's compilation report
- The accountant's compilation report on financial statements prepared in accordance with a special purpose framework
- Reporting when the accountant is not independent
- Reporting on financial statements that omit substantially all the disclosures required by the applicable financial reporting framework
- Reporting known departures from the applicable financial reporting framework
- Supplementary information that accompanies financial statements and the accountant's compilation report

- Required supplementary information
- Documentation in a compilation engagement

General Principles for Performing and Reporting on Compilation Engagements

The accountant is required to comply with the provisions of AR-C Section 80, as well as the provisions of AR-C Section 60—*General Principles for Engagements Performed in Accordance with SSARS* (previously outlined in Unit 2). AR-C Section 60 requires:

- The accountant to comply with applicable ethical requirements;
- The accountant to exercise professional judgment;
- The accountant to apply applicable SSARS guidance;
- The engagement partner to possess requisite competence and capabilities; and
- The engagement partner to take responsibility for quality control matters.

Independence

AR-C Section 80 includes provisions related to the evaluation of independence. The accountant must determine whether the accountant is independent. If the accountant is not independent, a final paragraph must be added to the compilation report stating that the accountant is not independent. The nature and content of this paragraph will be discussed later.

When the accountant provides non-attest services, including the preparation, or assisting in the preparation of financial statements, such services may present threats to the accountant's independence. Pursuant to the Code of Professional Conduct, non-attest guidance (ET 1.295.040.01), these threats would have to be at an acceptable level for independence to not be impaired when safeguards are in place.

The determination of the accountant's independence should be documented.

Acceptance and Continuance of Client Relationships and Compilation Engagements

In addition to the requirements of AR-C Section 60 dealing with conditions for accepting an engagement, which identify the conditions that would preclude the accountant from accepting the compilation engagement, the accountant should obtain the agreement of management that it acknowledges and understands its responsibility:

- For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework including informative disclosures that are appropriate

based on the applicable financial reporting framework. If the applicable financial reporting framework is a special purpose framework, this includes:

- A description of the special purpose framework, including a statement in the accounting policy note indicating how the SPF differs from GAAP;
 - A description of any significant interpretations of any contracts that are used to prepare the SPF financial statements; and
 - Additional disclosures that may be necessary for the SPF to prevent the financial statements from being misleading.
- To include the accountant's compilation report in any document containing financial statements that indicates the reporting entity's accountant has performed a compilation engagement on such financial statements unless a different understanding is reached.

If the client will not agree to these responsibilities, the accountant should not accept the proposed engagement. As a reminder, there are other circumstances under which the accountant should not accept the proposed engagement. They are:

- If the accountant has reason to believe that relevant ethical requirements will not be satisfied;
- If the accountant determines the information needed to complete the engagement is likely to be unavailable or unreliable; or
- If the accountant has cause to doubt management's integrity such that it is likely to affect the performance of the engagement.

Agreement on Engagement Terms

In addition to the requirements of AR-C Section 60, 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 should be included in the agreement.

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 reporting 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; or
 - That the accountant will not express any assurance, opinion, or other conclusion on the financial statements.
 - a. The engagement cannot be relied on to discover errors, fraud, or illegal acts.
 - b. 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.
 - c. The accountant is not independent (if appropriate). (The effects, if any, should also be stated.)

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
- Adoption of GAAP alternatives permitted pursuant to Private Company Counsel company standards (see TIC.32, .33, and .34)

FIGURE 4.1: 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:

- a. Prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you; and*
- b. Apply accounting and financial reporting expertise to assist you in the presentation of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.*

We will conduct our 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 non-compliance 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:

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

- iii) *Unrestricted access to persons within the entity of whom we determine it necessary to make inquiries*

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 or a conclusion nor provide any assurance on them. Circumstances may arise in which it is necessary for us to modify our report or to withdraw from the engagement.

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

Other Relevant Information

Our fees for these services...

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

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

Sincerely yours,

[Signature of accountant or accountant's firm]

Acknowledged and agreed on behalf of Finnigan Company by:

[Signed]

[Name and title]

[Date]

Items to Note in the Engagement Letter

The issuance of SSARS 21 resulted in some nuances that many practitioners may not pay attention to and/or have caused additional confusion, such as the following:

1. The sample engagement letter included in the AICPA's guidance (see above) assumes the accountant will *prepare* the financial statements as a non-attest service. This approach creates problems when the accountant also expects to perform other non-attest services, such as bookkeeping or tax return preparation, because the engagement letter should cover all non-attest services expected to be performed, accompanied by wording that satisfies ET 1.295, *Non-attest Services*.

2. If all services are to be covered in one engagement letter, the standard wording will need to be revised accordingly. (Note that the accountant is never precluded from covering additional services in a separate engagement letter. For example, a separate letter may work best for tax preparation services, where copious wording for IRS Circular 230 is involved.)

The first paragraph of the sample engagement letter above includes “and the related notes to the financial statements.” This reference to the notes appears throughout SSARS in all sample engagement letters and reports based on the assumption footnotes are included. The engagement letter will need customization if disclosures will be omitted.

Additional customizations are required when, the CPA is not independent, supplemental information will be presented with the financial statements, or if material departures from GAAP (or the applicable financial reporting framework) are anticipated.

FIGURE 4.2: Sample Compilation Engagement Letter (Includes Bookkeeping Assistance)

To the appropriate representative of management of Finnigan Company:

We are pleased to confirm our understanding of the services we are to provide for Finnigan Company in the year ended December 31, 20XX.

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 will assist your bookkeeper in adjusting the books of accounts with the objective that he (or she) will be able to prepare a working trial balance from which financial statements can be prepared. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

Our Responsibilities

The objective of our engagement is to:

- I. Prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you; and*
- II. 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 non-compliance 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:

- I. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements*
- II. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America*
- III. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements*
- IV. The prevention and detection of fraud*
- V. To ensure that the entity complies with the laws and regulations applicable to its activities*
- VI. To make all financial records and related information available to us*
- VII. 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 bookkeeping services and the 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 or 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]

The Accountant's Knowledge and Understanding of the Reporting Entity's Financial Reporting Framework

The accountant should obtain an understanding of the applicable financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements.

Compilation Procedures

Accountants should **read** the financial statements and consider whether the financial statements appear to be appropriate in form and free from obvious material misstatements. The term *misstatement*, as used in SSARS, refers not only to math or clerical errors, but also includes obvious material errors in the preparation of the financial statements, including presentation and disclosure.

For example, the following would be considered obvious material errors:

- Elements of the financial statements that do not conform to the special purpose framework, such as deferred taxes on a tax basis financial statement or accounts receivable on a cash basis financial statement
- Titles that are inappropriate for the basis of accounting used (e.g., use of the term *balance sheet* without modification in a special purpose framework's financial statement)
- Mathematical mistakes in the preparation of financial statements
- Misclassification of current assets or current liabilities as long-term
- Not disclosing interest rates, terms, maturities, and the 5-year principal payments on loans
- Not disclosing significant concentration of credit risk
- Not properly classifying transactions as financing and operating in the statement of cash flows
- Undisclosed deficiencies or departures from the financial reporting framework
- Omission of any required disclosures for the specified reporting framework (such as method used for inventories in GAAP statements)

Note: Irrespective of the fact that a compilation is neither an assurance nor a verification service engagement, if the accountant becomes aware during the course of the engagement that the financial statements do not adequately refer to or describe the applicable financial reporting framework (including disclosures), revisions to the financial statements required for the financial statements to be in accordance with the applicable financial reporting framework (accounting principles), or the financial statements are otherwise misleading, then the accountant should propose the appropriate adjustments or revisions to management. If management does not make the appropriate revisions or provide requested information, the accountant would be unable to satisfactorily complete the compilation, and the accountant should withdraw from the engagement.

Further, while the accountant is not required to verify the accuracy or completeness of the information management provides, or otherwise gather evidence for the purpose of expressing an opinion or a conclusion, the accountant, for whatever reason, may perform certain procedures customarily performed in a review or audit (but not in a compilation). In such instances, the

engagement remains a compilation with no step up in level of service. However, in such circumstances, the accountant should consider the appropriateness of the compilation (and whether such services may constitute engagement creep) and whether a more appropriate service would be a review, an audit, or an agreed-upon procedures engagement.

Reading the Financial Statements

While reading the financial statements is the only required procedure in a compilation engagement, the accountant may have made inquiries, performed bookkeeping services, had knowledge from prior engagements, or performed other procedures in order to corroborate or review information supplied by the client. The results of these other procedures may suggest to the accountant that certain financial information supplied or developed by the client may be incorrect, incomplete, or misstated, or that fraud or illegal acts may have taken place. Once this information is known to the accountant, the accountant has the responsibility to inform the client and have the financial information adjusted or revised.

Reading the financial statements has other implications. For example, if the accountant is aware of evidence or information that subsequent events require adjustment or disclosure in the financial statements, the accountant should propose revisions to management.

Since the accountant has an ethical responsibility to not be associated with financial statements that the accountant knows to be misleading, the reading of the financial statements should be done in that context. For example, if in conjunction with providing tax services to several family members of the business entity's owner, the accountant becomes aware that there is another entity that provides a material amount of services to the reporting entity, and there is not a related party disclosure that appropriately (and sufficiently) addresses the required financial statement disclosure, the accountant should propose the appropriate revisions to management. Other examples might include knowledge of tax examinations, litigation, or possible regulatory or legislative violations. All knowledge about the client is assessed and applied in the reading of the financial statements.

TAKE NOTE

While the accountant is not required to make inquiries or perform other procedures that might verify, corroborate, or review financial information provided, the accountant may consider findings and/or understandings learned through other services provided, such as bookkeeping, payroll, or tax services, as well as the knowledge gained through or from prior engagements.

TAKE NOTE

In many cases, the smaller the client, the more difficult this step can be. For example, if the accountant offers payroll or other consulting services, errors related to those services will be more obvious than it would be for a client where these services were not rendered.

EXAMPLE

Jake Whiting, CPA, helped a client obtain a loan from a local bank. The loan document requires the company to maintain a 1.5 current ratio. The bank loan is presented as a long-term liability. Jake has now been engaged to compile a financial statement to be given to a leasing company. The financial statement shows a current ratio of 1.4. While the CPA has no requirement to perform analytical procedures, the

incorrect presentation of the bank loan should be obvious to a CPA knowledgeable about the debt covenant.

Consideration of Materiality

Consideration of materiality is made in the context of the applicable financial reporting framework. Generally, the considered terms include:

- Misstatements, including omissions, which are considered to be material if they, individually or in the aggregate, would reasonably be expected to influence the economic decisions of users taken on basis of the financial information;
- Judgments about materiality, which are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial information, which are based on a consideration of the common financial information needs of users as a group.

With regard to the users of the financial statements, practitioners can assume that users:

- Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the financial information with reasonable diligence;
- Understand that financial information is prepared and presented to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- Make reasonable economic decisions on the basis of the financial information.

CASE STUDY: JMT, INC.

This is a new compilation engagement for the firm; therefore, no prior year files exist. Assume you are assigned to the JMT engagement. The engagement partner has asked you to assist him/her by developing a series of questions that would address additional information needed to plan the JMT engagement. Further assume that all information requested will be provided by the client on a timely basis.

Using the JMT profile memo prepared by the partner and the compilation material in this section, you are to develop a list of questions that should be asked of client management to adequately plan this compilation.

In developing your list of questions to assist in planning this engagement, consider the potential for engagement risk and risk of error in the financial statements.

JMT, Inc., Client Profile Memo

Introduction

Its present owner and president, Jane Thompson, formed JMT, Inc., an S corporation, in X1. The company was organized to sell women's apparel and related accessories through outlets in large shopping malls. Thompson's operating philosophy is to sell traditional upscale clothing to professional women who can pay a premium price. By X3, her business has grown to three outlets in southern New Jersey shopping malls.

Due to increased sales and purchase volume and the expected need to obtain an increased working capital loan, JMT engaged your firm to prepare compiled financial statements and assist with the preparation of its tax returns.

Jane Thompson's Background

Jane Thompson is a college graduate with a degree in fashion merchandising. Since graduation, she has been employed by various retail businesses as a buyer or marketing representative. JMT is her first attempt at running her own business. Thompson is a 90% owner of JMT, and her brother owns 10%. Her brother partially financed JMT by loaning JMT \$500,000.

Company Background

JMT established its first store in X1 in Cherry Hill, New Jersey, under the name of Professional Women's Fashions. JMT has added one store in each of X2 and X3 in other South Jersey malls. Each store has approximately 1,500 square feet of space used for merchandise display, dressing rooms, storage, and a cashier's area.

Mall leases are for renewable three-year periods, with penalty clauses for early termination. Lease costs range from \$27 to \$29 a square foot, with additional charges for allocated maintenance charges. The company accepts most credit cards for payment, and approximately 60% of all sales are made with credit cards.

The lines of business are seasonal, requiring close attention to inventory levels and pricing strategies. Due to the nature of JMT's clothing lines, much of its inventory can be stored and offered for sale again in the future.

JMT maintains its company office in additional space leased in the Cherry Hill Mall. Located in this office are Jane Thompson and three full-time employees: an accountant, a buyer, and a secretary. In the future, Thompson hopes to franchise her store concept throughout the Northeast.

Organization

The company employs 16 full-time staff and 11 part-time salespeople. The employees are organized in this manner:

Office	Administrative	Manager	Assistant Manager	Full-Time Sales	Part-Time Sales
Central office	4	-	-	-	-
Cherry Hill	-	1	1	2	5
Deptford	-	1	1	2	4
Burlington	-	1	1	2	2
	<u>4</u>	<u>3</u>	<u>3</u>	<u>6</u>	<u>11</u>
Total employees	27				

Administrative employees, managers, and assistant managers are paid a fixed salary plus a performance bonus. Salespeople are paid minimum wage plus a commission of 3% to 5% of each sale made. JMT provides full health benefits, as well as paid vacations, to all full-time employees. Part-time employees are not entitled to benefits.

Products

JMT buys from four primary designers approximately 200 different apparel products ranging from dresses, suits, sweaters, jackets, skirts, and blouses, to accessories such as belts, pins, hats, scarves, et cetera. All products are marked up at least 100% and some specialty, one-of-a-kind items are marked up at least 200%.

JMT has a limited 10-day return policy for credit only. Exceptions are rare and must be approved by a store manager. JMT never advertises sales but occasionally will mark down a discontinued item. Markdowns have been limited to only 4% of unit sales since X1.

Purchasing

Jane Thompson and JMT's buyer, Marcia Wood, do all purchasing centrally. The purchasing function is critical to the success of JMT because of its professional customer base, premium prices, and product mix.

The annual volume of purchase and disbursement transactions is as follows:

■ Purchase orders	600
■ Invoices	1,500
■ Cash disbursements	1,200

Sales Volume

JMT breaks out sales by product, category, and location. Sales records indicate the following:

	X3		X2		X1	
Working apparel	\$1,175,000	65%	\$ 750,000	68%	\$400,000	67%
Casual apparel	500,000	28%	250,000	23%	150,000	25%
Accessories	125,000	7%	100,000	9%	50,000	8%
	<u>\$1,800,000</u>	<u>100%</u>	<u>\$1,100,000</u>	<u>100%</u>	<u>\$600,000</u>	<u>100%</u>
Cherry Hill	\$1,000,000		\$ 800,000		\$600,000	
Deptford	500,000		300,000		-	
Burlington	<u>300,000</u>		=		=	
	<u>\$1,800,000</u>		<u>\$1,100,000</u>		<u>\$600,000</u>	

Litigation

JMT is being sued by a primary designer for nonpayment on certain purchases made in X2. JMT alleges these items were of faulty design and refused delivery. The designer insists that JMT's purchase order was at fault and insists on payment. A trial date has not been scheduled, pending an industry arbitrator's decision on the dispute.

Financial Results

The following summarized financial information has been provided by Mary Scott, accountant:

	X3	X2	X1
<u>Sales</u>	\$1,800,000	\$1,100,000	\$ 600,000
Cost of sales	<u>765,000</u>	<u>500,000</u>	<u>325,000</u>
Gross profit	1,035,000	600,000	275,000
Operating expenses	<u>910,000</u>	<u>538,000</u>	<u>360,000</u>
Net income (loss)	<u>\$ 125,000</u>	<u>\$ 62,000</u>	<u>(\$ 85,000)</u>

<u>Assets</u>			
Cash	\$ 90,000	\$ 70,000	\$ 180,000
Accounts receivable	45,000	30,000	20,000
Inventory	437,000	327,000	195,000
Other	25,000	20,000	10,000
Furniture/fixtures (net)	130,000	75,000	40,000
Leasehold improvements	<u>380,000</u>	<u>280,000</u>	<u>200,000</u>
Total	<u>\$1,107,000</u>	<u>\$ 802,000</u>	<u>\$ 645,000</u>
<u>Liabilities</u>			
Accounts payable	\$ 210,000	\$ 100,000	\$ 60,000
Other accrued liabilities	20,000	25,000	20,000
Working capital loan	175,000	100,000	50,000
Long-term debt	500,000	500,000	500,000
Total	<u>\$ 905,000</u>	<u>\$ 725,000</u>	<u>\$ 630,000</u>
<u>Capital</u>			
Jane Thompson	\$ 90,000	\$ 90,000	\$ 90,000
Paul Thompson	10,000	10,000	10,000
Retained earnings (deficit)	<u>102,000</u>	<u>(23,000)</u>	<u>(85,000)</u>
Total	<u>\$ 202,000</u>	<u>\$ 77,000</u>	<u>\$ 15,000</u>
Total liabilities/capital	\$1,107,000	\$ 802,000	\$ 645,000

CASE STUDY: JMT, INC. – YOUR QUESTIONS

CASE STUDY: JMT, INC. – SUGGESTED QUESTIONS

The following is a partial list of questions that should be answered by the client or determined by the partner:

- Was the client's S Election filed properly and has the client maintained its S status?
- Has the client filed tax returns in a timely manner?
- What are the names of any external users of the financial statements?
- What are the names of the client's banker, attorney, insurance agent, etc.?
- Are we independent from the client?
- What are the expected engagement timing, fee arrangements, and client assistance?
- Does the client require full-disclosure GAAP financial statements?
- Is comparative financial information desired?
- Is any supplementary information desired?
- What is the client's basis of accounting?
- What are the operating cash flow amounts and trends?
- How are accounting transactions processed (i.e., manually, computer, or service bureau)?
- What are the stated qualifications of Mary Scott?
- Is there a need for us to provide any accounting services?
- Can the client make available industry statistics and other industry-specific information?
- What agreements or other legal documents are there (e.g., leases, buying commitments, debt agreements)?
- What are the debt covenant restrictions of both JMT's working capital loan and long-term debt?
- Do any related parties exist beyond Jane Thompson's brother?
- Do any personal guarantees exist either from Jane Thompson, her brother, or anyone else?
- How are commissions accrued at year-end?
- How is inventory determined at year-end?
- What is the nature of the litigation, and are there other claims, asserted or unasserted, that exist?

- What is the impact on JMT, Inc., if the designer's claim is found to be without merit? Would the designer refuse to continue supplying JMT with the product?

The significant risk areas appear to include the following:

- **Litigation** – Here, the firm must obtain more information to determine the proper accounting treatment (accrual or disclosure).
- **Inventory** – Inventory is the most significant asset. Since this is the fashion industry, obsolescence or write-downs are key concerns.
- **Leasehold improvements** – This is the second-largest asset reflected on the books. A determination must be made if all of the amounts are capitalized and if the useful lives are appropriate.
- **Related parties** – The financial statements must adequately disclose the terms of all related party transactions—specifically debt. Is this really long term?
- **Accounts payable** – Payables have doubled since last year and exceed “quick assets.”

THE ACCOUNTANT'S COMPILATIONS REPORT

This section will provide an overview and some examples of the standard and variations of compilation reports. Additional examples are illustrated later in the program.

The Accountant's Compilation Report—Overview

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 should:

- Include a statement that management (owners) is responsible for the financial statements;
- Identify the financial statements that have been compiled;
- Identify the reporting 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 or a conclusion, nor provide any assurance on the financial statements;
- Include the signature of the accountant or the accountant's firm (revised with SSARS 23);

- 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; and
- Include the date of the report, which should be the date that the accountant has completed the procedures required by AR-C Section 80.

TAKE NOTE

GAAP Subtopic 855-10-50-1 states that a reporting entity should disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued/available to be issued. Accordingly, because the accountant's compilation report should be dated as of completion of the compilation, the date of the accountant's compilation report should never be earlier than the date through which management has evaluated subsequent events.

FIGURE 4.3: Accountant's Compilation Report*

Management is responsible for the accompanying 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 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 (SSARS) 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 or 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:

- A report title (e.g., Independent Accountant's Compilation Report),
- An address/salutation, and
- Separate paragraphs.

TAKE NOTE

While SSARS no longer requires a reference to the accountant's report on all the pages of the financial statements, the author strongly suggests the accountant add to the engagement letter that management agrees to include such reference on the financial statements (such as See accountant's report or See accountant's compilation report) to minimize the possibility that the written report becomes unattached from the financial statements so that the user of the financial statements might infer an unintended level of reliance on the financial statements.

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

Unless the reporting entity elects to omit substantially all disclosures, the accountant should modify the compilation report when that accountant becomes aware that the financial statements do not include:

- A description of the special purpose framework,
- A summary of significant accounting policies,
- An adequate description about how the special purpose framework differs from GAAP, and
- Informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

In the case of financial statements prepared in accordance with the provisions of a **contract**, the accountant should consider whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based and modify the compilation report if the financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based.

In the case of an accountant's compilation report on special purpose financial statements, if management has a choice of financial reporting frameworks in the preparation of the special purpose financial statements, the explanation of management's responsibility for the financial statements should also refer to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

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

- Indicates that the financial statements are prepared in accordance with the applicable special purpose framework;
- Refers to the note to the financial statements that describes the framework, if applicable; and
- States that the special purpose framework is a basis of accounting other than GAAP.

For special purpose financial statements prepared in accordance with a **contractual basis** of accounting, the separate paragraph should also state that, as a result, the financial statements may not be suitable for another purpose.

Reporting When the Accountant Is Not Independent

When the accountant is not independent of the reporting entity, the accountant should indicate the accountant's lack of independence in a final paragraph of the accountant's compilation report. If the accountant elects to disclose a description about the reasons the accountant's independence is impaired, the accountant should include all such reasons in the description.

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

The accountant should not issue an accountant's compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework if, in the accountant's professional judgment, such financial statements would be misleading to users of the financial statements.

When reporting on financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should include a separate paragraph in the accountant's compilation report that includes the following:

- A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework
- A statement that if the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the reporting 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

Note: In a June 26, 2020, article in the Journal of Accountancy, *Handling Nondisclosure Compilations Amid the Pandemic*, the following is noted:

Pandemic-related issues related to cash flow, liquidity, subsequent events, and going concern create a danger that financial statements that omit disclosures about such issues may mislead users. And a practitioner is not permitted to issue a compilation report if, in the practitioner's professional judgment, the financial statements would be misleading to users of the financial statements.

The article goes on to state:

With many businesses struggling to remain solvent during the pandemic, the risk that financial statements that omit substantially all disclosures may be misleading is heightened. This creates a challenge for many practitioners engaged to perform a nondisclosure compilation, particularly around the issues of going concern and subsequent events.

Potential solutions noted in the article include selected coronavirus disclosures with a separate paragraph in the compilation report referencing these disclosures.

Reporting Known Departures from the Applicable Financial Reporting Framework

When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and the financial statements are not revised, the accountant should consider whether modification of the standard compilation report is adequate to disclose the departure.

If the accountant believes that the modification of the standard compilation report is adequate, the departure should be disclosed in a separate paragraph of the report. If the accountant believes that modification of the compilation report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should resign from the engagement and provide no further services with respect to the financial statements.

The accountant should not modify the compilation report to include a statement that the financial statements are not in conformity with the applicable financial reporting framework. In other words, an adverse conclusion is not permitted.

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

When supplementary information accompanies the financial statements, the accountant must indicate in the compilation report the degree of responsibility the accountant is taking, if any, by either:

- Including a separate paragraph in the accountant's compilation report on the financial statements or
- Including a separate report on the supplementary information.

Required Supplementary Information

When required supplementary information is included in the reporting entity's financial statements, the accountant should include a separate paragraph in the accountant's compilation report on the financial statements. This other-matter paragraph should include the following circumstances, when applicable:

- The required supplementary information is included, and the accountant performed a compilation engagement on the required supplementary information.
- The required supplementary information is included, and the accountant did not perform a compilation, review, or audit on the required supplementary information.
- The required supplementary information is omitted.
- Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines.
- The accountant has identified departures from the prescribed guidelines.
- The accountant has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

Documentation in a Compilation Engagement

The accountant should prepare documentation in connection with each compilation engagement in sufficient detail to provide a clear understanding of the work performed.

The quantity and type of documentation the accountant includes in a compilation file is a matter of professional judgment and depends on the engagement circumstances, methodology, and tools used. The documentation should contain enough detail to demonstrate that the accountant has complied with professional standards.

At a minimum, the accountant's documentation should include the following:

- An engagement letter
- A copy of the financial statements
- A copy of the accountant's report

In addition to these requirements, Kaplan suggests the following additional documentation be included to demonstrate that the engagement was properly planned and supervised as required by ethics requirements:

- Memo demonstrating that the accountant has knowledge of the client's business and industry (permanent file carryforward schedule updated annually, if used)
- A trial balance that helps bridge the general ledger to the financial statements
- Indication that the financial statements have been read and are free from obvious material error
- A work program, if required by firm policy
- A disclosure checklist, if required by firm policy
- Any significant findings and issues and how the accountant addressed them
- Any communications with management or those charged with governance regarding fraud or illegal acts
- Summarization of communication with predecessor accountant (if applicable)
- Any consultation performed (consultation would include discussion with firm personnel, technical research, et cetera)

Many practitioners perform bookkeeping services prior to or concurrent with the performance of compilation services. Practitioners have questioned how the performance of these bookkeeping services impacts the procedures they perform when performing compilations in accordance with AR-C Section 80 requirements.

The AICPA's *Guide: Preparation, Compilation, and Review Engagements* makes it clear that the performance of non-attest services (e.g., bookkeeping, taxes) should impact the nature, timing, and extent of engagement procedures performed. The accountant's knowledge that the client's support information is reliable based on the performance of non-attest services allows the accountant to perform a more efficient compilation or review engagement.

TAKE NOTE

Practitioners should take care that documentation associated with compilation engagements not be included with documentation associated with the performance of bookkeeping, accounting services, tax services, or internal control engagements. These are separate services, and documentation associated with these levels of services, such as depreciation analysis, bank reconciliations, tax analysis, trial balances, et cetera, should be included in separate documentation reflecting the nature of the services provided.

OTHER CONSIDERATIONS NOT INLCUDED IN AR-C 80

Changes in Engagement from Audit or Review to a Compilation Engagement

TAKE NOTE

This guidance is adapted from AR-C 90, where the context is changing from an audit to a review engagement. Its applicability to changing to a compilation engagement is the author's interpretation.

An accountant engaged to audit financial statements in accordance with generally accepted auditing standards or to review financial statements in accordance with SSARS who receives a request to change the engagement to a compilation before the completion of the audit to review must consider the circumstance resulting in the change request. The accountant should consider the circumstances affecting the reporting entity's requirements; misunderstandings about the nature of an audit, review, or compilation; or scope restrictions placed upon the engagement before commencing with a step-down. The accountant should consider:

- The reason given for the client's request, particularly the implications of a restriction on the scope of the audit or review, whether imposed by the client or by the circumstance;
- The additional audit or review effort required to complete the audit or review; and
- The estimated additional cost to complete the audit or review.

When the accountant has been engaged to audit an entity's financial statements and has been prohibited by the client from corresponding with the entity's legal counsel, the accountant would ordinarily be precluded from issuing a compilation report. Further, if in performing an audit or a review engagement a client does not provide the accountant with a signed representation letter, the accountant would ordinarily be precluded from issuing a compilation report on the financial statements.

In all circumstances, if the audit or review procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant would consider the appropriateness of accepting the change in the engagement.

If the accountant concludes, based upon his professional judgment, that reasonable justification exists to change the engagement, and if he complies with the standards applicable to a compilation

engagement, he should issue the appropriate compilation report without reference to the original engagement, the procedures that were performed or completed, or any scope limitations.

Communications Between Predecessor and Successor Accountants

SSARS 21 eliminated guidance on communications between predecessor and successor accountants (prior AR Section 400).

Unlike the audit literature, SSARS does not require that the successor accountant contact the predecessor accountant. Although not required, it is considered to be a best practice for the successor to inquire of the predecessor.

Matters uncovered in the compilation might strongly influence the successor to choose to contact the predecessor. The successor, in this scenario, should request that the client authorize the successor to make inquiries and for the predecessor to respond to those inquiries.

Some inquiries in connection with acceptance of the engagement might include:

- The integrity of the client;
- Disagreements with the client regarding accounting principles or the performance of procedures considered necessary by the accountant;
- How cooperative the client was;
- If the predecessor has any knowledge of fraud or illegal acts; and
- The reasons for the resignation or termination.

Generally, the Code of Conduct suggests that the predecessor respond fully and completely to the previously listed inquiries (if authorized and permitted). If, because of pending litigation or other such issues, the predecessor indicates that the response is limited, the successor should find out why and consider whether to accept the engagement. Also, if the client refuses to allow the predecessor to respond, the accountant should find out the reason and consider whether to accept the engagement.

Another issue is access to documentation. As with the inquiries, the successor should ask the client to let the predecessor provide access.

Note: The predecessor may deny access to documentation for valid reasons, such as nonpayment of fees, and the predecessor is not required to make documentation available to multiple accountants. Therefore, if more than one accountant is bidding on the job, requests of the predecessor should not be made until the successor is selected.

The following is a checklist that can be used to document the inquiries with the predecessor:

1. What was your relationship with the client? Were there any issues that would lead you to believe that we (I) cannot rely on answers or information supplied by the client?
2. Were there any disagreements with the client? If so, how were they resolved?
3. Was the client cooperative?

4. Were there any past-due fees?
5. Were there any issues with the records supplied by the client?
6. What, if any, non-attest services were required?
7. Were you required to spend extensive amounts of time on any particular area?
8. Will you permit us (me) to review documentation? _____ If yes:
 - When can we (I) review them?
 - Where can we (I) review them?
9. Are you aware of any fraud or illegal acts that have taken place at the client?

SSARS 22—COMPILATION OF PRO FORMA INFORMATION (SEE AR-C SECTION 120)

Pro forma financial information is a presentation that shows what the significant effects on historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date.

While SSARS 21 did not change the guidance for the compilation of pro forma information, SSARS 22 issued in September 2016 clarified compilations of pro forma financial information and clarified AR-C Section 120, effective for all reports issued on or after May 1, 2017.

The objective of the accountant in a compilation of pro forma financial information is to apply accounting and financial reporting expertise to assist management in the presentation of pro forma financial information and report in accordance with standards set in SSARS, and without undertaking to obtain or provide any assurance on the pro forma financial information.

The responsibilities of the accountant, when performing a compilation of pro forma financial statements, are no different than a compilation of a full set of financial statements, but the required procedures are more extensive. The accountant is limited to assisting management (owners) in presenting financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to that information. Pro forma financial information is created on the basis of assumed facts or circumstances and transactions that have not occurred and may never occur. Presentations of pro forma information are not financial statements.

Pro forma presentations are used to show the effects of assumed transactions such as:

- Proposed business combination,
- Proposed transaction,
- Change in the form of the business entity, and
- Change in product mix.

AR-C Section 120 states that a pro forma presentation should:

- Be labeled as *pro forma*;
- Describe the assumed or proposed transaction;
- Include the source of the historical information;
- Include significant assumptions (Note: An accountant cannot issue a pro forma report if the summary of significant assumptions is missing);
- Include any significant uncertainties about the assumptions;
- Indicate that the pro forma information should be read with the historical information; and
- Include a caveat that pro forma is not indicative of actual results.

AR-C Section 120 only applies to compilations when the accountant has been engaged to report. If the accountant is engaged to compile the pro forma financial information, the financial information must contain or incorporate, by reference, the historical financial information for the applicable period and the compilation, review, or audit report covering the historical information. In the case of a business combination, the information must include all significant parts of the combined entity.

AR-C Section 120 also states that an accountant must establish an understanding with the client that must be signed by both parties and must comply with the performance requirements in SSARS.

The accountant should also refer to AR-C Section 60 and AR-C Section 80 in performing a pro forma compilation engagement. Accordingly, the engagement requires the accountant to:

- Determine whether the accountant is independent;
- Apply acceptance and continuance procedures;
- Document the agreement of engagement terms;
- Obtain an understanding of the underlying transaction or event;
- Assess her knowledge and understanding of the applicable financial reporting framework;
- Apply compilation procedures;
- Issue her compilation report with appropriate disclosures and references; and
- Meet documentation requirements.

FIGURE 4.4: Sample Compilation Engagement Letter (Compilation of Pro Forma Information)

To the appropriate representative of management of Macklain, Inc.:

You have requested that we prepare the pro forma financial information of Macklain, Inc. (the company) and perform a compilation engagement with respect to that pro forma financial information. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

Pro forma financial information is a presentation that shows what the significant effects on historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date.

Our Responsibilities

The objective of our engagement is to:

- I. Prepare the pro forma financial information with accounting principles generally accepted in the United States of America; and*
- II. Perform a compilation engagement on the pro forma financial information we prepared in which we will apply accounting and financial reporting expertise to assist you in the presentation of the pro forma financial information and report without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the pro forma financial information in order for it 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 American Institute of Certified Public Accountants (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 provide any assurance on the pro forma financial information.

Our engagement cannot be relied upon to identify or disclose any pro forma financial information misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the company or non-compliance with laws and regulations.

Management Responsibilities

The engagement to be performed is conducted on the basis that management acknowledges and understands that our role is to prepare the pro forma financial information in accordance with accounting principles generally accepted in the United States of America and perform a compilation engagement on the pro forma financial information we prepared. Management has the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARS:

- I. For the preparation and fair presentation of the pro forma financial information in accordance with accounting principles generally accepted in the United States of America and for the selection of accounting principles generally accepted in the United States of America as the applicable financial reporting framework*

- II. *To include the following in any document that contains the pro forma financial information:*
 - a. *The complete financial statements of the entity for the most recent year (or for the preceding year, if financial statements for the most recent year are not yet available or such financial statements are readily available)*
 - b. *If pro forma financial information is presented for an interim period, either historical interim financial information for that period (which may be in condensed form) or that such interim information is readily available*
 - c. *In the case of a business combination, the relevant historical financial information for the significant constituent parts of the combined entity*
- III. *To ensure that the financial statements of the entity (or, in the case of a business combination, of each significant constituent part of the combined entity) on which the pro forma financial information is based have been subjected to a compilation, review, or an audit engagement*
- IV. *To include the accountant's compilation or review report or the auditor's report on the financial statements (or make readily available) in any document containing the pro forma financial information*
- V. *To present a summary of significant assumptions with the pro forma financial information*
- VI. *To obtain the accountant's permission prior to including the accountant's compilation report in any document containing the pro forma financial information that indicates that the entity's accountant has performed a compilation engagement on such pro forma financial information*
- VII. *To prevent and detect fraud*
- VIII. *To ensure that the company complies with the laws and regulations applicable to its activities*
- IX. *To ensure the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement*
- X. *To provide us with the following:*
 - a. *Assumptions that provide a reasonable basis for presenting the significant effects directly attributable to the underlying transaction (or event)*
 - b. *Documentation and other related information that is relevant to the preparation and presentation of the pro forma financial information*
 - c. *Additional information that may be requested for the purpose of the preparation of the pro forma financial information*
 - d. *Unrestricted access to persons within the company of whom we determine necessary to communicate*

You are also responsible for all management decisions and responsibilities and for designating an individual with suitable skills, knowledge, and expertise to oversee our preparation of your pro forma financial information. 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 examine or review the pro forma financial information and that, accordingly, we do not express an opinion nor provide any assurance on it. There may be circumstances in which the report differs from the expected form and content.

We have no responsibility to update our report for events and circumstances occurring after the date of such report.

If management intends to reproduce and publish the pro forma financial information and our report thereon, they must be reproduced in their entirety, and both the first and subsequent corrected drafts of the document containing the pro forma financial information and any accompanying material must be submitted to us for approval.

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 pro forma financial information described herein and to perform a compilation engagement with respect to that same pro forma financial information, and our respective responsibilities.

Sincerely yours,

[Signature of accountant or accountant's firm]

Acknowledged and agreed on behalf of ABC Company by:

[Signed]

[Name and title]

[Date]

FIGURE 4.5: Accountant's Compilation Report on Pro Forma Financial Information

Management is responsible for the accompanying pro forma condensed balance sheet of XYZ Company as of December 31, 20X1, and the related pro forma condensed statement of income for the year then ended (pro forma financial information), based on the criteria in Note 1. The historical condensed financial statements are derived from the financial statements of XYZ Company, on which I (we) performed a compilation engagement, and of ABC Company, on which other accountants performed a compilation engagement. The pro forma adjustments are based on management's assumptions described in Note 1. I (we) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not examine or review the pro forma financial information nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on the pro forma financial information.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the underlying transaction (or event) occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the abovementioned transaction (or event) actually occurred at such earlier date.

[Additional paragraph(s) may be added to emphasize certain matters relating to the compilation engagement or the subject matter.]

(Signature of accounting firm or accountant, as appropriate)

(Accountant's city and state)

(Date of the accountant's report)

COMMON PEER REVIEW ISSUES—COMPILATIONS

The AICPA's Peer Review Committee periodically publishes a peer review report that includes examples of matters noted in peer reviews. In addition, the AICPA's annual National Advanced Accounting and Auditing Technical Symposium Conference includes a concurrent session on inspection findings and peer review results. Both of these initiatives are designed to alert practitioners as to the frequent and recurring peer review deficiency issues associated with the performance of audit, review, and compilation engagements.

Peer Review is in an enhanced oversight mode so as to increase the probability that peer reviewers are identifying all material issues in must-select engagements, including whether engagements are properly identified as non-conforming. Peer review issues pertaining to SSARS engagements generally spike an increase following substantive issuance of new standards, as occurred following the issuance of SSARS 19 and now with SSARS 21–25.

The following list identifies the most frequent compilation peer review matters identified in recent peer reviews, followed by a longer list of compilation peer review deficiencies also identified by the Peer Review Committee.

Peer Review Matters

- **Engagement letters** – Engagement letters are required in all compilation engagements. SSARS 21 requires that engagement letters be signed. These engagement letters are required to include statements related to the objectives of the compilation engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. Peer review has identified the following items lacking in engagement letters:
 - Language that indicates the engagement cannot be relied upon to disclose errors, fraud, or illegal acts
 - Language that indicates the accountant will inform management or those in charge of governance of any material errors or any evidence of fraud or illegal acts that comes to the accountant's attention
- **Basic elements of a compilation report** – Peer reviewers see many instances when the compilation report does not follow the basic report elements, as required by SSARS 21.
 - Use the new SSARS 21 compilation paragraph
 - Inclusion of EM and OM paragraphs, particularly compilations in accordance with a special purpose framework

- Use of impaired independence paragraph
- If a non-disclosure compilation, a statement limiting the usefulness of the financial statements
- **Compilation performance requirements** – Certain financial statement matters that are incorrect continue to be found by peer reviewers. These could have been avoided if a thorough workpaper review was performed as part of the engagement. Matters frequently identified by peer reviewers that should not continue to occur include:
 - Incorrect headings (GAAP headings) when a special purpose framework is used by the entity;
 - Incorrect or non-existent captions in a classified balance sheet or classified statement of assets, liabilities, and stockholders' equity—income tax basis;
 - Math or presentation clerical errors;
 - Incorrect periods identified as being compiled;
 - Incorrect accounting principles applied for the basis of accounting used; and
 - Inadequate or non-existent disclosures for full disclosure financial statements.

PEER REVIEW DEFICIENCIES—COMPILATIONS

Reporting

- Compilation reports that did not disclose that management had elected to eliminate substantially all disclosures or omitted supplemental information, as applicable in the circumstances
- Incorrect report dating (This would include reports without appropriate reference to all time periods covered by the financial statements.)
- Failure to disclose the lack of independence in a compilation report
- Inappropriate references to GAAP in the accountant's report on special purpose frameworks financial statements
- Not modifying the report for a departure from the basis of accounting used for the financial statements
- Failure to report on supplementary information
- Preparation of compiled financial statements prepared by a special purpose framework, and that basis is not disclosed in either the accountant's report or the financial statements
- Failure of the accountant's report to indicate the periods covered by the financial statements and not being able to determine them from reading the financial statements

- Failure to identify and/or reference that the financial statements were compiled on a prescribed form
- Failure to properly identify the financial reporting framework in a compilation on a prescribed form
- Failure to report departures from the applicable financial reporting framework
- Omitted or inappropriate titles and headings
- Failure to appropriately label select disclosures as “Selected Information – Substantially All Disclosures Required by [Appropriate Financial reporting Framework] Are Not Included”

Measurement

- Not presenting and disclosing revenues and expenses in accordance with the appropriate financial reporting framework
- Special purpose framework statements containing inconsistencies between the report and the financial statements where the actual basis is not readily determinable
- Failure to disclose the fair value of investments by levels 1, 2, or 3 as required, including quoted prices in active markets for identical assets or liabilities (level 1), significant other observable inputs (level 2), or significant unobservable inputs (level 3)
- Not including amounts necessary to conform to the basis of accounting used. Improper revenue recognition.
- Failure to provide an allowance for doubtful accounts when it is probable that a material amount of accounts receivable is uncollectible

Presentation and Disclosure

- Situations where supplementary information is not clearly segregated or marked as such
- Situations where supplementary information departs from the standard report presentation
- Not disclosing the company’s revenue recognition policy as required by professional standards
- Improperly classifying items in the statement of cash flows
- Inadequate or missing disclosures relating to account balances or transactions—for example, disclosure deficiencies in accounting policies, inventory, valuation allowances, long-term debt, related party transactions, and concentrations of credit risk
- Bank overdrafts being included in cash and cash equivalents where there is no right of set off with positive balances
- Failure to include disclosures of uncertain tax positions for all open years

- Failure to disclose the combined aggregate amounts of maturities and sinking fund requirements for all long-term borrowing for five years
- Missing disclosure when the item was included in a disclosure checklist used in preparing the financial statements
- Accountant's report uses different financial statement titles than those included on computer-generated financial statements
- Failure to say "See accountant's report" on each page of the financial statements
- Failure to state that management has elected to eliminate substantially all disclosures in a compilation without disclosures
- Misclassification of transactions or balances—for example, recording a loan secured by accounts receivable as a sale when the sales criteria were not met
- Omission of significant required disclosures
- Not including or disclosing the omission of the statement of cash flows in GAAP financial statements
- Significant departures from the financial statement formats prescribed by industry accounting and audit guides
- Omission of significant accounting policies disclosures required by either GAAP or a special purpose framework
- Omission of significant matters related to the understanding of the financial statements. The peer review report indicated that this was the cumulative effect of a number of deficiencies.
- Failure to provide disclosures for risks and uncertainties, including use of estimates, nature of operations, certain significant estimates, and vulnerabilities due to concentrations
- Not including a summary of significant assumptions in a financial forecast or projection in accordance with attestation standards
- Not disclosing the cumulative effect of a change in accounting principle when required
- A statement of income and retained earnings not being included when it is referred to in the report
- Not disclosing significant related party transactions
- Failure to adequately identify and disclose cash flow items as operating, investing, and/or financing activities
- Omission of the actual financial statements that are referred to in the report

SSARS Procedures and Documentation

- Failure to meet the documentation of professional standards that may be applicable to the engagement, in all material respects
- Failure to document (and obtain representations for) subsequent events considered for reflection in the financial statements
- Not segregating the current portion of long-term debt
- Financial statements that did not make reference to the compilation report
- Failure to establish an understanding with management regarding the services to be performed through a written communication (engagement letter)
- Failure to document that the accountant read the financial statements and considered whether such financial statements appeared to be appropriate in form and free from obvious material errors
- Missing or lacking required signatures
- Missing required wording stating the engagement could not be relied upon to disclose errors, fraud, or illegal acts
- Missing required wording stating the accountant would inform the appropriate levels of management if any matters came to their attention, unless clearly inconsequential
- Failure to note the lack of independence in the engagement letter
- Failure to identify non-attest services provided in engagement letter
- Failure to obtain required signatures on engagement letter

POTENTIAL CAUSES FOR LIABILITY—COMPILATIONS

The purpose of issuing a compilation report is always to limit the accountant's exposure to third parties by defining the limits of the accountant's responsibilities in a report that accompanied the financial statements. The compilation report makes it clear that the financial statements are the responsibility of management. The accountant's responsibility is to assist management in presenting financial statements without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements. However, there are certain implied representations made by the accountant.

- Unless stated otherwise, the accountant is independent.
- The financial statements conform to the applicable financial reporting framework.
- The accountant is knowledgeable about the financial reporting framework being reported upon.

Although the compilation report language clearly defines what the accountant is not doing, as opposed what they are doing—that is, reading the financial statements to see that they are free from obvious material misstatement—accountants should be aware of the following:

1. The performance of bookkeeping, tax, consulting, or other non-attest services may make the accountant aware of potential errors in the financial statement presentation. An accountant can never be associated with a set of financial statements that he believes materially depart from the financial reporting framework or intentionally mislead the users of the financial statements.
2. In assisting in preparing the financial statements, the accountant should be familiar with the financial reporting framework being reported on. If the statements purport to be prepared on the basis of GAAP, for example, the accountant must be familiar with GAAP to recognize obvious errors. Thus, if an accountant is not totally conversant with GAAP, she can be held liable for being associated with a financial statement that states that it was prepared in accordance with GAAP when, in fact, it is not.
3. If the financial statements are full disclosure, the accountant should be aware of the required disclosures relating to the financial reporting framework being reported on. In most cases, the accountant includes a disclosure checklist in the compilation file. If disclosures are inadequate, the accountant may be liable because the accountant again is associated with financial statements that state that it was prepared in accordance with the applicable financial reporting framework when, in fact, it is not.
4. The accountant is not independent but does not indicate the lack of independence in the report. The accountant often argues that the event that caused the lack of independence has no bearing on the adequacy of the financial statements. However, the plaintiff's argument is likely to be that the report would not have been accepted by the user if the lack of independence was indicated. Therefore, another accountant would have been required to compile the financial statements and whatever the problem was would have been detected or disclosed.
5. The accountant fails to discover a theft or embezzlement. Although it seems almost impossible that the failure to detect a fraud or embezzlement could create liability in a compilation, it is perhaps the single largest cause of complaints against CPAs. CNA, one of the nation's largest providers of malpractice insurance to accountants, recently stated fraud claims are being made alleging the following:
 - Accountants do not inform management when they see things that might indicate embezzlement—for example, receipts not posted promptly, unreconciled items on the bank reconciliation, high credit card charges, and numerous payments to new vendors.
 - Accountants did not catch fraud when they should have since they check or prepare the bank reconciliation. Here the client expects the accountant to examine signatures and names of payees on checks and compare them to the cash disbursements records and signatures. However, the accountant does not do this.
 - Accountants did not inform management of internal control weaknesses on a timely basis. If they had, the client would have corrected them and subsequently prevented the fraud.
 - Accountants should have been aware of internal control weaknesses and possible fraud because of the frequent and continuous relationship with the client and its employees.

CASE STUDY: FLEMING PRODUCTS, INC.

As a new staff assistant, you are assigned to the Fleming Products, Inc., compilation engagement. The previous assistant to this client had an auto accident and will be unavailable for several weeks. It appears that the assistant had completed most of the work.

The engagement partner has requested that you review the work completed and advise her of the status and the projected delivery date of the completed financial statements. She also informs you that the client needs to meet with their banker within the next week to renew the company's line of credit. The partner further explains that you are to review the work completed, the workpapers, and the draft of the financial statements left by the assistant to determine if they are complete and sufficient for the firm to be able to issue the financial statements.

Since time is important and the partner will be out of town, she would like a projected date for her final review and a draft available for the client's review and approval. She has given the following detailed instructions to assist you in reviewing all of the workpapers and the draft of the financial statements.

Questions for Case Study

Review the following compilation workpapers:

1. Read the engagement letter.
 - Why is it important to read the engagement letter?
 - What specific elements of an engagement can be determined from the engagement letter?
2. Review the planning memo. What information can be obtained from the planning memo?
3. Review the work program. Note that many of the procedures were performed before year-end. Is this acceptable?
 - What procedures were used most often?
 - Would the working trial balance need to be available when the procedures were done?
4. Review the trial balance.
 - Agree that the numbers from the working trial balance to the balance sheet and income statement for the current year.
 - Determine if accounts were combined the same for both years on the financial statements.
5. Review the financial statements. Identify and list any obvious or material errors.
6. Determine if the workpapers will meet documentation requirements; if not, develop a list of needed workpapers.

7. Review the conclusion.

- Based on the information developed in this example, do you agree with the conclusion?
- List reasons of agreement or disagreement.

T-11 1/3 ST Engagement Letter 12/1/X4

To the appropriate representative of management of Fleming Products, Inc.:

You have requested that we prepare the financial statements of Fleming Products, Inc.—which comprise the balance sheets as of December 31, 20X4 and 20X3, 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 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 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 reporting entity or non-compliance 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
- To ensure that the reporting 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 or 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 Fleming Products, Inc., by:

[Signed] [Name and title]

[Date]

T-19 S Planning Memo 12/1/X4

Fleming Products, Inc., is a recurring client and we perform extensive accounting services, as well as prepare federal and state tax returns. In prior years, accounting errors after the performance of our accounting services have been minimal, and we believe this will continue to be the case this year. The principal users of these financial statements are management and a passive owner, Shawn Fleming.

Obvious material errors, which we will be searching for when we read Fleming's financial statements, will include the following:

- Use of appropriate financial statement titles and classifications consistent with prior periods
- Footing and cross-footing of all financial information
- Existence of any typos or grammatical errors
- Misclassification of long-term debt based on compliance with debt covenants
- Existence of any related party transactions requiring separate asset or liability classification
- Existence of inconsistent financial statement relationships that may imply unrecorded amounts or incorrect postings
- Existence of relationships that vary significantly from industry norms
- Any other information that may have come to our attention as a result of providing accounting services or the preparation of tax returns

T-7 1/3 ST Compilation Work Program 3/31/20X5

Name of Client: Fleming Products, Inc.

Client Number: 467A Fiscal year-end: December 31, 20X4

A compilation of financial statements is defined as a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

Prepared by:

Name ST

Date 3/31/20X5

Reviewed by:

Name JE

Date 4-1-20X5

Conclusion (by in-charge staff accountant):

I believe the financial statements are appropriate in form and free from obvious error.

Name ST

Date 3/31/20X5

T-7 2/3		3/31/20X5
ST		
	Initials	Date
A. General Procedures		
Obtain knowledge of the client's industry, accounting principles, and practices (AR 2)	ST	10/31/X4
Obtain an understanding of the client's business, accounting records and personnel, basis of accounting, and financial statements (AR 2)	ST	10/31/X4
B. Planning Procedures		
Obtain an understanding of services to be performed (AR 2) Prepare engagement letter	ST	12/1/X4
Review the following items included in prior period workpapers:		12/1/X4
Engagement letter	ST	12/1/X4
Work program	ST	12/1/X4
Engagement workpapers	ST	12/1/X4
Financial statements and report	ST	12/1/X4
Permanent file	BL	12/1/X4
Discuss with client any significant changes in operations and fluctuations	ST	12/1/X4
Update permanent file with current data on industry and client's business	ST	12/1/X4
Discuss with partner the nature, timing, and scope of the services to be performed and materiality guidelines	ST	12/1/X4
Modify work program, as appropriate	ST	12/1/X4
Prepare a memorandum documenting any special engagement problems or changes, as required	ST	12/1/X4
Perform bookkeeping services (if any)	ST	1/10/X4
C. Completion Procedures		
Prepare or read the financial statements (AR 2)		
Determine if the appropriate financial statement titles are used, per the basis of accounting	ST	3/31/X5

T-7 2/3 ST		3/31/20X5
	Initials	Date
Consider the client's business and industry, and determine if the presentation and format are appropriate and consistent	ST	3/31/X5
Determine if classifications are correct and consistent with prior years	ST	3/31/X5
Compare account balances from period to period and identify significant differences	ST	3/31/X5
Compare account balance trends and relationships from period to period and identify unexpected results	ST	3/31/X5
Foot and cross-foot all numerical information	ST	3/31/X5
Determine if typos or grammatical errors exist	ST	3/31/X5
Read all footnotes for appropriateness and consistency	ST	3/31/X5
Determine if any supplemental information exists. If so, is it consistent with basic financial statement data?	ST	3/31/X5
Prepare the appropriate report (AR 2)	ST	3/31/X5

Fleming Products, Inc. Trial Balance December 31, 20X4 and 20X3				T-3 ST 3/18/20X5
	Z	X	Y	Y
	20X4		20X3	
Cash	197,786		247,711	
Accounts receivable	162,805		145,971	
Allowance for doubtful accounts		3,000		3,000
Inventory	436,917		379,108	
Prepaid items	12,000		10,000	
Land	125,000		125,000	
Building	895,000		845,000	
Accumulated depreciation		360,334		327,906
Equipment	878,000		654,000	
Accumulated depreciation		456,000		414,000
Furniture and fixtures	118,000		116,000	
Accumulated depreciation		54,000		46,000
Goodwill	421,694		417,645	
Accounts payable		137,890		127,572
Accrued liabilities		226,267		170,179
Long-term debt		282,933		273,442
Deferred income taxes		171,999		154,457
Common stock		40,000		40,000
Additional paid in capital		60,000		60,000
Retained earnings		1,323,879		1,270,463
Dividends	88,628		126,926	
Sales		3,099,165		2,815,609
Sales returns	200,000		100,000	
Cost of sales	1,694,404		1,588,360	

Fleming Products, Inc. Trial Balance December 31, 20X4 and 20X3				T-3 ST 3/18/20X5
	Z	X	Y	Y
	20X4		20X3	
Sales salaries	125,000		110,000	
Salaries officers	300,000		300,000	
Salaries administrative	89,459		86,668	
Employee benefits	55,000		50,000	
Advertising expense	122,000		118,000	
Utility expense	43,000		41,000	
Miscellaneous	25,000		24,000	
Interest expense	26,845		24,603	
Taxes expense	143,929		145,636	
Shipping expense	55,000		47,000	
Total	6,215,467	6,215,467	5,702,628	5,702,628
Z = agreed to 20X3 workpapers Y = agreed to 20X4 general ledger				

T-1 1/3 Compilation Report

File Copy
JF

4/1/X5

Fleming Products, Inc.
402 River Road
River, NJ 55443

Management is responsible for the accompanying financial statements of Fleming Products, Inc.—which comprise the balance sheets as of December 31, 20X4 and 20X5, 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 (SSARS) 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 or a conclusion, nor do we provide any form of assurance on these financial statements.

Management has elected to omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, 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]

T-1 2/3 File Copy JF	4/1/X5	
	Fleming Products, Inc. Balance Sheet December 31, 20X4 and 20X3	
	Z	Y
	20X4	20X3
Assets		
Cash	\$ 197,786	\$ 247,711
Accounts receivable	162,805	145,971
Allowance for doubtful accounts	(3,000)	(3,000)
Inventory	436,917	379,108
Prepaid items	<u>12,000</u>	<u>10,000</u>
Current assets	<u>\$ 806,508</u>	<u>\$ 779,790</u>
Land	\$ 125,000	\$ 125,000
Building	895,000	845,000
Accumulated depreciation	(360,334)	(327,906)
Equipment	878,000	654,000
Accumulated depreciation	(456,000)	(414,000)
Furniture and fixtures	118,000	116,000
Accumulated depreciation	(54,000)	(46,000)
Property, plant, and equipment	\$1,145,666	\$ 952,094
Goodwill	<u>421,694</u>	<u>417,645</u>
Total assets	<u>\$2,373,868</u>	<u>\$2,149,529</u>
	✓	✓
Liabilities And Equity		
Accounts payable	\$ 137,890	\$ 127,572
Accrued liabilities	226,267	170,179
Current liabilities	\$ 364,157	\$ 297,751
Long-term debt	282,933	273,442
Deferred income taxes	<u>171,999</u>	<u>154,457</u>
<u>Total liabilities</u>	<u>\$ 819,089</u>	<u>\$ 725,650</u>

T-1 2/3 File Copy JF	4/1/X5	
	Fleming Products, Inc. Balance Sheet December 31, 20X4 and 20X3	
	Z	Y
	20X4	20X3
Common stock	\$ 40,000	\$ 40,000
Additional paid in capital	60,000	60,000
Retained earnings	<u>1,454,779</u>	<u>1,323,879</u>
Stockholders' equity	<u>\$1,554,779</u>	<u>\$1,423,879</u>
Total liabilities and stockholders' equity	<u>\$2,373,868</u>	<u>\$2,149,529</u>
	✓	✓
Z = agreed to 20X3 workpapers Y = agreed to 20X4 general ledger		

T-1 3/3 File Copy JF		
4/1/X5		
Fleming Products, Inc. Statements of Income and Retained Earnings For the periods ending December 31, 10X4 and 20X3		
	Z	Y
	20X4	20X3
Sales	\$3,099,165	\$2,815,609
Sales returns	<u>200,000</u>	<u>100,000</u>
Net sales	2,899,165	2,715,609
Cost of sales	1,694,404	1,588,360
Gross profit	1,204,761	1,127,249
Operating expenses	814,459	776,668
Interest expense	<u>26,845</u>	<u>24,603</u>
Net income before taxes	363,457	325,978
Income taxes	143,929	145,636
Net income	219,528	180,342
Retained earnings—beginning	<u>1,323,879</u>	<u>1,270,463</u>
	1,543,407	1,450,805
Less dividends	<u>88,628</u>	<u>126,926</u>
Retained earnings—ending	<u>\$1,454,779</u>	<u>\$1,323,879</u>
	✓✓	✓
Z = agreed to 20X3 workpapers Y = agreed to 20X4 general ledger		

CASE STUDY: FLEMING PRODUCTS, INC. – YOUR QUESTIONS

CASE STUDY: FLEMING PRODUCTS, INC. – SUGGESTED SOLUTION

Review the following compilation workpapers:

1. Read the engagement letter.
 - Why is it important to read the engagement letter?
 - The engagement letter provides the scope of the engagement, the specific services the firm has been engaged to perform, the responsibilities the client is taking, the responsibilities the firm is taking, and the level of assurance that will be provided.
 - What specific elements of an engagement can be determined from the engagement letter?
 - Whether there will be accounting or tax services provided in addition to the compilation. Also, the form and content of the financial statements will be defined—for example, whether management elects to omit required disclosures and what specific disclosures are omitted.
2. Review the planning memo. What information can be obtained from the planning memo?
 - The planning memo is the preliminary assessment of where errors might occur and specific procedures to address those errors.
3. Review the work program. Note that many of the procedures were performed before year-end. Is this acceptable?
 - Many procedures can be performed before year-end and can be efficient for most engagements.
 - What procedures were used most often?
 - For a compilation, inquiries are adequate in most cases, as long as they appear to be reasonable in the circumstances.
 - Would the working trial balance need to be available when the procedures were done?
 - No, the working trial balance would not have to be available for planning the engagement but is recommended to finalize the compilation.
4. Review the trial balance.
 - Agree that the numbers from the working trial balance to the balance sheet and income statement for the current year.
 - This illustrates the necessity of transferring numbers correctly.
 - Determine if accounts were combined the same for both years on the financial statements.
 - This illustrates the necessity of classification for comparison from year to year.

5. Review the financial statements. Identify and list any obvious or material errors.
 - Obvious errors might include the following:
 - No change in allowance for doubtful accounts
 - Goodwill increased a small amount
 - Sales returns doubled
 - Net income before taxes increased; income taxes decreased
 - Dividends paid
 - While these may be obvious errors, the materiality has not been determined.
6. Determine if the workpapers will meet documentation requirements; if not, develop a list of needed workpapers.
 - At a minimum, there should be documentation of potential material errors and how they should be resolved.
7. Review the conclusion.
 - Based on the information just developed, do you agree with the conclusion?
 - No, as long as there appears to be obvious or material errors, additional procedures are required.
 - List reasons of agreement or disagreement.
 - The stated issues must be resolved to be satisfied that there no longer exist obvious or material errors.

Unit 5

AR-C Section 90—Review of Financial Statements as Amended by SSARS 25

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ☐ Apply the requirements of AR-C Section 90, *Review of Financial Statements*.
- ☐ Apply SSARS requirements found in recently issued SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, to accounting and review service issues such as engagement terms, independence, reporting, and documentation.
- ☐ Identify common peer review issues in review engagements.

INTRODUCTION

AR-C Section 90 applies when an accountant is engaged to perform a review of financial statements. In addition to the review of traditional financial statements, AR C Section 90 applies to other historical financial information excluding pro forma financial information. Reviews of pro forma financial information are to be performed in accordance with Statements on Standards for Attestation Engagements, or SSAEs, such as:

- Specified elements, accounts, or items of a financial statement;
- Supplementary information;
- Required supplementary information; and
- Financial information contained in a tax return.

AR-C Section 90 does not apply when the accountant is engaged to review interim financial statements when:

- I. The reporting entity's latest annual financial statements have been audited by the accountant or a predecessor;
- II. The accountant has either:
 - Been engaged to audit the reporting entity's current-year financial statements, or
 - Audited the reporting entity's latest annual financial statements and, in situations in which it is expected that the current-year financial statements will be audited, the engagement of another accountant to audit the current-year financial statements is not effective prior to the beginning of the period covered by the review; and
- III. The reporting entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

AU-C 930, *Interim Financial Information*, provides guidance for review engagements when the conditions I–III are met.

A review engagement is both of the following:

- **Attest engagement** – One requiring independence, as defined in AICPA Professional Standards
- **Assurance engagement** – One “in which the accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria)”

In a review of financial statements, the accountant **expresses a conclusion** regarding the reporting entity's financial statements in accordance with an applicable financial reporting framework. The accountant's conclusion is based on the accountant obtaining limited assurance. The accountant's report includes a description of the nature of the review engagement as context for the readers of the report to be able to understand the conclusion.

The accountant performs primarily analytical procedures and inquiries to obtain sufficient appropriate review evidence as the basis for the conclusion on the financial statements as a whole, expressed in accordance with the requirements of AR-C Section 90.

If the accountant becomes aware of a matter that causes the accountant to believe the financial statements may be materially misstated, the accountant designs and performs additional procedures, as the accountant considers necessary in the circumstances, to be able to conclude on the financial statements in accordance with AR-C Section 90.

Note: Illustrated review reports can be found at the end of this section.

The objective of the accountant when performing a review of financial statements is to:

- Obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made

to the financial statements for them to be in accordance with the applicable financial reporting framework and

- Report on the financial statements as a whole and communicate, as required by AR-C Section 90.

Limited assurance is a level of assurance that is less than the reasonable assurance obtained in an audit engagement but is an acceptable level as the basis for the conclusion expressed in the accountant's review report.

The following topics are in detail in this section of the program:

- Section Objectives
- Scope
- Definitions
- SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*
- Requirements of AR-C Section 90:
 - General Principles for Performing and Reporting on Review Engagements
 - Independence
 - Professional Skepticism
 - Acceptance and Continuance of Client Relationships and Review Engagements
 - Agreement on Engagement Terms
 - Communication with Management and Those Charged with Governance
 - Performing the Engagement
 - Understanding of the Industry
 - Knowledge of the Reporting Entity
 - Designing and Performing Review Procedures
 - Analytical Procedures
 - Inquiries of Members of Management Who Have Responsibility for Financial and Accounting Matters
 - Reading the Financial Statements
 - Procedures to Address specific Circumstances

- Using the Work of Others
 - Reconciling the Financial Statements to the Underlying Accounting Records
 - Additional Procedures When the Accountant Becomes Aware That the Financial Statements May be Materially Misstated
 - Evaluating Review Evidence Obtained from the Procedures Performed
 - Subsequent Events and Subsequently Discovered Facts
 - Written Representations
 - Forming the Accountant’s Conclusion on the Financial Statements
 - Form of Conclusion
 - Reporting on the Financial Statements
 - Change in the Engagement from Audit to a Review
 - Review Documentation
- Practice Guide - Review Inquiry Questionnaire

SECTION OBJECTIVES

In conducting a review of financial statements, the objectives of the accountant are to:

- Obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework and
- Report on the financial statements as a whole and communicate, as required by Section 90.

SCOPE

Section 90 applies when the accountant is engaged to perform a review of financial statements. This section also applies when the accountant is engaged to review other historical financial information, excluding pro forma financial information. Review of pro forma financial information is to be performed in accordance with Statements on Standards for Attestation Engagements.

DEFINITIONS

Adverse conclusion. When the effects of the matter or matters giving rise to the modification are both material and pervasive to the financial statements.

Analytical procedures. Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Comparative financial statements. A complete set of financial statements for one or more prior periods included for comparison with the financial statements of the current period.

Emphasis-of-matter paragraph. A paragraph included in the accountant's review report that is required by SSARs, or is included at the accountant's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to the users' understanding of the financial statements.

Error. Mistakes in the financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosures.

Experienced accountant. An individual (whether internal or external to the firm) who has practical review experience and a reasonable understanding of

1. Review processes;
2. SSARs and applicable legal and regulatory requirements;
3. The business environment in which the reporting entity operates; and
4. Review and financial reporting issues relevant to the reporting entity's industry.

Fraud. An intentional act that results in a misstatement in financial statements.

Generally accepted accounting principles (GAAP). References to GAAP in SSARs mean generally accepted accounting principles promulgated by bodies designated by the Council of the AICPA pursuant to the "Compliance With Standards Rule" (ET sec. 1.310.001) and the "Accounting Principles Rule" (ET sec. 1.320.001) of the AICPA Code of Professional Conduct.

Historical financial information. Information expressed in financial terms regarding a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Inquiry. Inquiry consists of seeking information of knowledgeable persons within or outside the reporting entity.

Limited assurance. A level of assurance that is less than the reasonable assurance obtained in an audit engagement but is at an acceptable level as the basis for the conclusion expressed in the accountant's review report.

Management. The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (e.g., executive members of a governance board or an owner-manager).

Misstatement. A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is

required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error. Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the accountant's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

Modified conclusion. The accountant should express a modified conclusion in the accountant's review report on the financial statements as a whole when the accountant determines, based on the procedures performed and the review evidence obtained, that the financial statements are materially misstated, resulting in a qualified conclusion or an adverse conclusion.

Non-compliance. Acts of omission or commission by the reporting entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into, by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. *Non-compliance* does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

Other-matter paragraph. A paragraph included in the accountant's review report that is required by SSARSs, or is included at the accountant's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the accountant's professional judgment, is relevant to users' understanding of the review, the accountant's responsibilities, or the accountant's review report.

Pervasive. A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements. Pervasive effects on the financial statements are those that, in the accountant's judgment:

- Are not confined to specific elements, accounts, or items of the financial statements;
- If so confined, represent or could represent a substantial portion of the financial statements; or
- With regard to disclosures, are fundamental to users' understanding of the financial statements.

Professional skepticism. An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of review evidence.

Qualified conclusion. When the accountant concludes that the effects of the matter or matters giving rise to the modification are material but not pervasive to the financial statements.

Reasonable period of time. The period of time required by the applicable financial reporting framework or, if no such requirement exists, 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).

Report release date. The date the accountant grants the reporting entity permission to use the accountant's review report in connection with the financial statements.

Required supplementary information. Information that a designated accounting standards-setter requires to accompany a reporting entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards-

setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

Review documentation. The record of review procedures performed, relevant review evidence obtained, and conclusions the accountant reached (terms such as *working papers* or *workpapers* are also sometimes used).

Review evidence. Information used by the accountant to provide a reasonable basis for obtaining limited assurance. Review evidence includes both information contained in the accounting records underlying the financial statements and other information, which primarily consists of the results of analytical procedures and inquiries. Sufficiency of review evidence is the measure of the quantity of review evidence. Appropriateness of review evidence is the measure of the quality of review evidence, that is, its relevance and reliability in providing support for the conclusions on which the accountant's review report is based.

Specified parties. The intended users of the accountant's review report.

Subsequent events. Events occurring between the date of the financial statements and the date of the accountant's review report.

Subsequently discovered facts. Facts that become known to the accountant after the date of the accountant's review report that, had they been known to the accountant at that date, may have caused the accountant to revise the accountant's review report.

Supplementary information. Information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the reviewed financial statements or separate from the reviewed financial statements.

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

Updated report. A report issued by a continuing accountant that takes into consideration information that the accountant becomes aware of during the accountant's current engagement and that re-expresses the accountant's previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period reviewed by the accountant as of the date of the accountant's current report.

Unmodified conclusion. The accountant should express an unmodified conclusion in the accountant's review report on the financial statements as a whole when the accountant has obtained limited assurance to be able to conclude that nothing has come to the accountant's attention that causes the accountant to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

When the accountant expresses an unmodified conclusion, the accountant should, unless required by law or regulation, use the following language:

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements for them to be in accordance with [the applicable financial reporting framework].

Written representation. A written statement by management provided to the accountant to confirm certain matters or to support other review evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

SSARS 25, MATERIALITY IN A REVIEW OF FINANCIAL STATEMENTS AND ADVERSE CONCLUSIONS

SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, was issued February 2020 by the Accounting and Review Services Committee (ARSC).

SSARS 25 aligns ARSC engagements closer to the International Standards for Review Engagements (ISRE 2400 – *Engagements to Review Historical Financial Statements*). The ARSC’s objective is to converge as closely as possible with the ISRE to allow engagements to be performed and reported on in accordance with both sets of standards. It is anticipated that less confusion about the level of assurance being given will result.

SSARS concepts, such as materiality, will also align with generally accepted auditing standards (GAAS).

Effective Date

Effective date will be for financial statements with periods ending on or after December 15, 2021. Early implementation will be allowed.

The standard will amend SSARS 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, as amended in the following sections:

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

Section 5 of this program has been updated to include the guidance issued in SSARS 25 for review engagements.

Summary of SSARS 25 Changes

- The review definition is modified from the accountant providing “limited assurance” that the financial statements are free from material misstatement to now “**expressing a conclusion**” that the reporting entity’s financial statements are free from material misstatement.

- The accountant now obtains **limited assurance** in order to express a conclusion in the review report.
- Related to expressing a conclusion, the accountant may reach a “**modified conclusion**,” which is a qualified conclusion or an adverse conclusion.
- A **qualified conclusion** is reached when the accountant concludes that the effects of the matter or matters giving rise to this modification are material but not pervasive to the financial statements.
- An **adverse conclusion** is reached when the effects of the matter or matters giving rise to this modification are both material and pervasive to the financial statements.
- As a result of “expressing a conclusion,” the review **report language** changes to reflect the conclusion reached.
- The accountant is required to determine **materiality** for the financial statements as a whole and apply this materiality when designing the procedures and evaluating the results obtained from those procedures.
- Further, the accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to determine a different amount initially.
- Consistent with the increased emphasis on materiality, the accountant, when **designing and performing analytical procedures and inquiries**, should address (1) all material items in the financial statements, including disclosures, and (2) areas in the financial statements where the accountant believes there are increased risks of material misstatement.
- **Additional review guidance** is included in SSARS 25 in the areas of related parties, fraud and non-compliance with laws and regulations, and going concern.
- **Examples of transactions, events, or matters** the accountant should inquire about are included in SSARS 25.

REQUIREMENTS OF AR-C SECTION 90

The requirements of AR-C Section 90 are discussed here and listed in the following topics:

- General Principles for Performing and Reporting on Review Engagements
- Independence
- Professional Skepticism
- Acceptance and Continuance of Client Relationships and Review Engagements
- Agreement on Engagement Terms
- Communication with Management and Those Charged with Governance

- Performing the Engagement
- Understanding of the Industry
- Knowledge of the Reporting Entity
- Designing and Performing Review Procedures
- Analytical Procedures
- Inquiries of Members of Management Who Have Responsibility for Financial and Accounting Matters
- Reading the Financial Statements
- Procedures to Address Specific Circumstances
- Using the Work of Others
- Reconciling the Financial Statements to the Underlying Accounting Records
- Additional Procedures when the Accountant Becomes Aware That the Financial Statements May Be Materially Misstated
- Evaluating Review Evidence Obtained from the Procedures Performed
- Subsequent Events and Subsequently Discovered Facts
- Written Representations
- Forming the Accountant's Conclusion on the Financial Statements
- Form of Conclusion
- Reporting on the Financial Statements
- Change in the Engagement from Audit to a Review
- Review Documentation

General Principles for Performing and Reporting on Review Engagements

The accountant is required to comply with the provisions of AR-C Section 90, as well as the provisions of AR-C Section 60, *General Principles for Engagements Performed in Accordance with SSARS* (previously outlined in Section 2). AR-C Section 60 requires:

- The accountant to comply with applicable ethical requirements;
- The accountant to exercise professional judgment;

- The accountant to apply applicable SSARS guidance;
- The engagement partner to possess requisite competence and capabilities; and
- The engagement partner to take responsibility for quality control matters.

Independence

Threats

Independence is required in all review engagements. If the accountant's independence is impaired for any reason, the accountant is precluded from performing a review engagement. Independence guidance is found in the AICPA's Code of Professional Conduct, Topic 1.200, *Independence*. Independence is described in Interpretation 0.300.21 as the following:

- **Independence of mind** – The state of mind that permits a member to perform an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism
- **Independence in appearance** – The avoidance of circumstances that would cause a reasonable and informed third party, who has knowledge of all relevant information, including the safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the review engagement team is compromised

PRACTICE POINT

Professional skepticism is an attitude that includes questioning possibly contradictory or inconsistent evidence observed or obtained, being alert to conditions that may indicate possible misstatements, and being critical in assessing review evidence as to sufficiency, applicability, reliability, or consistency.

In addition, the AICPA guidance states that if there is no independence interpretation or ruling under ET 1.200 that addresses a specific situation, a member should determine if a reasonable person would believe that there is an unacceptable threat to the member's and firm's independence.

Threats, by themselves, do not create an impairment of independence. A member must evaluate the threat using the independence in appearance standard and then evaluate whether the proper safeguards exist to meet the standard. Threats that could impair independence include:

- **Adverse interest** – The threat that a member will not act with objectivity because the member's interests are in opposition to the interests of an attest client. An example would be expressing an intention to sue or beginning a lawsuit between the client and member.
- **Advocacy** – The threat that a member will promote an attest client's interests or position to the point that her independence is compromised; for example, preparing non-GAAP financial statements for purposes of selling a client's business, supporting a client's insurance claim, or representing a client in litigation.
- **Familiarity** – The threat that, because of a long or close relationship with an attest client, a member will become too sympathetic to the attest client's interests or too accepting of the attest client's work or product. This could include:

- Socializing with a long-standing client;
 - A close friend in a key position at the client;
 - A spouse of a covered member in a key position at the client;
 - Providing attest services for a long-term period;
 - Accepting documentation without verification in an audit because the firm prepared it as part of bookkeeping services; and
 - A shareholder of the firm being appointed as a director or officer of the client.
- **Management participation** – The threat that a member will take on the role of attest client management or otherwise assume management responsibilities for an attest client. Examples include:
- Serving as an officer or director;
 - Setting up and maintaining internal controls;
 - Hiring, supervising, or terminating employees; and
 - Non-attest services, such as the following:
 - Setting policies or strategic direction for the client
 - Directing or accepting responsibility for client employees except when permitted in assisting internal auditors during an audit under auditing or attestation standards
 - The CPA authorizing, approving, executing, or consummating a transaction or exercising authority on behalf of a client (This would be true by merely having the authority to do the previously stated.)
 - Preparing source documents
 - Having custody of client assets
 - Deciding recommendations to be implemented or prioritized
 - Reporting to those in charge of governance on behalf of management
 - Serving as the client transfer agent

This threat creates common practice problems. The above use of the terms *authorize*, *approve*, *execute*, or *consummate* is often considered to include making any decision on the client's behalf without the client's consent or knowledge. Such decisions could be depreciation methods, tax elections, or classifications of transactions. This can often be problematic when servicing small clients and is discussed further here.

- **Self-interest** – The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, an attest client or persons associated with the attest client. Some examples include:
 - Direct or material indirect financial interests in the client;
 - Loans from a client, its officers, directors, or 10% or more owners;
 - A joint venture or material joint business with the client; and
 - Significant revenue from one client.
- **Self-review** – The threat that a member will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the member or an individual in the member's firm and that the member will rely on that service in forming a judgment as part of an attest engagement. An example includes preparing sales invoices for a client and then auditing accounts receivable and sales.
- **Undue influence** – The threat that a member will subordinate her judgment to that of an individual associated with an attest client or any relevant third party due to that individual's reputation or expertise, aggressive personality, or attempts to coerce or exercise excessive influence over the member. This can include the following:
 - Client threatening to replace the firm over a disagreement
 - Client bullying a firm to do less work so fees are reduced
 - Client giving expensive gifts to firm personnel

Note: For some of these threats, there are existing independence rules and interpretations.

Management Participation

ET 1.295 requires that in order for a practitioner to perform non-attest services for a client and maintain independence, the member *must not assume management responsibilities*. This rule is strongly stated as follows:

If a member were to assume a management responsibility for an attest client, the management participation threat would be so significant that no safeguards could reduce the threat to an acceptable level and independence would be impaired.

The non-attest management participation threat would be at an acceptable level, and independence would not be impaired when all of the following safeguards are met:

- Management agrees to:
 - Assume all management responsibilities (ET 1.295.030);
 - Oversee the service by designating an individual (preferred member of senior management) who possesses suitable skill, knowledge, and/or experience (SKE) who should oversee and be satisfied that such an individual sufficiently understands the services to be performed to

oversee them (The individual is not required to possess the expertise to perform or re-perform the services. However, they must possess the SKE to understand the implications and applications of the service overseen.);

- Evaluate the adequacy and results of the non-attest services performed; and
 - Accept responsibility for the results of the services.
- The accountant does not assume management responsibilities when providing non-attest services and is satisfied that the reporting entity and management will:
- Be able to meet all of the criteria listed in the aforementioned “management agrees to” section;
 - Make an informed judgment on the results of the accountant’s non-attest services; and
 - Accept responsibility for making the significant judgments and decisions that are the proper responsibility of management.

TAKE NOTE

If management is unable or unwilling to assume these responsibilities (such as cannot oversee non-attest services or unwilling to accept the responsibilities), the accountant’s performance of non-attest services would impair the accountant’s independence.

-
- Before performing non-attest services, the accountant establishes and documents in writing his understanding with management regarding:
- Objectives of the engagement,
 - Services to be performed,
 - The client’s acceptance of its responsibilities,
 - The accountant’s responsibilities, and
 - Any limitations of the engagement.

TAKE NOTE

If independence is impaired by virtue of the non-attest services safeguard just described, the accountant would be limited to providing either a compilation (AR-C section 80) or a preparation (AR-C section 70).

Independence Definitions

Independence is evaluated using an **engagement team approach**. This approach defines who must be independent in order to participate in a review engagement. Those who need to be independent are referred to as *covered members*. Covered members and their immediate family must remain independent for the period of the engagement.

When discussing AICPA independence rules, let's define three important terms:

1. **Covered members** – These include:

- Anyone who participates in the review engagement team;
- Anyone in a position to influence the review engagement, defined as an individual who:
 - Evaluates the performance or recommends compensation of the review engagement partner—for example, the managing partner or executive committee,
 - Directly supervises or manages the review engagement partner, including all senior levels above the review engagement partner through to the firm's CEO,
 - Consults with anyone on the review engagement team on technical or industry issues related to the review engagement, and
 - Participates in or oversees, at all successively senior levels, quality control activities, including monitoring, with respect to the specific review engagement;
- A partner, partner equivalent, or manager providing non-attest services during the period beginning once the individual provides 10 hours of non-attest services and ending the later of the date the firm signs the review report for the year in which the services were performed or when individual no longer expects to provide 10 hours or more of non-attest services;
- A partner or partner equivalent in the office in which the lead review engagement partner primarily practices in connection with the client's review engagement;
- The firm, including the firm's own employee benefits plans; and
- Any reporting entity that can have its operating, financial, or accounting policies controlled (as defined by generally accepted accounting principles for consolidations) by any of that which was just listed.

2. **Period of the professional engagement** – Starts when the member signs the initial engagement letter or begins performing the services requiring independence, whichever is earlier, and ends with the later of:

- The formal or informal termination by the firm;
- The formal or informal termination by the client; or
- The issuance of the report.

TAKE NOTE

For continuing relationship, the period lasts throughout the entire relationship. Accordingly, the period doesn't end with the issuance of a report and recommence at the beginning of the following year's attest engagement.

3. **Partner equivalents** – Have the same responsibilities as partners. Partner equivalents are defined as a professional employee who is not a partner but who has the authority to bind the firm to conduct a review engagement or has ultimate responsibility for the conduct of a review engagement.

Professional Skepticism

The accountant should plan and perform the review with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

Acceptance and Continuance of Client Relationships and Review Engagements

AR-C Section 60, paragraph 26 states:

As a precondition for accepting an engagement to be performed in accordance with SSARs, the accountant should (a) determine whether the financial reporting framework selected by management to be applied in the preparation of the financial statements is acceptable, and (b) obtain the agreement of management that it acknowledges and understands its responsibility:

- For the selection of the financial reporting framework to be applied in the preparation of financial statements.
- For the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error, unless the accountant decides to accept responsibility for such internal control.
- For preventing and detecting fraud.
- For ensuring that the reporting entity complies with laws and regulations applicable to its activities.
- For the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments provided by management for the preparation of financial statements.
- To provide the accountant with:
 1. Access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters.
 2. Additional information that the accountant may request from management for the purpose of the engagement.
 3. Unrestricted access to persons within the reporting entity of whom the accountant determines it necessary to make inquiries.

SSARS 25 adds the following to this acceptance and continuance category:

If it is discovered after the engagement has been accepted that the accountant is not satisfied regarding any of the preconditions above, the accountant should discuss the matter with management or those charged with governance and should determine the following:

- Whether the matter can be resolved
- Whether it is appropriate to continue with the engagement
- Whether and how to communicate the matter in the accountant's report

Agreement on Engagement Terms

The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate, prior to performing the engagement. The agreed-upon terms of the engagement should be documented in an engagement letter (best practice) or other suitable form of written agreement between the parties and should include the following:

- The objectives of the engagement
- The responsibilities of management
- The responsibilities of the accountant
- The limitations of a review engagement, specifically including a statement that a review is substantially less in scope than an audit and that the accountant will not express an opinion on the financial statements
- Identification of the applicable financial reporting framework for the preparation of the financial statements
- The expected form and content of the accountant's review report and a statement that there may be circumstances in which the report may differ from its expected form and content

The engagement letter or other suitable form of written agreement should be signed by the following:

- The accountant or the accountant's firm
- Management or those charged with governance, as appropriate

Application to a Review of a Single-Year Financial Statement

In a review of a single year financial statement, the accountant's determination about whether the financial reporting framework selected by management to be applied in the single year financial statement includes consideration of whether the application of the financial reporting framework will result in a presentation that provides adequate disclosure to enable the intended users to understand the information conveyed in the financial statement and the effect of material transactions and events on the information conveyed in the financial statement.

For some private companies providing financial statements in conformity with U.S. GAAP, management may elect single-year financial statement reporting for a modified retrospective implementation of Topic 606, *Revenue from Contracts with Customers*. The extent and implications relative to the implementation of the new revenue standard are complex, far-reaching, and substantively challenging to sufficiently “review” for fair presentation within the amended reporting framework, as well as to communicate to users of the financial statements.

PRACTICE ALERT

Since the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework along with the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework used to prepare the financial statements is a precondition for accepting a review engagement, the accountant must obtain understanding of the satisfactory adoption, implementation, and application of material accounting principles, such as Topic 606, Revenue, and Topic 842, Leases. If the accountant is substantively involved in the implementation and application, recognition and measurement, and presentation and disclosure, and management’s designee does not have the requisite skills, knowledge and/or experience to be able to accept responsibility, the lack of safeguard pertaining to the non-attest accounting service would likely impair the accountant’s independence and preclude the accountant from performing a review of the financial statements.

FIGURE 5.1: 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:

- I. Prepare financial statements in accordance with accounting principles generally accepted in the United States of America based on information provided by you; and*
- II. 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 non-compliance 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 non-compliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

Your Responsibilities

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

- I. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements*
- II. 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*
- III. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements*
- IV. The prevention and detection of fraud*
- V. To ensure that the entity complies with the laws and regulations applicable to its activities*
- VI. To make all financial records and related information available to us*
- VII. To provide us with:*
 - a. Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;*
 - b. Additional information that we may request from you for the purpose of the review engagement; and*
 - c. Unrestricted access to persons within the entity of whom we determine it necessary to make inquiries*
- VIII. 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.

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.

You agree to include our accountant's review report with any documentation containing financial statements that indicates that such financial statements have been reviewed by us and, prior to inclusion of the report, ask our permission to do so.

Other Relevant Information

Our fees for these services...

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

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

Sincerely yours,

[Signature of accountant or accountant's firm]

Acknowledged and agreed on behalf of Finnigan Company by:

[Signed]
[Name and title]

[Date]

Communications with Management and Those Charged with Governance

The accountant should communicate with management or those charged with governance all matters concerning the review engagement that, in the accountant's judgment, are of significant importance to management or those charged with governance. Examples of items that may be communicated include:

- The accountant's responsibilities in the review engagement,
- Significant findings from the review, and
- Matters arising that may lead to modifications of the accountant's review report.

During the review, the accountant should remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that management has not

previously identified or disclosed to the accountant. If the accountant identifies significant transactions outside the reporting entity's normal course of business when performing review procedures, the accountant should inquire of management about the following:

- The nature of these transactions
- Whether related parties could be involved

Performing the Engagement

Consideration of Materiality in a Review Engagement

The accountant's consideration of materiality should be made within the context of the applicable financial reporting framework. Generally, materiality applies in the context of:

- Misstatements, including omissions, which are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic basis of the financial statements;
- Judgments about materiality, which are made in light of surrounding circumstances and are affected by the size and/or nature of a misstatement or a combination of both; and
- Judgments about matters that are material to users of the financial statements, which are based on a consideration of the common financial information needs of users as a group. (Note: The possible effect of misstatements on specific individual users, whose needs may vary, is not considered.)

The accountant's determination of materiality is a matter of professional judgment, and it is affected by the accountant's perception of the needs of the intended users of the financial statements. In this context, accountants would assume that users:

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

SSARS 25 discusses materiality as part of a review engagement as the following:

- The accountant should **determine materiality** for the financial statements as a whole and apply this materiality when designing the procedures and evaluating the results obtained from those procedures.
- The accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to determine a different amount initially.

- In obtaining **sufficient appropriate review evidence** as the basis for a conclusion on the financial statements as a whole, the accountant should design and perform the analytical procedures and inquiries to address the following:
 - a. **All material items** in the financial statements, including disclosures
 - b. Areas in the financial statements where the accountant believes there are **increased risks** of material misstatements

Understanding the Industry

Obtaining an understanding of the industry was discussed in Section 2 of this course material.

Review procedures can only be designed and performed effectively if the accountant is sufficiently familiar with the industry and the specific accounting principles and practices used by the reporting entity. This suggests that the accountant will need a deeper understanding of the industry when performing a review engagement.

Knowledge of the Reporting Entity

The accountant is required to obtain knowledge about the reporting entity that is sufficient to identify areas in the financial statements where there is a greater likelihood that material misstatement may arise and be able to design procedures to address those areas. This includes knowledge of the business and the accounting principles and practices used by the reporting entity.

The accountant should understand the accounting principles and practices used by the reporting entity for measuring, recognizing, recording, and presenting all significant accounts and disclosures in the financial statements. The accountant may obtain an understanding of the accounting policies and procedures used through a combination of inquiry, the review of reporting entity-prepared documents, or experience with the reporting entity and other clients.

The following are some examples:

1. Knowledge of the client's business might include the following:
 - The history of the client, principals and key personnel, and identification of commonly owned entities
 - The production cycle, including the types of products and where they are manufactured or distributed
 - The types of compensation paid, such as commissions, bonuses, etc.
 - Related-party transactions
2. Knowledge of accounting policies and principles would include the following:
 - The methods used to value inventory
 - Revenue recognition, including whether the reporting entity has a unique revenue recognition policy (expanded applicability due to Topic 606 adoption in 2019)

- The methods used to calculate depreciation (e.g., straight line, MACRS, Bonus, Section 179)
 - As part of the understanding, the accountant should understand which method is appropriate for the financial reporting framework being reported on.
- The methods for recording revenue and whether there are any specific industry requirements (e.g., lower of cost or market, percentage of completion, multiple deliverables)
- The method and types of estimates required (e.g., evaluation of the collectability of accounts receivable, impairment of long-lived assets, impairment of goodwill)
- Changes in accounting principles either because of new standards or client preference and what the reporting requirements are [e.g., new revenue recognition standard (Topic 606) to be adopted for calendar 2019 and new lease accounting (Topic 842), which may have been adopted for calendar 2020, though the FASB extended the implementation to 2022 via ASU 2019-10 and then ASU 2020-5]

TAKE NOTE

Understanding the industry and knowledge of the reporting entity usually includes having an awareness of (a) broad economic conditions, (b) industry-specific conditions, and (c) entity-specific conditions. Thus, this knowledge and understanding are integral to designing and performing review procedures.

Other elements of knowledge of the reporting entity include the following:

Principals and Key Personnel

Knowledge of the principals and key personnel of the organization allows the accountant to assess the client's level of sophistication relative to financial reporting and financial information matters. Further, this knowledge assists in recognizing possible related party transactions or conflicts of interest, and their implications to the financial statements.

Related Party Transactions

Understanding a reporting entity's organization helps the accountant identify related party transactions. Related party transactions occur when one party to a transaction can impose on the other party terms that would not have been acceptable in an arm's length transaction. Factors that may assist the accountant to identify potential related party transactions include, but are not limited to, the following:

- Major sources of financing
- Significant vendors and customers
- Relationships (if any) of key employees
- Relationships (if any) of the reporting entity to affiliated companies

Effective with SSARS 25, during the review, the accountant should remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that

management has not previously identified or disclosed. If the accountant identifies significant transactions outside the entity's normal course of business when performing the review procedures required, the accountant should inquire of management about:

- The nature of these transactions and
- Whether related parties could be involved.

Understanding the Entity's Operating Characteristics

The accountant's understanding of the reporting entity's operating characteristics may include the following:

- Understanding the entity's products and services
- Identifying the entity's operating locations
- Understanding the entity's production methods
- Understanding the entity's distribution system
- Understanding the entity's compensation methods

Products and Services

Obtain a list of products sold and/or services provided and develop knowledge of special accounting or disclosure problems related to the reporting entity's products and services (Note: this knowledge is particularly essential in GAAP financial statements upon implementation of Topic 606), making special consideration of characteristics such as:

- Products that may be sensitive to technological or style changes (LCM/NRV write-downs),
- Products sold with warranty commitments (estimated liability provisions),
- Products that are custom built (extended time to complete/pattern of revenue recognition), and
- Products and/or services that are multiple-deliverable bundles (bifurcating distinct performance obligations, point in time vs. over time recognition, VSOE).

Operating Locations

Obtain knowledge of business locations and activities that occur at each location, being aware of characteristics, such as:

- Locations that store/ship inventories (cut-off, existence, obsolescence);
- Locations that include property, plant, and equipment;
- Locations that include leasing arrangements; and
- Locations that establish tax nexus.

Production Methods

For manufacturing entities, knowledge of production methods is an important part of the overall understanding of the reporting entity's business. Familiarity with the production process can help the accountant identify factors affecting the financial statements, such as spoiled goods, use of returnable containers, estimates required as to percentage complete on unfinished goods, or whether there are by-products of production that require additional accounting consideration. These factors must be reviewed in conjunction with the accounting requirements of the applicable financial reporting framework.

Distribution System

Understanding the reporting entity's distribution system allows the accountant to consider whether there are inventory control matters, such as with consignment goods and identifying ownership of the inventory, or how in-transit items are cut-off controlled/handled where there are multiple warehouses or outlet locations. Further, this understanding gives the accountant insights into matters of property, plant, and equipment for analytical purposes as well as carrying values (Topic 360 impairment for U.S. GAAP).

Compensation Methods

Knowledge of compensation methods can identify alternative methodologies, including stock or stock options, qualified and/or non-qualified deferred compensation or retirement plans, which may require consideration as to the valuation measurement (non-monetary exchanges) as well as additional disclosures. Even queries as to the satisfactory treatment and satisfaction pertaining to tax regulations, filing requirements, and handling of trust fund tax liabilities may be required.

Designing and Performing Review Procedures

In a review engagement, the accountant is required to perform procedures designed to accumulate sufficient appropriate **review evidence** that will provide a reasonable basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework based on the accountant's understanding of the industry, specific knowledge of the reporting entity, and awareness of the risks that the accountant may unknowingly issue an inappropriate accountant's review report.

In obtaining sufficient appropriate review evidence as the basis for a conclusion on the financial statements as a whole, the accountant should design and perform the analytical procedures and inquiries to address the following:

- All material items in the financial statements, including disclosures
- Areas in the financial statements where the accountant believes there are increased risks of material misstatement

Review evidence obtained through the performance of analytical procedures and inquiries will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, in certain circumstances based on the accountant's judgment, the accountant may perform other procedures ordinarily done in an audit. Although the performance of such procedures requires professional judgment, the following are some frequently performed procedures:

- Confirming a receivable or payable balance, inspecting an invoice, physically observing a large, fixed asset addition, or performing limited procedures on the client year-end inventory. Care should be taken to document the reason for performing these procedures so it does not give the appearance that an audit was performed.
- Obtaining and reviewing reports from other accountants to ensure that amounts included in consolidated or combined reports are appropriate. This might include reviewing K 1s or other financial information included in an equity pick-up adjustment to ensure the amounts received are on the appropriate basis of accounting.
- Inquiring about actions taken at stockholders or board of directors' meetings

If incorrect, incomplete, or unsatisfactory information is discovered, the accountant should ask management how this affects the financial statements. If the financial statements may be materially misstated, the accountant should perform additional procedures.

Although the accountant is not required to verify management's responses, additional inquiries or procedures should be performed if management's responses do not appear reasonable in light of the accountant's knowledge of the client's industry or business.

Review evidence consists of:

- Designing and performing analytical procedures;
- Performance of inquiries;
- Performance of other review procedures necessary to obtain limited assurance; and
- Obtaining a client representation letter.

Analytical Procedures

Note: As a result of COVID-19, analytics are significantly altered for a significant number of entities and industries—accordingly, the accountants will be required to extrapolate and document alternate expectations and revised financial relationships.

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

The use of analytical procedures to determine if any material modifications are required to be made in order for the financial statements not to be misleading is rooted in the fact that certain relationships exist within account balances and classes of transactions. For example, if sales increased, you would expect accounts receivable and cost of sales to increase. It is, therefore, imperative that the accountant be aware of both the financial and non-financial relationships that exist within the client's business. AR-C Section 90 makes it clear that a thorough knowledge of the client and its industry is needed in order to perform effective analytical procedures.

Analytical procedures may include such statistical techniques as trend analysis and may be performed manually or with the use of computer-assisted techniques.

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.

Expectations (again, note that with the coronavirus impact on many financial statements, developing expectations for 2020 and 2021 financial statements will be more difficult and time consuming than in past years) are the accountant's predictions of amounts developed by identifying and using the relationships and ratios that are expected to exist. The accountant develops the expectations in such a way that material differences between the expectations and the actual recorded amounts may be indicative of possible misstatements and, accordingly, explanations of the differences must be obtained from management. The expectations should be developed by identifying plausible relationships that would be reasonably expected to exist based on the understanding the accountant has of the reporting entity and the industry in which the reporting entity operates.

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. The extent to which the analytical procedures to be applied should be disaggregated 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.

In designing analytical procedures to be applied, the accountant should consider the intended objective of the procedure, including:

- Existence or occurrence,
- Completeness,
- Rights or obligations,
- Accuracy or classification, and
- Cutoff.

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:
 - Comparison of current amounts to prior periods
 - Comparison of actual amounts to budgeted or forecasted amounts
 - Consider changes in the business and the business economic conditions
 - Identifying appropriate interrelationships of accounts
 - Comparison of operating results to industry standards
 - Comparison of financial to non-financial data
 - Comparison to similar clients
 - Scanning the general ledger

Published industry data can provide an important source of information for analytical procedures—as many industry trade organizations publish current and relevant data—and are often readily available. However, if the reporting entity differs substantively from other companies in the industry with respect to characteristics such as ownership, financial structure, product diversity, age of assets, or customer mix, such industry ratios may not be meaningful.

FIGURE 5.2: Use of Non-financial Data

Data, Inc., a furniture manufacturing business, uses non-financial data in a number of ways, including the following:

- Weekly, a reconciliation of raw material input (in pounds and board feet of lumber) is made to finished product plus spoilage during the week. A variation of plus or minus ½% is investigated.
- Monthly, the number of shipments times the average truck capacity is compared to the sales recognized during the month. A variation of plus or minus 2% is investigated.
- Sales per month by customer are developed and analyzed to determine if any unusual or unexpected variations have taken place.
- Monthly, sales returns by customer are developed and analyzed to determine if any unusual or unexpected variations have taken place.
- Monthly, operating expenses per employee by department are developed and analyzed to determine if any unusual or unexpected variations have taken place.

- A weekly maximum test is utilized for payroll hours per employee, number of trucks to shipments, plant utilization and capacity, and number of shipments to customers. These maximums vary based on the time of the year.
- Monthly, customer orders to shipments are reconciled. A variation of plus or minus 3% is investigated.
- Monthly, cost of sales in units is reconciled to sales per units.

Tests involving non-financial data are sometimes referred to as reasonableness tests because non-financial data are used to determine the reasonableness of amounts recorded in the financial information. Usually, non-financial data are generated outside the accounting department, so comparisons involving such data can offer an independent check on the reasonableness of related financial information. Accordingly, the accountant should consider the accuracy and completeness of the non-financial data.

The **documentation** of an analytical procedure is a matter of preference and professional 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 (e.g., 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

The following are some suggested analytical procedures that can be performed on specific accounts:

1. Cash:

- Review year-end bank reconciliation to ensure that there are no large or unusual items
- Consider whether there might not be proper cutoff of cash receipts and disbursements
- Consider reconciliation of intercompany transfers
- Consider held check, overdrafts, or compensating balances arrangements

2. Accounts receivable:

- Accounts receivable turnover ratio
- Days' sales in accounts receivable
- Bad debts expense as a percentage of net credit sales
- Consider whether receivables might need to be bifurcated between current and non-current
- Review whether any receivables are pledged, discounted, or factored

- Consider whether receivables might exist with related parties
 - Comparison of the year-end aged accounts receivable to a subsequent one to ensure there is no build up in the aging indicating that accounts are not being collected
3. Inventory:
- Inventory turnover ratio
 - Days' sales in inventory
 - Gross profit margin
 - Comparison of changes in inventory to sales versus production
 - Identified consignment amounts
 - Inquire whether inventory evaluated for obsolescence, scraps, or costs in excess of net realizable values
 - Inquire as to cutoffs, returns, or goods in transit
4. Property, plant, and equipment:
- Scan general ledger for any significant additions or retirements
 - Inquire regarding gains or losses on disposals
 - Inquire as to criteria for capitalization, nature of repairs and maintenance, and regarding any unrecorded additions, retirements, abandonments, sales, or trade-ins
 - Determine if fully depreciated assets are still in service
 - Inquire regarding any material lease arrangements
5. Accounts payable:
- Accounts payable turnover ratio
 - Accounts payable days outstanding
 - Comparison of accounts payable for the current year to the prior year to ensure that similar items have been accrued
 - Inquire whether any liabilities are collateralized or subordinated
 - Determine whether any liabilities are with related parties
 - Inquire regarding nature and extent of accrued liabilities

6. Sales/cost of sales:

- Gross profit ratio
- Profit margin ratio
- Comparison of current to prior year's gross profit percentage
- Units sold multiplied by unit price
- Revenue by employee, square feet, hospital bed, hotel room, shipment, et cetera
- Operating expenses to sales ratio

7. SG&A:

- Year-to-year comparison of individual expense categories
- Scan SG&A detail in general ledger for missing or unusual items

TAKE NOTE

If the CPA's review procedures and analytics do not provide sufficient review evidence that there are no material modifications required, the ARSC provides options of other procedures and inquiries toward obtaining the level of limited assurance, including inspection, observation, confirmation, recalculation, or even re-performance. The practitioner, however, may need to carefully consider and document alternative or other procedures that may resemble audit-related procedures in the pursuit of sufficient review evidence and the requisite level of limited assurance.

Illustrative Analytics

The following examples are presented to help illustrate how the accountant might document expectations, and not to serve as a representation of either documentation minimum or maximum requirements.

Example #1 – Expected Increase in Revenue

Gaming Company manufactures components that are utilized by other companies in customizing video gaming equipment. The review engagement accountant expects sales to rise in light of the recent legislation legalizing slot machine gaming. Knowledge of the reporting entity, its business, and its industry leads the accountant to conclude an expected sales increase of 10% to 15%. Accordingly, a related increase in A/R, as well as loans payable and interest expense (increased production costs requiring increased borrowings), and, quite probably, higher carrying levels and amounts of inventory.

Expanding on the expectations, factors that impact relationships between the current and prior years' amounts might include the following:

- Increase in demand for video gaming equipment due to the recent legislation legalizing slot machine gaming should result in an increase in sales of 10% to 15%, with a similar increase in accounts receivable and the number of days sales in receivable ratios.
- To generate increased sales, a correlating increase in production may likely require loan borrowings (hiring, processing, production, and materials), resulting in increased debt leverage and interest expenses (also, in the 10% to 15% expected range).
- Based on the knowledge of the reporting entity, no significant change in either days that sales are in inventory or the inventory turnover is expected, even though the accountant does expect a slight build up in inventory because the expected demand increase should mitigate lag. Accordingly, any change exceeding 5% would be subject to additional inquiries.

From the above, and other client knowledge and queries, the accountant can determine expected amounts in both the income statement and balance sheet, as compared to balances over the prior years. Upon obtaining the current actual financial position and results, the accountant applies trend analysis in conjunction with horizontal and vertical analysis to identify the actual amounts and analytics ratios and relationships, to be assessed based on the extensive expectations to determine tolerance levels of deviations found.

The accountant documents not only the expectations and how they were determined, but also calculated analytics to determine whether the expected amounts and assumptions are consistent with the actual. Analytics applied would include (at a minimum):

- Days sales in receivables [$\text{ending Accounts Receivable} \div (\text{Net Sales}/365)$];
- Days sales in inventory [$\text{ending Inventory} \div (\text{Total COGS}/365)$]; and
- Inventory turnover [$\text{COGS} \div \text{Average Inventory}$].

Results (amounts or analytics) outside the expected will require the accountant to make additional inquiries of the reporting entity and document the reasons for the actual variance or change. The accountant must then determine what additional procedures would be necessary to determine whether an adjusted might be required.

Example #2 – Expected Decrease in Revenue

River Mall has been experiencing the hit to the retail economy with lost tenants during the year. The review engagement accountant expects revenue decreases in light of lost tenants. Knowledge of the reporting entity, its business, and its industry leads the accountant to conclude an expected sales decrease of 5% to 10%. However, an increase to general administrative expenses is also expected due to increased sales and leasing expense efforts, as well as compensated costs to be absorbed by the Company. Decreased revenues, though, should result in a correlating decrease in management fees.

These are some of the factors that should affect the relationships between the current and prior years' amounts:

- Loss of tenants due to poor economy should result in a decrease in revenue. Expected decrease is between 5% and 10%.

- Because of the increased number of vacancies, general and administrative expenses are expected to increase because of an increase in leasing and sales expenses. Expected increase is between 5% and 10%, corresponding with the revenue decrease.
- Because of the decrease in the number of tenants in the building, management fees are expected to decrease between 5% and 10%, corresponding with the revenue decrease.

Similar balance sheet analytics to those applied in example 1 should be performed, in establishing expectations and applying trends, horizontal and vertical analyses. To the extent that analytics procedures do not agree with the documented expectations associated with those procedures, the accountant should inquire and document why any variances, increases or decreases, resulted outside the expected range parameters.

Inquiries of Management Who Have Responsibility for Financial and Accounting Matters

The accountant should **inquire** of members of management who have responsibility for financial and accounting matters concerning the financial statements, and **others within the reporting entity**, as appropriate, about whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied, including how management determined that significant accounting estimates are reasonable in the circumstances. Inquiries should be both of the following:

- **Predetermined** – This is what distinguishes a review from a compilation. In a compilation, the accountant may make inquiry as a result of reading or assisting in the preparation of the financial statements. In a review, the questions are specific and targeted to determine if any material modifications to the financial statements are required.
- **Probative** – The questions should not only request a yes or no answer, but also a response that might elicit additional inquiry. For example, the accountant might ask whether a physical count of inventory was taken. If the answer is no, the accountant should follow up with an inquiry as to how the client knows inventory is correct.

Inquiries should include the following:

- a. The identification of related parties and related party transactions, including the purpose of those transactions
- b. Whether there are significant, unusual, or complex transactions, events, or matters that have affected or may affect the reporting entity's financial statements, including the following:
 - Significant changes in the reporting entity's business activities or operations
 - Significant changes to the terms of contracts that materially affect the reporting entity's financial statements, including terms of finance and debt contracts or covenants
 - Significant journal entries or other adjustments to the financial statements
 - Significant transactions occurring or recognized during the period, particularly those in the last several days of the reporting period

- The status of any uncorrected misstatements identified during the previous review (that is, whether adjustments were recorded subsequent to the periods covered by the prior review and, if adjustments were recorded, the amounts recorded and period in which such adjustments were recorded)
 - Effects or possible implications for the reporting entity of transactions or relationships with related parties
 - Matters about which questions have arisen in the course of applying the review procedures
 - The existence of any actual, suspected, or alleged fraud or non-compliance with laws and regulations
 - Non-compliance with provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations
 - Whether management has identified and addressed events subsequent to the date of the financial statements that require adjustment of, or disclosure in, the financial statements
- c. The basis for management's assessment of the reporting entity's ability to continue as a going concern
 - d. Whether there are events or conditions that appear to cast doubt on the reporting entity's ability to continue as a going concern
 - e. Material commitments, contractual obligations, or contingencies that have affected or may affect the reporting entity's financial statements, including disclosures
 - f. Material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration
 - g. Communications from regulatory agencies, if applicable
 - h. Any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management's response to the accountant's inquiry
 - i. Actions taken at meetings of stockholders, the board of directors, or committees of the board of directors or comparable meetings that may affect the financial statements
 - j. Any other matters that the accountant may consider necessary

Reading the Financial Statements

The accountant should read the financial statements and consider whether any information has come to the accountant's attention to indicate that the financial statements do not conform to the applicable financial reporting framework. In other words, are the financial statements free from material misstatement? The process of reading the statements was covered in Unit 4, *Compilation Engagements*.

AR-C Section 90 makes it clear that the accountant must read the financial statements and consider whether the financial statements appear to be appropriate in form and free from obvious material errors based on his knowledge of the client, knowledge of the client's industry, and the performance of review procedures. The term error, as used in SSARS, refers not only to math or clerical errors, but also includes obvious errors in the preparation of the financial statements, including presentation and disclosure.

Procedures to Address Specific Circumstances

Specific procedures are discussed in Section 90 related to related parties, fraud and non-compliance with laws and regulations, and going concern. Related party and fraud procedures are primarily inquiries. **Going concern** though, has specific procedures that must be performed. These going concern procedures are;

- Whether the going concern basis of accounting for the client is appropriate
- Management's evaluation of whether there are conditions or events that raise substantial doubt about the reporting entity's ability to continue as a going concern
- If there are conditions or events that raise substantial doubt about the reporting entity's ability to continue as a going concern, management's plans to mitigate those matters
- The adequacy of the related disclosures in the financial statements

Using the Work of Others

In performing the review, it may be necessary for the accountant to use work performed by other accountants or the work of an individual or organization possessing expertise in a field other than financial reporting. If the accountant uses work performed by another accountant or an expert in the course of performing the review, the accountant should take appropriate steps to be satisfied that the work performed is adequate for the accountant's purposes.

Reconciling the Financial Statements to the Underlying Accounting Records

The accountant should obtain evidence that the financial statements agree or reconcile with the accounting records. The accountant may compare the financial statements to:

- The accounting records;
- A consolidating schedule derived from the accounting records; and
- Other supporting data in the reporting entity's records.

Additional Procedures when the Accountant Becomes Aware That the Financial Statements May Be Materially Misstated

If the accountant becomes aware of a matter or matters that cause the accountant to believe the financial statements may be materially misstated, the accountant should design and perform additional procedures sufficient to enable the accountant to:

- Conclude that the matter or matters are not likely to cause the financial statements as a whole to be materially misstated or
- Determine that the matter or matters cause the financial statements as a whole to be materially misstated

Evaluating Evidence Obtained from the Procedures Performed

If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant's attention is incorrect, incomplete, or otherwise unsatisfactory, the accountant should:

- a. Request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and
- b. Consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be materially misstated.

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

If the accountant is not able to obtain sufficient appropriate review evidence to form a conclusion, the accountant should withdraw from the engagement.

When the accountant expresses a **qualified conclusion** on the financial statements because of a material misstatement, the accountant should, unless otherwise required by law or regulation, use the following language:

Based on my (our) review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with [the applicable financial reporting framework].

When the accountant expresses an **adverse conclusion** on the financial statements, the accountant should, unless otherwise required by law or regulation, use the following language:

Based on my (our) review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with [the applicable financial reporting framework].

In the **Basis for Conclusion paragraph**, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the accountant should do the following:

1. Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures) and the effects of the departure on the financial statements have been determined by management or are known to the accountant as a result of the accountant's procedures.
2. If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to

determine the effects of the departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.

3. Explain how disclosures are misstated if the material misstatement relates to narrative disclosures.
4. Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. The accountant should include the omitted disclosures when practicable to do so.

Note: An adverse conclusion relating to a specific matter described in the Basis for Modification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the accountant's conclusion. In instances in which other identified matters would have otherwise required a modification of the accountant's conclusion, the disclosure of such other matters of which the accountant is aware may be relevant to users of the financial statements.

Subsequent Events and Subsequently Discovered Facts

When evidence or information that subsequent events that require adjustment or disclosure in, the financial statements comes to the accountant's attention, the accountant should request that management consider whether each such event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

In addition, Section 90 provides additional guidance on subsequently discovered facts that become known to the accountant before the report release date and subsequently discovered facts that become known to the accountant after the report release date.

Written Representations

In a review engagement, the accountant must obtain written representations from management. Written representations are necessary information that the accountant requires in connection with a review of the reporting entity's financial statements. Written representations are review evidence.

For all financial statements presented and all periods covered by the review, the accountant should request management to provide written representations that are dated as of the date of the accountant's review report and that indicate that management has fulfilled its responsibilities, as set out in the terms of the engagement, including the following:

- Management has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- Management acknowledges its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements, including its responsibility to prevent and detect fraud.
- All transactions have been recorded and reflected in the financial statements.
- Management has provided the accountant with all relevant information and access to information, as agreed upon in the terms of the engagement.

- Management has disclosed to the accountant the identity of the reporting entity's related parties and all related party relationships and transactions of which management is aware, and management has appropriately accounted for and disclosed such relationships and transactions.
- Management has disclosed to the accountant significant facts relating to any fraud or suspected fraud known to management that may have affected the reporting entity involving:
 - Management,
 - Employees who have significant roles in internal control, or
 - Others, when fraud could have a material effect on the financial statements.
- Management has disclosed to the accountant significant facts relating to any allegations of fraud or suspected fraud known to management that may have affected the reporting entity's financial statements communicated by employees, former employees, regulators, or others.
- Management has disclosed to the accountant all known actual or possible instances of non-compliance with laws or regulations whose effects should be considered when preparing financial statements.
- Management has disclosed to the accountant all information relevant to the use of the going concern assumption in the financial statements.
- Management has properly accounted for all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework required adjustment or disclosure, and management has made the necessary adjustments or disclosures.
- Management has disclosed to the accountant whether management believes that the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation.
- Management has disclosed to the accountant all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements, and management has appropriately accounted for and disclosed such litigation and claims in accordance with the applicable financial reporting framework.
- Management has disclosed to the accountant whether management believes that significant assumptions management used in making accounting estimates are reasonable.

AR-C Section 90 reiterates that the representation letter should be tailored and, like previous SSARS, contains a listing of additional representations that may be appropriate.

The following representation letter is from AR-C Section 90.

FIGURE 5.3: 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 Topic 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 require adjustment or disclosure have been adjusted or disclosed.*

- *The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole.*
- *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 non-compliance or suspected non-compliance 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 FASB Topic 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.*
- *We have disclosed to you all information relevant to use of the going concern assumption in the financial statements.*
- *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 non-compliance.*
- *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]

Additionally, the accountant should tailor the representation letters to include additional appropriate representations from management relating to matters specific to the entity's business or industry.

Forming the Accountant's Conclusion on the Financial Statements

In forming the conclusion on the financial statements, the accountant should do the following:

- Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework
- Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:
 - The terminology used in the financial statements, including the title of each financial statements, is appropriate
 - The financial statements adequately disclose the significant accounting policies selected and applied
 - The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate
 - Accounting estimates made by management appear reasonable
 - The information presented in the financial statements appears relevant, reliable, comparable, and understandable
 - The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements

The form of the conclusion should express one of the following as previously discussed:

- Unmodified conclusion
- Qualified conclusion
- Adverse conclusion

Reporting on the Financial Statements

Reporting consists of the following items:

- Standard report
- Financial statements prepared in accordance with a special purpose framework
- Comparative financial statements
- Emphasis-of-matter and other-matter paragraphs
- Known departures from the applicable financial reporting framework
- Alert that restricts the use of the accountant's report
- The accountant's consideration of a reporting entity's ability to continue as a going concern
- Subsequent events and subsequently discovered facts
- Reference to the work of other accountants
- Supplementary information
- Change in engagement (covered in Unit 4, AR-C Section 80—*Compilation Engagements*)

Accountant's Review Report

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 and reach a conclusion. The written review report should include the following:

- A title, such as *Independent Accountant's Review Report*
- The accountant's report should be addressed, based on circumstances of the engagement, to the appropriate party, such as a stockholder, owner, board of directors, etc.
- The introductory paragraph in the accountant's report should:
 - Identify the reporting entity whose financial statements have been reviewed;
 - State that the financial statements have been reviewed;

- Identify the title of each statement (the report would use the exact financial statement titles used);
 - Specify the date or period covered by the financial statements;
 - Include a statement that a review includes primarily applying analytical procedures to management's or the owners' financial data and making inquiries of company management or owners; and
 - 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, whether due to error or fraud
 - A section with the heading *Accountant's Responsibility* that includes the following:
 - The accountant's responsibility to conduct the review in accordance with SSARS issued by the AICPA
 - The accountant believes that the results of the accountant's procedures provide a reasonable basis for the accountant's conclusion.
 - The accountant is required to be independent of the reporting entity and to meet the accountant's other ethical responsibilities, in accordance with the relevant ethical requirements relating to a review.
 - A concluding section with an appropriate heading that includes the accountant's conclusion on the financial statements and identifies the country of origin of the financial reporting framework, if applicable
 - When the accountant's conclusion on the financial statements is modified:
 - A paragraph, under the appropriate heading, that contains the accountant's modified conclusion, and
 - A paragraph, under the appropriate heading, that provides a description of the matter or matters giving rise to the modification
 - The signature of the accountant or the accountant's firm
 - Accountant's city and state

- The date of the review report, which should be dated no earlier than the date on which the accountant has obtained sufficient appropriate review evidence as the basis for the accountant's conclusion on the financial statements, including being satisfied that:
 - All the statements that the financial statements comprise, including the related notes, have been prepared, and
 - Management has asserted that management has taken responsibility for those financial statements

Each page of the financial statements may bear the legend *See Accountant's Review Report* (optional).

The following is a sample of the SSARS review report.

FIGURE 5.4: Independent Accountant's Review Report*

To the Board of Directors or Stockholders:

We have reviewed the accompanying financial statements of Macklain, Inc., which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. We believe the results of our procedures provide a reasonable basis for our conclusion.

We are required to be independent of Macklain, Inc., and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Accountant's Conclusion

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

(Signature of the accounting firm or accountant, as appropriate)

*(Accountant's city and state)**

(Date of the accountant's review report)

*Note: SSARS requires the use of headings in the report, as well as disclosing the city and state of the issuing office.

Change in Engagement from Audit to Review

If the accountant who was engaged to perform an audit engagement in accordance with generally accepted auditing standards, has been requested to change the engagement to a review engagement, the accountant should consider the following before deciding whether to agree with the change:

- The reason given for the request, particularly the implications of a restriction on the scope of the audit engagement, whether imposed by management or the circumstances
- The additional audit effort required to complete the audit engagement
- The estimated additional cost to complete the audit engagement

In all circumstances, if the audit procedures are substantially complete or the cost to complete such procedures is relatively insignificant, the accountant should consider the propriety of accepting a change in the engagement.

Review Documentation

The extent and type of documentation in a review file is a matter of professional judgment. However, verbal explanations in and of themselves are not sufficient to support the work performed or the conclusions reached. The documentation should be sufficient to demonstrate the work performed. Documentation provides evidence that their review was performed in accordance with professional standards and supports the accountant's conclusion. This should include (review) evidence of:

- The nature, timing, extent, and results of the work performed, such as inquiry, analytical, or other procedures;
- The review evidence obtained from the review procedures performed and the accountant's conclusion formed on the basis of that review evidence;
- The source of the review evidence; and
- Significant matters arising during the review, the accountant's conclusions reached, and significant professional judgments made in reaching those conclusions.

An accountant can include any additional documentation that the accountant believes is appropriate. AR-C Section 90 states the accountant's documentation should include the following:

- An engagement letter
- A copy of the review report issued and the financial statements
- Analytical procedures performed, including documentation of:
 - The expectation, if not self-evident, and the factors considered in their development;
 - The results of comparing the results of the procedure performed to the general ledger (e.g., calculating a gross margin would not be sufficient unless it was compared to prior periods or an industry standard); and
 - Management's explanations if the procedures differ significantly from expectations
- Any additional review procedures performed in response to significant unexpected differences and the results of these procedures
- The results of significant inquiries
- Any significant findings or issues
- Significant unusual matters
- Any verbal or written communication of fraud or illegal acts
- Communications with management regarding the accountant's expectation to include emphasis-of-matter or other-matter paragraph(s) in the accountant's review report
- Communications with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters
- If, in the course of the engagement, the accountant identified information that is inconsistent with the accountant's findings regarding significant matters affecting the financial statements, how the inconsistency was addressed
- Communications with other accountants who have audited or reviewed the financial statements of significant components
- A signed representation letter

Note: While SSARS 25 does not explicitly state that **materiality** should be documented in a review, there is now an explicit requirement for the accountant to determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. When determining and using materiality in a review engagement,

the accountant must document materiality in order to reach a review conclusion. The accountant's conclusion states the following:

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the applicable financial reporting framework.

In documenting the nature, timing, and extent of procedures performed, the accountant should document the following:

- Who performed the work and the date such work was completed
- Who reviewed the work performed for the purpose of quality control for the engagement and the date and extent of the review

In addition to the above, Kaplan suggests that the following additional documentation be included:

- That the accountant has knowledge of the client's business and industry
- A trial balance that bridges the general ledger to the financial statements
- Indication that there are no material modifications required to the financial statements
- A work program, if required by firm policy
- A disclosure checklist, if required by firm policy
- Any consultation performed (e.g., discussion with firm personnel, technical research)

Best practice: Practitioners should consider that documentation associated with review engagements not be included with documentation associated with the performance of bookkeeping, accounting services, tax services, or internal control engagements. These are separate services, and documentation associated with these services, such as depreciation analysis, bank reconciliations, tax analysis, trial balances, etc., should be included in separate documentation reflecting the nature of the services provided. However, the review engagement workpapers would include performance of such non-attest services (ET 1.295 of the Code of Conduct) in the accountant's assessment of independence (ET 1.210.010 of the Code of Conduct).

COMMON PEER REVIEW ISSUES—REVIEW

Periodically, the AICPA's Peer Review Committee publishes a peer review report that includes examples of matters noted in peer reviews. In addition, the AICPA's annual National Advanced Accounting and Auditing Technical Symposium Conference includes a concurrent session on inspection findings and peer review results. Both of these initiatives are designed to alert practitioners as to the frequent and recurring peer review deficiency issues associated with the performance of audit, review, and compilation engagements.

Additionally, peer review deficiencies are published in the annual AICPA *Alert: Developments in Preparation, Compilation, and Review Engagements*. The following list identifies the most frequent review and compilation peer review matters identified in recent peer reviews.

Review Engagements

- **Comparative financial reporting** – Peer reviewers indicate that some accountants do not report on comparable periods when reviewed financial statements presented include two or more years of financial information. Accountants are required to reference all periods reviewed in their review report, or if they are reporting on the current period only, issue only single-period financial statements.
- **Engagement letters** – Engagement letters are required in all review engagements. These engagement letters are required to include statements related to the objectives of the review engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. Peer review has identified the following issues in engagement letters:
 - Lacking language that indicates the engagement cannot be relied upon to disclose errors, fraud, or illegal acts
 - Lacking language that indicates the accountant will inform management or those in charge of governance of any material errors or any evidence of fraud or illegal acts that come to the accountant's attention
 - Failure to obtain engagement letter, or failure to include signed engagement letters (for post SSARS 21 reviews)
 - Failure to include all representations required by the applicable professional standards
 - Failure to appropriately date the representation letter
 - Failure to include all financial statement periods
- **Basic elements of a review report** – Peer reviewers still see many instances when the review report does not follow the basic report elements, as required, along with failure to report the degree of responsibility taken with respect to supplementary information presented with the financial statements and the accountant's review report.
- **Documentation of analytical procedures expectations** – As in audit engagements, the primary issue identified in peer reviews related to analytical procedures is the failure to document analytic expectations prior to performing analytical procedures. This has been a requirement in review engagements since 2005 with the issuance of SSARS 10 and continues to be a documentation and performance issue in reviews. Additional analytical review findings include:
 - Failure to compare financial statements with comparable information for the prior period, considering knowledge about changes in the reporting entity's business and specific transactions;
 - Failure to consider plausible relationships among both financial and, when relevant, non-financial information;
 - Failure to compare recorded amounts or ratios developed from recorded amounts to such expectations (that should have been) developed by the accountant through identifying and using relationships that are reasonably expected to exist based on the accountant's understanding of the reporting entity and the industry in which the reporting entity operates;

- Failure to compare disaggregated revenue data (as applicable); and
 - Failure to document expectations or the comparison of expectations to recorded amounts for analytical procedures.
- Departures from the applicable financial reporting framework – Financial reporting frameworks include:
- GAAP;
 - Income tax basis;
 - Special purpose framework, such as income tax basis;
 - IFRS;
 - Contractual; and
 - AICPA’s Financial Reporting Framework for SMEs.

When a material departure from the requirements of a financial reporting framework exists, the accountant is required to modify the standard review report to identify the nature and, if possible, the financial statement impact of the departure on the financial statements. Peer review indicates that material departures from a financial reporting framework are frequently ignored in review reports.

When accountants believe that a departure is pervasive and management refuses to correct the item, the accountant should withdraw from the review engagement because the accountant is not permitted in a review engagement to associate with misleading financial statements.

- Management representations – Items pertaining to representation letters that are frequently missing in review engagements include the following:
- Comparative financial statements issued by management—representation letter only covers the current year
 - Management representation letter—does not include a statement about management’s responsibility to detect and prevent fraud
 - A representation letter that is not appropriately dated
 - Omitted required representations that are required by standards, such as departures

ILLUSTRATED REVIEW REPORTS

Exhibit – Illustrations of Accountant Review Reports on Financial Statements are Provided to Assist in Complying with the Requirements of Updated AR-C Section 90

Illustration 1—An Accountant’s Review Report on Comparative Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America when a Review Has Been Performed for Both Periods

Circumstances include the following:

- Review of a complete set of comparative financial statements
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Accountant’s Review Report

[Appropriate Addressee]

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

Management’s Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant’s Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be **independent** of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Accountant's Conclusion

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 2—An Accountant's Review Report on Single-Year Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited

assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our review.

Accountant's Conclusion

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 3—An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance with the Tax Basis of Accounting

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are of a partnership and prepared in accordance with the basis of accounting the partnership uses for **income tax purposes** (that is, a special purpose framework).
- Management has a choice of financial reporting frameworks.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Partnership, which comprise the statement of assets, liabilities, and partners' capital (tax basis as of December 31, 20XX, and the related statements of revenue and expenses); tax basis; and partners' capital (tax basis for the year then ended)—and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (partners') financial data and making inquiries of partnership management (partners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Partners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the partnership uses for income tax purposes; this includes determining that the basis of accounting the partnership uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances. Management

(Partners) is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the partnership uses for income tax purposes. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Partnership and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our review.

Accountant's Conclusion

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the basis of accounting the partnership uses for income tax purposes.

Basis of Accounting

I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the partnership uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 4—An Accountant's Review Report on Interim Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of interim financial statements for the period ended September 30, 20XX, and for the three and nine months then ended.
- The interim financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- The accountant appropriately performs the engagement in accordance with SSARs (AU-C Section 930, *Interim Financial Information*, is not applicable).

Independent Accountant's Review Report²

[Appropriate Addressee]

I (We) have reviewed the accompanying interim financial statements of XYZ Company, which comprise the balance sheet as of September 30, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the three and nine months then ended, and the related notes to the interim financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the interim financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these interim financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of interim financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the interim financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our review.

Accountant's Conclusion

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

² All AU-C sections can be found in AICPA Professional Standards.

Illustration 5—An Accountant’s Review Report on Comparative Financial Statements Disclosing a Departure from Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements contain a departure from accounting principles generally accepted in the United States of America.

Independent Accountant’s Review Report

[Appropriate Addressee]

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

Management’s Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant’s Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Basis for Qualified Conclusion

As disclosed in Note X to these financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only and that the effects of this

departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.

or

As disclosed in Note X to these financial statements, the company has adopted *[description of newly adopted method]*, whereas it previously used *[description of previous method]*. Although the *[description of newly adopted method]* is in accordance with accounting principles generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by FASB Accounting Standards Codification 250, Accounting Changes and Error Corrections.

Qualified Conclusion

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 6—An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America Containing an Adverse Conclusion Due to a Misstatement of the Financial Statements That Is Both Material and Pervasive to the Financial Statements

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements contain a departure from accounting principles generally accepted in the United States of America that is both material and pervasive to the financial statements due to no consolidation of a subsidiary.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X1, 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. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Basis for Adverse Conclusion

As disclosed in Note X to these financial statements, the Company has not consolidated the financial statements of subsidiary ABC Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Conclusion

Based on my (our) review, due to the significance of the matter described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

CASE STUDY: JMF, INC.

JMF, Inc.

You have just been engaged to perform a first-time review engagement of JMF, Inc., a closely held manufacturer of generic drugs. The management of JMF has provided you with the attached historical financial information, and you have performed the analytical procedures for the most recent three-year period.

Required: Develop a listing of questions (inquiries) you believe should be asked of JMF management to help you determine if the financial statements need of any material modifications.

JMF, Inc. Analytical Procedures December 31, X3, X2, X1						
	X3		X2		X1	
	\$	% as decimal	\$	% as decimal	\$	% as decimal
Assets						
Current assets:						
Cash	\$ 445	0.04	\$ 589	0.06	\$ 926	0.10
Accounts receivable	2,298	0.19	1,899	0.18	1,702	0.18
Less: allowance	(143)	(0.01)	(136)	(0.01)	(125)	(0.01)
Inventories	2,142	0.18	1,702	0.16	1,425	0.15
Deferred taxes	327	0.03	238	0.02	209	0.02
Prepaid assets	<u>354</u>	<u>0.03</u>	<u>441</u>	<u>0.04</u>	<u>340</u>	<u>0.03</u>
Total current assets	5,423	0.46	4,733	0.45	4,477	0.47
Investments	769	0.06	799	0.07	512	0.06
Property & equipment (net)	4,115	0.35	3,667	0.35	3,247	0.34
Deferred taxes	506	0.04	300	0.03	290	0.03
Intangible assets	<u>1,071</u>	<u>0.09</u>	<u>1,014</u>	<u>0.10</u>	<u>980</u>	<u>0.10</u>
Total assets	<u>\$11,884</u>	<u>1.00</u>	<u>\$10,513</u>	<u>1.00</u>	<u>\$9,506</u>	<u>1.00</u>
Liabilities						
Notes payable	\$1,532	0.13	\$ 679	0.06	\$ 600	0.06
Accounts payable	710	0.06	934	0.09	852	0.09
Accrued liabilities	1,302	0.11	918	0.09	738	0.08

Taxes payable	<u>183</u>	<u>0.01</u>	<u>158</u>	<u>0.01</u>	<u>215</u>	<u>0.02</u>
Total current liability	3,727	0.31	2,689	0.25	2,405	0.25
Long-term debt	1,365	0.11	1,301	0.12	1,316	0.14
Deferred taxes	585	0.05	379	0.04	60	0.01
Other liabilities	<u>911</u>	<u>0.08</u>	<u>719</u>	<u>0.07</u>	<u>715</u>	<u>0.07</u>
Total liabilities	<u>\$6,588</u>	<u>0.55</u>	<u>\$5,088</u>	<u>0.48</u>	<u>\$4,496</u>	<u>0.47</u>
Stockholders' Equity						
Common stock (529 SHS O/S)	\$ 529	0.05	\$ 529	0.05	\$ 529	0.06
Retained earnings	<u>4,767</u>	<u>0.40</u>	<u>4,896</u>	<u>0.47</u>	<u>4,481</u>	<u>0.47</u>
Total stockholders' equity	<u>5,296</u>	<u>0.45</u>	<u>5,425</u>	<u>0.52</u>	<u>5,010</u>	<u>0.53</u>
Total liabilities & stockholders' equity	<u>\$11,884</u>	<u>1.00</u>	<u>\$10,513</u>	<u>1.00</u>	<u>\$9,506</u>	<u>1.00</u>

JMF, Inc. Analytical Procedures December 31, X3, X2, X1						
	X3		X2		X1	
	\$	% as decimal	\$	% as decimal	\$	% as decimal
Revenue						
Sales	\$13,753	100	\$12,447	100	\$11,232	100
Cost of sales	<u>5,078</u>	<u>0.37</u>	<u>4,504</u>	<u>0.36</u>	<u>3,937</u>	<u>0.35</u>
Gross profit	\$ 8,675	0.63	\$ 7,943	0.64	\$ 7,295	0.65
Expenses						
Operating expenses	\$6,384	0.46	\$5,583	0.45	\$4,997	0.44
Depreciation	560	0.04	493	0.04	474	0.04
Interest expense	<u>124</u>	<u>0.01</u>	<u>129</u>	<u>0.01</u>	<u>201</u>	<u>0.02</u>
Income before taxes	1,607	0.12	1,738	0.14	1,623	0.15
Income tax expense	<u>443</u>	<u>0.03</u>	<u>695</u>	<u>0.06</u>	<u>649</u>	<u>0.06</u>
Net income from operations	<u>\$1,164</u>	<u>0.09</u>	<u>\$1,043</u>	<u>0.08</u>	<u>\$ 974</u>	<u>0.09</u>

JMF, Inc. Ratio Analysis			
	X3	X2	X1
Current ratio	1.46	1.76	1.86
Quick ratio	0.88	1.13	1.27
Working capital ratio	0.14	0.19	0.22
Accounts receivable turnover	6.55	6.91	6.6*
A/R collection period	55	52	55
Inventory turnover	2.64	2.88	2.76*
Inventory sales period	136	125	130
Accounts payable turnover	6.18	5.04	4.62*
A/P payments period	58	71	78
Operating cycle	133	106	107
Debt/equity	1.24	0.94	0.90
Debt/assets	0.55	0.48	0.47
Earnings × interest expense	13.96	14.47	9.07
Cash flow × interest paid	9.20	9.88	6.35
Book value per share	\$10.01	\$10.26	\$9.47
Return on assets	10%	10%	10%*
Return on equity	22%	20%	19%*
Profit margin on sales	9%	8%	9%
Quality of earnings	66%	83%	88%
Cash flow/sales	8%	10%	11%
CF/total assets	10.2%	12.7%	13.4%
*Assume X1 amounts are average balances.			

CASE STUDY: JMF, INC. – YOUR QUESTIONS

CASE STUDY: JMF, INC. – SUGGESTED QUESTIONS

- Although slight, why is gross profit as a percent of sales decreasing each year?
- What are the components of operating expenses and what is causing the increase as a percentage of sales?
- Interest expense as it relates to notes payable and long-term debt dropped from 10½% in X1 to 4% in X3. Is interest expense reasonable?
- Why has tax expense as a percentage of income decreased in X3?
- Why is the cash balance declining from period to period?
- What are the components of property and equipment, and what is causing the increase from period to period?
- Why are inventory levels building up from period to period?
- Why isn't the allowance for doubtful accounts keeping pace with the increasing gross receivables?
- What is causing the deferred tax balances?
- Why did notes payable more than double in X3?
- Why is JMF making more frequent payments to its suppliers when cash is declining?
- What has caused the increase in accrued liabilities?
- What are the components of other liabilities, and what is the cause of the X3 increase?
- The increases in net income from year to year exceed the increase in retained earnings each year. What causes this discrepancy?
- Liquidity ratios are declining from period to period. What is causing this and what is management doing about it?
- Is the client's increasing financial leverage (debt/equity and debt/assets) planned by the client or a result of other negative activities?
- Why is the quality of earnings poor for each of the three years presented?
- Are JMF's profitability ratios comparable to industry averages?

CASE STUDY: XYZ COMPANY

Review of Analytical Procedures Workpapers

Your staff accountant has prepared the following analytical procedures workpapers. The client is a closely held soft goods retailer expanding into selected hard goods products for the first time this year. The engagement is an annual review.

The accountant prepared the following workpapers with inquiry results as noted.

Required

Prepare any review comments you believe would be necessary, based on your review of the workpapers. What expectations should the accountant develop based on the recurring nature of this engagement?

XYZ Company Analytical Procedures For the Period Ended December 31, 20X5				JMF R-3 2/16/X6
	X5	X4	X3	Comments Based on Inquiries
Sales	\$1,965,000	\$1,550,000	\$1,300,000	Reflects higher sales
Cost of sales	\$1,193,000	\$1,038,000	\$880,000	No significant change
Gross profit	\$772,000	\$512,000	\$420,000	Increased margins on hard goods sales
Gross profit %	39%	33%	32%	
Operating exp.	\$605,000	\$520,000	\$438,000	Increase due to expanded marketing program and introduction of new credit card
Operating exp./sales	31%	34%	34%	
Accts. receivable	\$625,000	\$50,000	\$8,000	Reflects increased use of credit card by customers for hard goods sales
Allow for DA	\$18,000	\$4,000	\$1,000	
Inventories	\$658,000	\$400,000	\$300,000	Build-up reflects introduction of hard goods for new product line this year

XYZ Company Analytical Procedures For the Period Ended December 31, 20X5				JMF R-3 2/16/X6
	X5	X4	X3	Comments Based on Inquiries
Current liabilities	\$290,000	\$270,000	\$275,000	
Line of credit	\$600,000	\$350,000	\$200,000	Additional debt incurred reflects financing of inventory expansion
Long-term debt	\$320,000	\$125,000	\$130,000	
Operating cash flow	\$14,365	\$35,421	\$37,077	Reflects collection delays resulting from the use of credit cards for payment

XYZ Company Analytical Procedures For the Period Ended December 31, 20X5					JMF R-3 2/16/X6
	X5	X4	X3	X2	Comments Based on Inquiries
Current ratio	1.6	1.6	1.8	1.9	No significant change
Quick ratio	0.91	0.89	1.08	1.07	
A/R turnover	5.8	53	173	165	Reflects increased use of credit cards for payments
# of days in AR	63	69	2.1	2.2	
INV turnover	2.3	2.97	3.06	3.24	Declining trend due to the introduction of a new product line—hard goods
# of days in inventory	156	121	118	111	
Debt to equity	3.5	2.32	1.9	1.67	Additional debt incurred to finance inventory expansion
Times interest earned	1.05	3.95	4.72	4.76	

XYZ Company Analytical Procedures For the Period Ended December 31, 20X5					JMF R-3 2/16/X6
	X5	X4	X3	X2	Comments Based on Inquiries
Profit margin	0.09	0.03	0.04	0.07	
Return on assets	0.1	0.07	0.08	0.11	Reflects higher profit margins on hard goods sales
Return on net worth	0.26	0.19	0.2	0.25	

CASE STUDY: XYZ COMPANY – YOUR REVIEW COMMENTS

CASE STUDY: XYZ COMPANY – SUGGESTED REVIEW COMMENTS

1. Your workpapers do not include your expectations of the trends and relationships based on the introduction of the new product line. X4, X3, and X2 do not include the effects of the new product line, but X5 does. Based on the significance of the new product line activity, comparison to prior periods may not be very meaningful.
2. Why do the current ratio and the quick ratio continue to decline? Does the company have a liquidity problem?
3. Inventory:
 - Is the decline in the inventory turnover solely due to the introduction of the new product line? How do we know inventory obsolescence is not a problem elsewhere?
 - How do the inventory relationships compare to industry averages? Break out the inventory trends and relationships for product lines, compare for the three-year period, and compare to industry averages.
4. Receivables:
 - Accounts receivable has significantly increased during the past year. What is the allowance for doubtful accounts based on?
 - What effect has the introduction of the new credit card program had on collection experience for those customers? Break out sales trends and relationships for product lines and compare to industry averages.
5. Debt:
 - What interest rates is the company paying, and is the company able to obtain additional long-term debt at prevailing market rates?
6. Profitability ratios and returns are significantly higher in X5, but operating cash flows are declining. Are these increased sales and related receivables collectible? What is management doing to ensure collection of its credit card receivables?
7. Obtain a detailed product line and cost/expense analysis for each significant component of the income statement and statement of cash flows. Inquire of management as to inconsistencies or relationships that are not comparable to industry averages.
8. Determine what constitutes the operating expense to sales decrease. Evaluate the reasonableness of these relationships by comparing to prior years and industry averages.
9. Compare X5 information to the company's X5 general ledger.
10. Compare X4, X3, and X2 information to prior period workpapers.
11. Prepare a conclusion memo once review comments have been completed.

PRACTICE GUIDE: REVIEW INQUIRY QUESTIONNAIRE

In addition to the inquiries identified earlier in this section, accountants may wish to consider the following inquiries in specific account areas:

General

1. Have there been any changes in the reporting entity's business activities?
2. Are there any unusual or complex situations that may have an effect on the financial statements? (This could include litigation, environmental issues, plans to acquire another company, plans to close down operations, restructuring debt, etc.)
3. What procedures are in place related to recording, classifying, and summarizing transactions and accumulating information related to financial statement disclosures?
4. Have the financial statements been prepared in conformity with generally accepted accounting principles or, if appropriate, a special purpose framework other than generally accepted accounting principles?
5. Have there been any changes in accounting principles and methods of applying those principles?

Have voluntary changes in accounting principles been reflected in the financial statements through retrospective application (or prospective where required) of the new principle in comparative financial statements?

6. Have there been any instances of fraud or illegal acts within the reporting entity?
7. Have there been any allegations or suspicions that fraud or illegal acts might have occurred or might be occurring within the reporting entity?

If so, where and how?

8. Are any entities, other than the reporting entity, commonly controlled by the owners?

If so, has an evaluation been performed to determine whether those other entities should be consolidated into the financial statements of the reporting entity?

9. Are there any entities other than the reporting entity in which the owners have significant investments (for example, variable interest entities)?

If so, has an evaluation been performed to determine whether the reporting entity is the primary beneficiary related to the activities of these other entities?

10. Is the reporting entity a general partner in a limited partnership arrangement?

If so, has an evaluation been performed to determine whether the limited partnership should be consolidated into the financial statements of the reporting entity?

11. Is the reporting entity a controlling partner in a general partnership arrangement?

- If so, has an evaluation been performed to determine whether the partnership should be consolidated into the financial statements of the controlling partner?
12. Have all accounts requiring fair value measurements been identified and are these accounts presented applying the applicable fair value guidance (identifying by levels 1, 2, and 3, and applying the fair value and impairment procedures related thereto)?
 13. Have any significant transactions occurred or been recognized near the end of the reporting period?
 14. Has the reporting entity disposed of any components of the business? If so, has the reporting entity complied with the provision of ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Components of an Entity*?
 15. Has the reporting entity elected any of the accounting policy elections available for non-public entities as recommended by the Private Company Council and issued as Accounting Standard Updates by FASB?
 16. Has the reporting entity complied with the provisions of ASU 2014-15, *Going Concern*?
 17. Are there any existing, new, or proposed regulatory policies or practices applicable to the entity (e.g., Wayfair)?
 18. Have any changes been made in the entity's personnel in the accounting or governance functions?
 19. Is there any industry-specific AICPA guide or industry publication that the entity should follow?

Cash and Cash Equivalents

1. Is the reporting entity's policy regarding the composition of cash and cash equivalents in accordance with Topic 230?

Has the policy been applied on a consistent basis?
2. Are all cash and cash equivalents accounts reconciled on a timely basis?
3. Have old or unusual reconciling items between bank balances and book balances been reviewed and adjustments made where necessary?
4. Has there been a proper cutoff of cash receipts and disbursements?

Since a review would not include any cutoff procedures (bank cutoff statements or interbank transfer analysis), this inquiry is necessary to address the possibility of an overstatement of cash.
5. Has a reconciliation of intercompany transfers been prepared?
6. Have checks written but not mailed as of the financial statement date been properly reclassified into the liability section of the balance sheet?
7. Have material bank overdrafts been properly reclassified into the liability section of the balance sheet?

8. Are there compensating balances or other restrictions on the availability of cash and cash equivalents balances?

If so, has consideration been given to reclassifying these amounts as non-current assets?

9. Have cash funds been counted and reconciled with control accounts?

Receivables

1. Has an adequate allowance for doubtful accounts been properly reflected in the financial statements?

Although a review would require an analytical comparison of the age of receivables and the total account balance, it does not require the accountant to evaluate each account balance and vouch subsequent payments.

2. Have uncollectible receivables been written off through a charge against the allowance account or earnings?
3. Has interest earned on receivables been properly reflected in the financial statements?
4. Has there been a proper cutoff of sales transactions?
5. Have there been any changes in major contracts with customers that may affect the classification or valuation of receivables?
6. Are there receivables from employees or other related parties?

Have receivables from owners been evaluated to determine if they should be reflected in the equity section (rather than the asset section) of the balance sheet?³

7. Are any receivables pledged, discounted, or factored?

Are recourse provisions properly reflected in the financial statements?

8. Have receivables been properly classified between current and non-current?
9. Have there been significant numbers of sales returns or credit memoranda issued subsequent to the balance sheet date?
10. Is the accounts receivable subsidiary ledger reconciled to the general ledger account balance on a regular basis?¹
11. If there are financing receivables, analyze by class of financing receivable that are past due, identifying those (a) on non-accrual status, and (b) those past due 90 days or more and still accruing?

³ Owner's receivables should be evaluated to determine if they are equity transactions as follows:

- If they are deemed to be uncollectible—write-offs should be through equity.
- Topic 505 requires notes received for stock to be a deduction from equity, unless there is an ability and intent to pay within a short time frame. An AICPA risk alert indicates that it would normally be inappropriate to show a stockholder loan received for stock as an asset.

12. Are there carrying amounts of trade receivables that do not approximate fair value (Subtopic 825-10-50 to be superseded by ASU 2016-01 beginning after 2018 for non-public entities)?
13. Are there receivables (including lease receivables) whose terms have been modified in a troubled debt restructuring (Subtopic 310-40)? Analyze by class of financing receivable and by portfolio segment.

Inventory

1. Are physical inventory counts performed on a regular basis, including at the end of the reporting period?

Are the count procedures adequate to ensure an appropriate count?

If not, how have amounts related to inventories been determined for purposes of financial statement presentation?

If so, what procedures were used to take the latest physical inventory and what date was that inventory taken?

Only an audit requires an observation of inventory. However, if a client has not taken a physical at year-end, an accountant must satisfy himself, in a review, that inventory dollars, as reported by the client, are not materially misstated.

Have general ledger control accounts been adjusted to agree with the physical inventory count?

If so, were the adjustments significant?

2. If the physical inventory counts were taken at a date other than the balance sheet date, what procedures were used to determine changes in inventory between the date of the physical inventory counts and the balance sheet date?
3. Were consignments-in and consignments-out considered in taking physical inventories?
4. What is the basis of valuing inventory for purposes of financial statement presentation?
5. Does inventory cost include material, labor, and overhead where applicable (with the framework)?
6. Has inventory been reviewed for obsolescence or cost in excess of net realizable value?

If so, how are these costs reflected in the financial statements?
7. Have proper cutoffs of purchases, goods in transit, and returned goods been made?
8. Are there any inventory encumbrances?
9. Is scrap inventoried and controlled?
10. Have abnormal costs related to inventory been expensed as incurred?

11. Have the lower of cost or net realizable value provisions of ASU 2015-11 simplified measurement of inventory (Topic 330) been applied as applicable since 2016?
12. Is there any inventory held at other locations or held for others (“bill & hold” or other)?

Prepaid Expenses

1. What is the nature of the amounts included in prepaid expenses?
2. How are these amounts being amortized?

Investments

1. What is the basis of accounting for investments reported in the financial statements (for example, securities, joint ventures, or closely held businesses)?
2. Are derivative instruments properly measured, recorded, and disclosed in the financial statements?

If those derivatives are utilized in hedge transactions, have the documentation or assessment requirements related to hedge accounting been met?
3. Are investments in marketable debt and equity securities properly classified as trading, available-for-sale, and held-to-maturity?
4. How were fair values of the reported investments determined? Have unrealized gains and losses been properly reported in the financial statements?
5. If the fair values of marketable debt and equity securities are less than cost, have the declines in value been evaluated to determine whether the declines are other-than-temporary?
6. For any debt securities classified as held-to-maturity, does management have the positive ability and intent to hold the securities until they mature?

If so, have those debt securities been properly measured?

7. Have gains and losses related to disposal of investments been properly reflected in the financial statements?
8. How was investment income determined?

Is investment income properly reflected in the financial statements?
9. Has appropriate consideration been given to the classification of investments between current and non-current?
10. For investments made by the reporting entity, have consolidation, equity, or cost method accounting requirements been considered?
11. Are any investments encumbered?

12. Analyze and disclose financial instrument investments in tabular form, separated by the fair value hierarchy (1, 2, or 3) and related methods and significant assumptions.

Property and Equipment

1. Are property and equipment items properly stated at depreciated cost or other proper value?
2. When was the last time a physical inventory of property and equipment taken?
3. Are all items reflected in property and equipment held for use?

If not, have items that are held for sale been properly reclassified from property and equipment?
(Consideration of discontinued operations)

4. Have gains or losses on disposal of property and equipment been properly reflected in the financial statements?

5. What are the criteria for capitalization of property and equipment?

Have the criteria been consistently and appropriately applied?

6. Are repairs and maintenance costs properly reflected as an expense in the income statement?

Since a review does not contemplate vouching expenses, the accountant must determine that items requiring capitalization have been recorded accordingly.

7. What depreciation methods and rates are utilized in the financial statements?

Are these methods and rates appropriate and applied on a consistent basis?

8. Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?

9. Does the reporting entity have any material lease agreements?

If so, have those agreements been properly evaluated for financial statement presentation purposes?

10. Are there any asset retirement obligations associated with tangible long-lived assets?

If so, has the recorded amount of the related asset been increased because of the obligation, and is the liability properly reflected in the liability section of the balance sheet?

11. Has the reporting entity constructed any of its property and equipment items?

If so, have all components of cost been reflected in measuring these items for purposes of financial statement presentation, including, but not limited to, capitalized interest?

12. Has there been any significant impairment in value of property and equipment items?

If so, has any impairment loss been properly reflected in the financial statements?

13. Are any property and equipment items mortgaged or otherwise encumbered?

If so, are these mortgages and encumbrances properly reflected in the financial statements?

Intangibles and Other Assets

1. What is the nature of the amounts included in other assets?
2. Do these assets represent costs that will benefit future periods?

What is the amortization policy related to these assets?

Is this policy appropriate?
3. Have other assets been properly classified between current and non-current?
4. Are intangible assets with finite lives being appropriately amortized?
5. Are the costs associated with computer software properly reflected as intangible assets (rather than property and equipment) in the financial statements?
6. Are the costs associated with goodwill (and other intangible assets with indefinite lives) properly reflected as intangible assets in the financial statements?

Has amortization ceased related to these assets?
7. Has there been any significant impairment in value of these assets (based on the qualitative factors and the related more-likely-than-not carrying value applied through the two-step test)?

If so, has any impairment loss been properly reflected in the financial statements?
8. Are any of these assets mortgaged or otherwise encumbered?
9. Has the company adopted PCC standards (ASU 2014-02 and ASU 2014-18) and applied amortization and trigger assessment guidance?
10. Has the company considered early adoption of 1-step simplified impairment testing of ASU 2017-04 if previous PCC standards (above) had not been adopted?

Accounts and Short-Term Notes Payable and Accrued Liabilities

1. Have significant payables been reflected in the financial statements?

Because a review would normally not include a search for unrecorded liabilities, the accountant should ask management whether all invoices applicable to the period being reported on have been recorded.
2. Are loans from financial institutions and other short-term liabilities properly classified in the financial statements?
3. Have significant accruals (for example, payroll, interest, provisions for pension and profit-sharing plans, or other post-retirement benefit obligations) been properly reflected in the financial statements?
4. Has a liability for employees' compensation for future absences been properly accrued and disclosed in the financial statements?

5. Are any liabilities collateralized or subordinated?
If so, are those liabilities disclosed in the financial statements?
6. Are there any payables to employees and related parties?
7. Were subsidiary accounts payable ledger balances in agreement with control account in the general ledger?
8. Have there been any changes in major contracts with suppliers that may affect the classification or valuation of payables?
9. Have troubled debt restructurings, with terms and features of settlement, been analyzed and adequately disclosed?

Long-Term Liabilities

1. Are the terms and other provisions of long-term liability agreements properly disclosed in the financial statements?
2. Have liabilities been properly classified between current and non-current?
3. Has interest expense been properly accrued and reflected in the financial statements?
4. Is the company in compliance with loan covenants and agreements?
If not, is the non-compliance properly disclosed in the financial statements?
5. Are any long-term liabilities collateralized or subordinated?
If so, are these facts disclosed in the financial statements?
6. Are there any obligations that, by their terms, are due on demand within one year from the balance sheet date?
If so, have these obligations been properly reclassified into the current liability section of the balance sheet?
7. Were there any non-cash financing activities where loan proceeds were paid directly to a vendor or other third party?

Income and Other Taxes

1. Do the financial statements reflect an appropriate provision for current- and prior-year income taxes payable?
2. Have any assessments or reassessments been received? Are there tax authority examinations in process?
3. Are there any temporary differences between book and tax amounts?

4. Have the implications of the Tax Cuts and Jobs Act been calculated, recorded, and disclosed?

If so, have deferred taxes on these differences been properly revised and reflected in the financial statements?
5. Are all deferred tax accounts reflected as non-current in accordance with ASU 2015-17?
6. Do the financial statements reflect an appropriate provision for taxes other than income taxes (for example, franchise, sales)?
7. Have all required tax payments been made on a timely basis?
8. Have uncertain tax positions been identified, accrued for, and properly disclosed in accordance with Topic 740?

Other Liabilities, Contingencies, and Commitments

1. What is the nature of the amounts included in other liabilities?
2. Have other liabilities been properly classified between current and non-current?
3. Are there any guarantees, whether written or verbal, whereby the reporting entity must stand ready to perform or is contingently liable related to the guarantee?

If so, are these guarantees properly reflected in the financial statements?

The accountant may not be aware of any guarantees made of affiliate loans, environmental liabilities, or unasserted legal claims. Consequently, in a review, this must be specifically asked of the client.

4. Are there any contingent liabilities (for example, discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims)?

Are there any potential unasserted claims?

Are these contingent liabilities, claims, and assessments properly measured and disclosed in the financial statements?

5. Are there any material contractual obligations for construction or purchase of property and equipment or any commitments or options to purchase or sell company securities?

If so, are these facts clearly disclosed in the financial statements?

6. Is the reporting entity responsible for any environmental remediation liability?

If so, is this liability properly measured and disclosed in the financial statements?

7. Does the reporting entity have any agreement to repurchase items that previously were sold?

If so, have the repurchase agreements been taken into account in determining the appropriate measurements and disclosures in the financial statements?

8. Does the reporting entity have any sales commitments at prices expected to result in a loss at the consummation of the sale?

If so, are these commitments properly reflected in the financial statements?

9. Are there any violations, or possible violations, of laws or regulations, the effects of which should be considered for financial statement accrual or disclosure?

Equity

1. What is the nature of any changes in equity accounts during each reporting period?
2. What classes of stock (other ownership interests) have been authorized?
3. What is the par or stated value of the various classes of stock (other ownership interests)?
4. Do amounts of outstanding shares of stock (other ownership interests) agree with subsidiary records?
5. Have pertinent rights and privileges of ownership interests been properly disclosed in the financial statements?
6. Does the reporting entity have any mandatory redeemable ownership interests?

If so, have these ownership interests been evaluated so that a proper determination has been made related to whether these ownership interests should be measured and reclassified to the liability section of the balance sheet?

Are redemption features associated with ownership interests clearly disclosed in the financial statements?

7. Have dividend (distribution) and liquidation preferences related to ownership interests been properly disclosed in the financial statements?
8. Do disclosures related to ownership interests include any applicable call provisions (prices and dates), conversion provisions (prices and rates), unusual voting rights, significant terms of contracts to issue additional ownership interests, or any other unusual features associated with the ownership interests?
9. Are syndication fees properly reflected in the financial statements as a reduction of equity (rather than an asset)?
10. Have any stock options or other stock compensation awards been granted to employees or others?

If so, are these options or awards properly measured and disclosed in the financial statements?

11. Has the reporting entity made any acquisitions of its own stock?

If so, are the amounts associated with these reacquired shares properly reflected in the financial statements as a reduction in equity?

Is the presentation in accordance with applicable state laws?

12. Are there any restrictions or appropriations on retained earnings or other capital accounts?

If so, are these restrictions or appropriations properly reflected in the financial statements?

Comprehensive Income

1. Have the changes and reclassification adjustments in accumulated balances for each component of other comprehensive income been identified (to be presented on the face of the statements or scheduled in the footnotes)?
2. Identify components of comprehensive income to be presented in either a single continuous statement or in two separate but consecutive financial statements.
3. Has accumulated other comprehensive income (OCI) reflected in equity separate from retained earnings and APIC?
4. Have components of OCI been presented either net of related tax effects, or before tax effects with a related amount representing aggregate income tax expense or benefit related to OCI?

Revenues and Expenses

1. What is the reporting entity's revenue recognition policy (Topic 606; IRC §451)?

Is the policy appropriate?

Has the policy been consistently applied and appropriately disclosed?

2. Are revenues from sales of products and rendering of services recognized in the appropriate reporting period (that is, when the products have been delivered and when the services have been performed)?

3. Were any sales recorded under a "bill and hold" arrangement?

If yes, have the criteria been met to record the transaction as a sale?

4. Are purchases and expenses recognized in the appropriate reporting period (that is, matched against revenue) and properly classified in the financial statements?

5. Do the financial statements include discontinued operations, items that might be considered extraordinary, or both?

If so, are amounts associated with discontinued operations, extraordinary items, or both properly displayed in the income statement?

6. Does the reporting entity have any gains or losses that would necessitate the display of comprehensive income (for example, gains/losses on available-for-sale securities or cash flow hedge derivatives)?

If so, have these items been properly displayed within comprehensive income (rather than included in the determination of net income)?

Other

1. Have events occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements?
2. Have actions taken at stockholders, directors, committees of directors, or comparable meetings that affect the financial statements been reflected in the financial statements?
3. Are significant estimates and material concentrations (for example, customers or suppliers) properly disclosed in the financial statements?
4. Are there plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities reflected in the financial statements?
5. Have there been material transactions between or among related parties (for example, sales, purchases, loans, or leasing arrangements)?

If so, are these transactions properly disclosed in the financial statements?

6. Are there uncertainties that could have a material impact on the financial statements?

Is there any change in the status of previously disclosed material uncertainties?

Are all uncertainties (including going concern matters) that could have a material impact on the financial statements properly disclosed in the financial statements?

7. Are barter or other non-monetary transactions properly recorded and disclosed?

Have non-monetary asset exchanges involving commercial substance been reflected in the financial statements at fair value?

Have non-monetary asset exchanges not involving commercial substance been reflected in the financial statements at carrying value?

8. What were the results of management's evaluation as to the following:

- Whether the going concern basis of accounting is appropriate
- Whether there are conditions or events that raised substantial doubt about the reporting entity's ability to continue as a going concern
- The adequacy of the related disclosures in the financial statements

9. Are there conditions or events that raised substantial doubt about the reporting entity's ability to continue as a going concern? What are management's plans to mitigate those matters?

NOTES

Unit 6

Special Purpose Frameworks

LEARNING OBJECTIVE

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe the accounting and disclosure requirements for special framework financial statement presentations.

INTRODUCTION

Many compilation and review engagements are performed for clients using a basis of accounting other than GAAP (i.e., special purpose frameworks (SPF)). While the compilation and review performance standards addressed in this program contain modifications to deal with SPF, understanding the differences in SPF ensures the accountant will perform SPF engagements in accordance with the related performance standards.

As discussed in Unit 3 of this program, when an accountant is engaged to perform a preparation service and is not engaged to perform an audit, review, or compilation engagement, the guidance in AR-C Section 70 applies to the performance of the preparation engagement, whether the engagement is based on GAAP or a SPF.

Special purpose frameworks, also referred to as other comprehensive basis of accounting (OCBOA), are defined in the audit standards under AU-C 800. They include:

- Cash basis,
- Tax basis,
- Regulatory basis,
- Contractual basis, and
- Other basis (e.g., the AICPA Financial Reporting Framework for Small- and Medium-Sized Entities—FRF for SME).

For decades, there has been discussion about whether there should be separate GAAP for public and private companies, colloquially known as “big GAAP vs. little GAAP.” In the past, a few GAAP standards seemed to comprehend the different uses and needs of big versus small enterprises. For example:

- More extensive pension plan disclosures for public companies;
- Exemption of private companies with less than \$100 million in assets and no derivatives from fair value of financial instruments disclosures;
- Phased-in effective dates for some standards based on public/private or size of reporting entity;
- Segment information and earnings per share required only for public companies; and
- Creation of the Private Company Council (PCC) whose mission is to identify areas in GAAP where an alternative for privately held entities makes sense.

For some time now, the profession has been committed to *principles-based standards* (as opposed to rules-based standards). This approach accomplishes two main objectives:

1. It furthers efforts to converge U.S. GAAP with international standards, which have always been principles-based.
2. It strives to eliminate opportunities to manipulate recognition and measurement by structuring transactions to fall within—or outside of—specific rules to achieve a desired result.

The most recent standards shy away from any specific thresholds or measurements in an apparent effort to curb such abuse. The unfortunate result is standards that reflect theoretical concepts intended to cast a broad net over problem areas, which are burdensome and exceedingly difficult to apply to specific fact patterns. One consequence is that the FASB routinely issues subsequent Accounting Standard Updates (ASUs) on to address implementation problems after a previous ASU was issued.

Further, there is general agreement among practitioners that privately held companies are sometimes unintended victims of standards designed to address issues relevant to larger enterprises. In some cases (such as fair values, VIEs, and uncertain tax positions), there is reason to believe that the impact of a new standard on privately held companies was at best underestimated, or at worst totally overlooked or misunderstood by the FASB.

Due to the above issues, as well as the increasing complexity of U.S. GAAP, practitioners in the private sector have been seeking cost-effective alternatives to U.S. GAAP that can still meet the needs of their various user groups. The following history provides participants with background leading to the frequent use of SPFs in the U.S. as alternative to U.S. GAAP.

HISTORY

FASB—1973

In 1973, the FASB replaced the AICPA Accounting Principles Board as the accounting standard-setting authority in the United States. The fear in the 1970s was that the FASB would become a

standard-setting body for public companies only and that non-public or private entities would have to struggle with public company GAAP not intended for their or their users' use.

This fear generated many discussions among CPAs concerning the issue of Big GAAP-versus-Little GAAP accounting standards and the perceived need by many practitioners that a standard-setting body for non-public or private entities should be created to meet the financial reporting needs of the 28 million non-public entities in the United States.

While these issues continued to provoke discussion, and in some cases, anger throughout the profession for many years, the issue of Little GAAP accounting standards did not get the attention of standard-setters until 1989.

SAS 62: Other Comprehensive Basis of Accounting (OCBOA)—1989

In 1989, the AICPA Auditing Standards Board (ASB) issued SAS 62, *Special Reports*, to address the reporting responsibilities of auditors when issuing an audit opinion on non-GAAP financial statements. During the 1980s, many non-public or private entities changed from presenting GAAP financial statements to presenting accrual income tax basis financial statements or cash basis financial statements in an attempt to avoid the increasing complexity of U.S. GAAP and the perceived lack of interest by the FASB in private company accounting issues.

In SAS 62, the term *Other Comprehensive Basis of Accounting (OCBOA)* was created reflecting non-GAAP financial statement presentations such as income tax basis, cash basis, and regulatory basis. What is interesting to note is that this additional accounting guidance resulted from an audit standards-setter, not an accounting standards-setter.

Sarbanes-Oxley—2002

In 2002, as a result of the numerous accounting frauds that came to light in the late 1990s and early 2000s, Congress passed legislation (Sarbanes-Oxley) that created the Public Company Accounting Oversight Board (PCAOB) and provided for increased oversight of the FASB by the Securities and Exchange Commission (SEC). This increased focus by the SEC on the FASB agenda topics caused the FASB to almost exclusively address public company accounting issues from 2003 to 2010.

This increased emphasis on public company accounting issues by the FASB caused renewed interest by private company practitioners in the Big-GAAP-versus-Little-GAAP issue.

Private Company Financial Reporting Committee (PCFRC)—2007

As previously noted, the Big GAAP-versus-Little GAAP debate has been going on for decades, but it reached a much higher pitch following the issuance of standards on variable interest entities, fair value, goodwill, and uncertain tax positions. A perceived lack of relevance to users of private company financial statements and a level of complexity, whose costs outweigh the benefits of compliance, resulted in a spike of privately held entities issuing financial statements with GAAP departures, or financial statements prepared using an SPF.

The PCFRC was formed in 2007 in response to these concerns. Its mission was to make recommendations to the FASB as to where there should be differences in proposed and existing standards to better meet the needs of private companies. Approximately 40 letters of recommendation were generated, with minimal results.

Blue-Ribbon Panel—2010

By 2010, these increasing concerns by private company practitioners concerning the direction of the FASB caused the creation of a Blue-Ribbon Panel to address private company accounting issues. This Blue-Ribbon Panel included membership by AICPA representatives, NASBA representatives, and representatives from the Financial Accounting Foundation (FAF).

The Blue-Ribbon Panel recommended that a separate private company standard-setter be created to address “the growing systemic problems at the FASB because U.S. GAAP currently fails to address different needs of users of public company versus private company financial statements.” This recommendation was provided to the Financial Accounting Foundation (FAF) that oversees the FASB for further consideration. The FAF rejected the Blue-Ribbon Panel’s recommendation, and in its place, created the Private Company Council (PCC) in 2012.

Private Company Council—2012 to Present

The PCC is the primary advisory body to the FASB on private company matters. The PCC uses the Private Company Decision-Making Framework to advise the FASB on the appropriate accounting treatment for private companies for items under active consideration on the FASB’s technical agenda.

The PCC also advises the FASB on possible alternatives within GAAP to address the needs of users of private company financial statements. Any proposed changes to GAAP are subject to endorsement by the FASB.

AICPA Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)—2013 to Present

In June 2013, the AICPA introduced the Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SME) to help the small business community with its financial reporting needs. The framework is an accounting option for preparing streamlined, relevant financial statements for privately held owner-managed businesses that are not required to report under U.S. GAAP.

FRF for SME is designed to be a self-contained, stand-alone framework that provides comprehensive guidance pertaining to the accounting principles intended to be the most appropriate for the preparation of financial statements to meet the needs of smaller businesses, bankers, and other users. FRF for SME focuses on the performance of the company and its assets, liabilities, and cash flows.

The framework was developed as a blend of traditional accounting principles (some pre-fair value GAAP) combined with accrual income tax accounting, thereby providing a familiar and intuitive reporting that should be easier to understand by all users of small business financial statements.

CASH AND MODIFIED CASH BASIS

Introduction

The cash basis of accounting is a basis of accounting the reporting entity uses to record cash receipts and cash disbursements, along with modifications of the cash basis having substantial support by practitioners. Thus, prescribed disclosures are set forth to provide meaningful and informative context while defining and describing the specific bases for recognition and measurement within the parameters of cash transactions.

Applicability of Cash Basis

The practitioner must first consider whether utilization of the cash basis is misleading to the users of financial statements. Matters to consider when the reporting entity is considering utilizing the cash basis of accounting include the following:

- The cash basis of accounting is not an acceptable alternative if the results could be misleading. For example, the cash basis financial statements would omit (most) accruals, reserves, and contingencies whose omission could be material.
- The timing of a change from GAAP to cash basis of accounting should be considered in light of surrounding facts and circumstances. While practitioners may be considering this alternative for simplicity purposes and because of the onerous nature or evolution of changes in GAAP, caution should be exercised if the timing coincided with an adverse change in the client's operations that would be obscured in a cash basis presentation. Accordingly, cash basis is not appropriate if it masks a problem.
- A strong working knowledge of GAAP is important when preparing cash basis financial statements. Understanding the differences between cash basis and GAAP, along with evaluating their impact on users, requires a thorough knowledge of GAAP. The foundation of disclosure requirements under any SPF is based on GAAP.
- As few entities use a pure cash basis, the modifications must (1) have substantial support (the modification is a method equivalent to the accrual basis of accounting), and (2) must not be illogical (e.g., recording revenues under accrual method, but not recognizing trade or accrued payables). Inclusion of such measurement or recognition would constitute a reportable departure from the cash basis of reporting framework, which must be evaluated the same way as a practitioner would evaluate a GAAP departure from GAAP financial statements.

TAX BASIS

Introduction

The income tax basis ("tax basis") of accounting is defined in AU-C 800 as "a basis of accounting that the [reporting] entity uses to file its tax return for the period covered by the financial statements." (Although not included in the definition, this is understood to mean federal, not state.) It is the most widely used SPF.

Accordingly, the framework for recognition and measurement of amounts and results are defined in the U.S. Internal Revenue Code (IRC) as applied in the reporting entity's federal tax return. As the

IRC contains no rules about disclosure, AU-C 800 provides that when utilizing the tax basis of accounting preparers of financial statements look to GAAP for appropriate disclosures.

When practitioners prepare tax basis presentations, the measurement and recognition rules are based on the tax return filed, while the disclosure requirements are those disclosures necessary to prevent the financial information from being misleading, as well as any other disclosures required by related professional standards (related parties, contingencies, debt terms, inventory costing, etc.).

Applicability of Tax Basis

The practitioner must first consider whether utilization of the tax basis is misleading to the users of financial statements. We will look at the applicable attributes of tax basis reporting and disclosure, review and compilation engagement considerations, and other aspects that represent compliance with the framework, which must be considered in assessing the appropriateness of the reporting framework.

Matters to consider when the reporting entity is considering utilizing the tax basis of accounting include the following:

- Tax basis of accounting is not an acceptable alternative if the results could be misleading. For example, if the reporting entity's tax basis is a cash basis tax reporting, then the financial statements would omit most accruals, reserves, and contingencies.
- The timing of a change from GAAP to tax basis of accounting should be considered in light of surrounding facts and circumstances. Many practitioners have seriously considered this alternative because of the onerous nature of recent changes in U.S. GAAP. But what if the timing coincides with an adverse change in the client's operations that would be obscured in a tax basis presentation? Tax basis is not appropriate if it masks a problem.
- A strong working knowledge of GAAP is important when preparing tax basis financial statements. Understanding the differences between tax basis and GAAP, along with evaluating their impact on users, requires a thorough knowledge of GAAP. The foundation of disclosure requirements under SPF is based on GAAP. It is naive to believe that a comprehensive knowledge of tax law is all you need to prepare tax basis financial statements.
- Financial statements prepared on the tax basis must not include methods of measurement or recognition that are not allowed under the IRC. Inclusion of such measurement or recognition, or applying a tax method for financial statement purposes not applied on the actual tax return, would constitute a reportable departure from the tax basis of reporting framework, which must be evaluated the same as a practitioner would evaluate a GAAP departure from GAAP financial statements.

While any non-public company, absent any practical limitation such as a loan agreement requirement, may prepare its financial statements on the tax basis, the following characteristics normally exist at companies that prepare tax basis presentations:

- The company is organized as a tax pass-through entity (S Corp, LLC, etc.).
- Primary owners are active in the management of the company.
- Management's focus is primarily on after-tax cash flows rather than accrual earnings.

- There are limited third-party users or passive owners.
- Limited financial resources are devoted to the accounting and reporting function.
- Management does not plan to take the company public in the foreseeable future.
- Management does not plan to sell the company in the foreseeable future.

Companies using tax basis include professional service firms, smaller manufacturing companies, real estate partnerships, contractors, service companies, and many smaller retailers.

GAAP requires the recognition of revenue when it is earned and the recognition of expenses when they are incurred (accrual method). Tax law often recognizes revenues and expenses when collected or paid. As a result of these differences between GAAP and tax law, revenues and expenses are often included in financial income before or after they are included in taxable income. Practitioners must be aware of these differences not only for measurement and recognition purposes, but also to determine the appropriate disclosures required.

There are additional differences between GAAP and tax basis rules that result in income that is never taxable and/or expenses that are never deductible (permanent differences). Common examples include:

- Dividends-received deduction (tax only) by C Corporations;
- Exempt income, such as municipal bond interest;
- Officers' life insurance expense (non-deductible) and death benefits (non-taxable);
- Penalties and fines, 50% meals and entertainment expense (through December 31, 2017—effective January 1, 2018, by the Tax Cuts and Jobs Act of 2017 (TCJA), 50% for qualifying meals with 100% no deduction permitted for entertainment expenses), political contributions (non-deductible);
- Membership dues with respect to any club organized for business, amusement, or recreation (100% non-deductible effective January 1, 2018, by the TCJA); and
- Transportation fringe benefits not deemed necessary for employee safety (100% non-deductible effective January 1, 2018, by the TCJA).

These differences do not really enter into a decision to use income tax basis and are still included in tax basis financial statements.

Further, the TCJA established new guidance in select areas that may create suspended deductions that, while constituting temporary timing differences for U.S. GAAP reporting purposes, will still be reconciling items between tax basis book net income (loss) and actual taxable income (loss).

Benefits that practitioners identify for using tax basis presentations include the following:

- Eliminate the need for multiple sets of records for both GAAP and tax basis
- Developing complex deferred tax calculations is avoided

- A cash flow statement is not required in tax basis financial statements (although often included)
- Complex GAAP measurement and recognition standards are avoided
- Many disclosure requirements are less complex or less detailed than the related GAAP measurement and recognition requirements
- Tax basis statements are less costly to prepare than similar GAAP statements
- Supplemental operational information can be better tailored to meet client needs based on after-tax cash flow information.

A desire to avoid the requirement to comply with the new revenue recognition standard and the soon to be effective new leases and credit losses standards has resulted in even more private entities utilizing the tax basis.

When to Use Tax Basis Financial Statements

As noted earlier, in practice, most SPF financial statements are prepared on the income tax basis of accounting. There are several reasons for this:

1. Certain entities are structured based on tax law, so operations lend themselves well to this approach; real estate entities are a good example.
2. Since all enterprises must file tax returns, the recordkeeping already done for tax filings provides the basis for preparing financial statements.
3. Many businesses do not have access (or it would be cost prohibitive) to adopt the level of internal controls and hire the professional standards expertise demanded by U.S. GAAP necessary to adopt and apply generally accepted accounting principles.

However, the cash basis for financial statements is, of course, not suitable for companies with inventory or complex operations where significant activity would be excluded from presentation (i.e., an accrual basis taxpayer).

Recognition and measurement rules are fairly clear and specifically defined for the income tax basis. As the tax code and related treasury regulations, tax court cases, revenue rulings, et cetera collectively provide the framework authoritative guidance, most every area of measurement or recognition has guidance.

Often, questions arise on the basis of accounting used when a reporting entity has elected to use the cash method for income tax filings. Should the financial statements also be presented utilizing the cash or income tax basis? This is a question that practitioners will need to answer based on the needs of their clients and other users of the financial statements.

REGULATORY BASIS

Introduction

The regulatory basis of accounting is a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction

the entity is subject. The prescribed disclosures are set forth by the specific regulatory or governmental agency, along with many areas that would default to guidance under GAAP.

Applicability of Regulatory Basis

The practitioner must determine that the reporting entity is, in fact, a regulated company required to report financial information to the federal, state, or local government agencies that regulates it. Usually, the regulating agency requires unique reporting requirements and information related to the specific regulated process. Some entities that may be called upon to report using the regulatory basis include insurance companies, credit unions, construction contractors, certain state and local governmental entities, and even some non-profits.

While the regulator determines the requirement for the regulatory reporting framework, a strong working knowledge of GAAP is essential in understanding the differences and the inherent implications of certain differences.

While the financial statements of most regulated companies may differ from GAAP, some regulated operations are covered by GAAP. Topic 980, *Accounting for the Effects of Certain Types of Regulation*, has applied to many public utilities. However, many of these utilities were moved away from GAAP under GASB 62 effective after December 15, 2011. Accordingly, the practitioner must be familiar with all applicable prevailing standards for compliance.

Regulatory Basis Financial Statements

SSARS provides that the accountant should restrict the use of the report when the subject matter of the accountant's report or the presentation being reported upon is based on measurement or disclosure criteria contained in regulatory provisions that are not in conformity with an applicable financial reporting framework.

Common Modifications Required for a Regulatory Basis

Liquidation basis—The liquidation basis of accounting presents assets at amounts expected to be realized in liquidation and presents liabilities at amounts expected to be paid to creditors.

Example: To obtain information about an insurance company's ability to pay claims in the future, a state regulatory agency may require an insurance company to report certain balance sheet accounts on a liquidation basis rather than on a going concern basis.

Statutory basis—The statutory basis of accounting is used by insurance companies for filing financial information, reports, or statements with a state regulatory authority (and which may vary somewhat from state to state—described as permitted practices for a particular state). Prescribed statutory accounting practices are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. The primary emphasis of statutory accounting is on demonstrating solvency of insurance companies to the state regulatory.

CONTRACTUAL BASIS

Introduction

The contractual basis of accounting is a basis of accounting that the reporting entity uses to comply with an agreement between the reporting entity and one or more third parties other than the auditor or accountant. The prescribed disclosures are set forth by the specific contract agreement, along with many areas that would default to guidance under GAAP.

Applicability of Contractual Basis

The practitioner must determine that the reporting entity is required to report using a framework or measurement and recognition set forth in a contract of agreement, rather than what might be a supplemental or special purpose report, such as an incomplete information, specified elements, accounts, or items report, that may or may not require a contractual accounting framework. Reports issued using a contractual accounting basis must be a restricted use/limited distribution report.

While the parties to the contract or agreement determine the requirement for the contractual reporting framework, a strong working knowledge of GAAP is essential in understanding the differences and the inherent implications of certain differences.

Reviewed or compiled financial reports or statements using the contractual basis of accounting, like other SPF bases, require knowledge of GAAP so as to be able to distinguish and assess the implications of those differences.

Generally, a reporting entity reporting on the contractual basis as the SPF prepares financial statements that are restricted to use by third parties, primarily to assess compliance with the guiding contract or agreement. AU-C 800 and SSARS provide guidance for contractual basis engagements.

EXAMPLE

A contractor realizes that due to certain circumstances, he must consolidate one of his subcontractors under Topic 810 variable interest entities guidance. The only user of their financial statements is a bonding company that normally receives GAAP-based financial statements. In a call with the bonding company, the bonding company requested that the company not consolidate the subcontractor.

In this case, the contractor has two choices:

1. Issue GAAP financial statements and disclose a GAAP departure; or
 2. Issue a contractual basis financial statement because it is based on the user's requirements. In this case, the basis must be disclosed and the accountant must add an SPF paragraph to the report and restrict the use of the report to the bonding company.
-

FINANCIAL REPORTING FRAMEWORK FOR SMALL- AND MEDIUM-SIZED ENTITIES (FRF FOR SME)

Introduction

The FRF for SME is an AICPA initiative to create an additional SPF as an alternative to U.S. GAAP. The framework was recognized by authoritative literature when the ASB issued SAS 127, which added *other* to the list of SPFs in AU-C 800.

The FRF for SME document is designed to be a self-contained and stand-alone framework, providing comprehensive guidance pertaining to the accounting principles intended to be the most appropriate for the preparation of smaller businesses' financial statements and based on the needs of bankers and other users, and focusing on the performance of the company and its assets, liabilities, and cash flows.

The framework was constructed as a blend of traditional accounting principles, combined with accrual income tax accounting, so as to provide a familiar and intuitive reporting that should be easier understood by lenders, insurers, and other users of financial statements.

With greater emphasis on historical cost basis activity, rather than fair value and impairment focused, financial position and results are more tangible and understandable by third-party users, and since the reporting foundation doesn't necessarily impact cash flows analysis, this framework should be appealing to bankers and lenders.

The framework was developed and issued with the expectation that U.S. GAAP's *Revenue Recognition* and *Leasing* standards were anticipated to have been implemented in 2012. The delays in the effective dates for Topic 606 and Topic 842 may have delayed a more critical consideration by private companies of the FRF for SME alternative framework.

Attributes and Characteristics of Entities Suitable for FRF for SME

FRF for SME was developed as an SPF intended for small- to medium-sized entities that require reliable and comparable financial statements for internal and external use, and where financial statements are not required to be prepared in accordance with U.S. GAAP.

While there is not a definitive measure of whether a reporting entity is an SME, the framework does identify specific characteristics of a reporting entity that would meet the guidance associated with an SME, and thus provide a basis for consideration for management to adopt FRF for SME as the accounting and reporting framework. These characteristics include the following:

- The reporting entity does not have regulatory reporting requirements that would essentially require GAAP financial statements.
- Most owners and management do not intend to take the company public.
- The reporting entity is for-profit.
- The reporting entity is generally owner-managed (a closely held enterprise in which the people who own a controlling interest are substantially the same people who manage or run the business).

- Management or owners rely on financial statements to assess performance, cash flows, and managing assets and obligations (liabilities).
- The reporting entity is not in an industry involved in transactions requiring highly specialized accounting guidance (such as financial institutions or governmental entities).
- The reporting entity does not engage in overly complicated transactions.
- The reporting entity does not have significant foreign operations.
- The key users of the reporting entity's financial statements have direct access to management and additional supplemental financial data.
- The users of the reporting entity's financial statements have a greater interest in cash flows, liquidity, financial position strength, and interest coverage.

The financial statements support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral, guarantees, and/or other evaluative mechanisms not directly related to the financial statements.

Summary Overview of FRF for SMEs

Chapter 1—Financial Statement Concepts

This chapter describes the purpose and scope of FRF for SMEs, including qualitative characteristics of the basis of accounting as well as its financial statements elements.

Chapter 2—General Principles of Financial Statement Presentation and Accounting Policies

This chapter addresses financial statements, going concern issues, comparative information, and disclosure of accounting policies.

Chapter 3—Transition

Transition issues – converting an existing basis of accounting to FRF for SMEs

Chapter 4—Statement of Financial Position

The form and content of the statement of financial position is addressed, and the accounting elements in the statement of financial position are identified.

Chapter 5—Current Assets and Liabilities

Current assets include those assets ordinarily realizable within one year from the date of the statement of financial position or within the normal operating cycle, when the normal operating cycle is more than one year.

Current liabilities should include amounts payable within one year from the date of the statement of financial position or within the normal operating cycle, when the normal operating cycle is more

than one year. Current liabilities should include only that portion of long-term debt obligations, including sinking fund requirements, payable within one year from the date of the statement of financial position. *Due on demand and debt covenant violations* are addressed in the FRF for SMEs in the identical manner as U.S. GAAP.

Chapter 6—Special Accounting Considerations for Certain Financial Assets and Liabilities

Assets and liabilities should be recognized as financial assets or financial liabilities when the reporting entity becomes a party to the contract. When a financial asset is originated or acquired or a financial liability is issued or assumed in an arm's-length transaction, a reporting entity should measure the transaction amount adjusted for any financing fees and transaction costs that are directly attributable to its origination, acquisition, issuance, or assumption.

Chapter 7—Statement of Operations

The form and content of the statement of operations is addressed and the accounting elements in the statement of operations are identified.

Chapter 8—Statement of Cash Flows

The form and content of the statement of cash flows is addressed and the accounting elements in the statement of cash flows are identified.

Chapter 9—Accounting Changes, Changes in Accounting Estimate, and Correction of Errors

Changes in accounting policies are the result of:

- Changes required by the FRF for SMEs accounting framework; and
- Voluntary changes causing the financial statements to be more reliable with more relevant information about the effects of transactions, other events, or conditions on the reporting entity's financial position, financial performance, or cash flows.

Chapter 10—Risks and Uncertainties

Chapter 10 addresses the same risk and uncertainties topics that are addressed in U.S. GAAP with the identical related disclosures:

- Nature of operations
- Use of estimates in the preparation of financial statements
- Certain significant estimates
- Current vulnerability due to certain concentrations

Chapter 11—Equity, Debt, and Other Investments

As opposed to U.S. GAAP, investments in FRF for SMEs do not use fair value as a measurement and recognition method. The general approach is to apply historical cost for most investments while applying the equity method to those investments when the investor has significant influence over the investee (normally represented by the investor owning more than 20% of the outstanding shares of the investee).

Investments held for sale should be recognized and measured at market value. Changes in market value should be recognized in net income in the period incurred.

Chapter 12—Inventories

In FRF for SMEs, inventories as a current asset are measured at the lower of cost or net realizable value. Net realizable value requires adjustments or write-downs to ensure inventory values do not exceed the amounts expected to be realized from their sale or use.

Chapter 13—Intangible Assets

Recognition of intangible assets should take place when the asset is identifiable, the reporting entity has control of the asset, the cost of the asset can be measured reliably, the useful life of the asset can be estimated, and there exists the probability of future economic benefits. Intangible assets can be internally developed or acquired. Research expenditures should always be expensed.

- All intangible assets are considered to have finite useful lives and are amortized over those useful lives.
- Accounting for start-up costs is based upon an accounting policy choice made by the reporting entity. The accounting policy choice is to either expense start-up costs as incurred or capitalize start-up costs, amortizing the amount over 15 years.
- Accounting for expenditures on internally generated intangible assets during the development phase directs management to choose to either expense those expenditures as incurred or capitalize the expenditures.
- Goodwill should be recognized on a reporting entity's statement of financial position at the amount initially recognized, less amortization.
- Goodwill is not tested for impairment, and it should be amortized for a period not to exceed 15 years.

Chapter 14—Property, Plant, and Equipment

The recognition and measurement of property, plant, and equipment (and related depreciation) is based on cost incurred. The provisions of FRF for SMEs for property, plant, and equipment are identical to U.S. GAAP except for the accounting of capitalized interest during the acquisition, construction, or development over time. In FRF for SMEs, the reporting entity has an accounting policy choice to capitalize interest costs during the acquisition, construction, or development periods, or directly expense the interest cost incurred.

Chapter 15—Disposal of Long-Lived Assets and Discontinued Operations

Long-lived assets to be disposed of by sale follow the same criteria as U.S. GAAP. A sale of assets can be considered a discontinued operation if both of the following conditions are met:

- The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the reporting entity as a result of the disposal transaction.
- The reporting entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

Chapter 16—Commitments

Commitments are not measured or recognized in FRF for SMEs. Commitments that are material in relation to the current financial position or future operations should be disclosed.

Chapter 17—Contingencies

FRF for SMEs uses the same recognition, measurement, and disclosure guidance as is found in the FASB Codification in Topic 450, Contingencies, and classifies contingent losses as probable, possible, or remote. Contingent gains should not be recognized until realized. Guarantees are also recognized, measured, and disclosed in accordance with Topic 450. Disclosures are required even when the likelihood of performing on the guarantee is remote.

Chapter 18—Equity

The guidance in this chapter is established for equity and capital accounts of unincorporated businesses, partnerships, and limited liability entities. The guidance is virtually identical to private company U.S. GAAP. When a reporting entity reacquires its own shares, this guidance permits two methods of accounting for the acquisition of these shares: cost method (equivalent to the treasury stock method) and constructive retirement method.

Chapter 19—Revenue

Revenue guidance in FRF for SMEs is broad principles-based and does not include any industry-specific guidance. U.S. GAAP's revenue recognition guidance requiring that persuasive evidence of an arrangement must exist, the delivery has occurred or services have been rendered, the seller's price is fixed and determinable, and the collection is reasonably assured is implicit in the FRF for SMEs guidance. FRF for SMEs will prove substantively simpler than GAAP's enormous revenue standard, ASU 2014-09.

Chapter 20—Retirement and Other Postemployment Benefits

The measurement, recognition, and disclosure guidance in this chapter is similar to U.S. GAAP in the areas of:

- Defined contribution plans,
- Multiemployer plans,

- Deferred compensation contracts,
- Defined benefit plans, and
- Termination benefits.

The primary difference is related to defined benefit plans. Reporting entities have an accounting policy option to account for the defined benefit plan using the current contribution payable method or an accrued benefit obligation method. The current contribution payable method recognizes the annual payment as pension expense, while the accrued benefit obligation method accrues the benefits earned by the employees during each reporting period and recognizes the pension expense and the related pension liability.

Chapter 21—Income Taxes

FRF for SMEs permits an accounting policy choice to account for income taxes using either the taxes payable method or the deferred income taxes method. There are minimal deferred tax differences from FRF for SMEs as compared to U.S. GAAP, and FRF for SMEs requires no evaluation or accrual of uncertain tax positions.

Chapter 22—Subsidiaries

FRF for SMEs permits an accounting policy choice to either consolidate its subsidiaries or account for the subsidiaries using the equity method.

Chapter 23—Consolidated Financial Statements and Non-Controlling Interests

FRF for SMEs guidance is virtually identical to U.S. GAAP consolidation and non-controlling interest requirements related to majority ownership consolidation. There is no concept of variable interest entity guidance in FRF for SMEs. Parent-only financial statements are permitted within FRF for SMEs. The reporting entity's consolidation policy should be disclosed.

Chapter 24—Interests in Joint Ventures

Reporting entities following FRF for SMEs guidance have an accounting policy choice to either account for the reporting entity's investment in the joint venture using the equity method or proportionate consolidation. Proportionate consolidation is only applicable to unincorporated reporting entities when it is an established industry practice.

Chapter 25—Leases

The FRF for SMEs references the transferring of substantially all the benefits and risks of ownership to the lessee. The FRF for SMEs guidance is substantially the same as income tax basis for lease accounting. Lease transactions between related parties should be accounted for and classified in accordance with the terms of the lease agreement, similar to other leases.

Chapter 26—Related-Party Transactions

Related-party identification and disclosure issues in FRF for SMEs are identical to current U.S. GAAP.

Chapter 27—Subsequent Events

As with U.S. GAAP, there are two types of subsequent events in FRF for SMEs: those events that provide further evidence of conditions that existed at the statement of financial position date, and those events that are indicative of conditions that arose subsequent to the statement of financial position date.

Chapter 28—Business Combinations

FRF for SMEs provides extensive recognition, measurement, and disclosure guidance in the area of business combinations. It requires the acquisition method for business combinations, which is identical to U.S. GAAP except U.S. GAAP requires that the net identifiable assets acquired be measured at acquisition date fair values, while the FRF for SMEs requires that the net identifiable assets be measured at their acquisition date market values.

Market value in FRF for SMEs is defined as “the amount of the consideration that would be agreed upon in an arm’s-length transaction between knowledgeable, willing parties who are under no compulsion to act.” Therefore, market value in FRF for SMEs is the negotiated value between the buyer and seller, not the market participant value associated with fair value. This is a significant difference between U.S. GAAP and FRF for SMEs.

Chapter 29—New Basis (Push Down) Accounting

Push down accounting consists of a comprehensive revaluation of assets and liabilities by reporting entities to establish a new cost basis. This is not required in current U.S. GAAP. Push down accounting is permitted in FRF for SMEs when a reporting entity gains control of another entity (acquires more than 50% of the voting interests).

As stated in FRF for SMEs, “the application of push down accounting provides symmetry between the carrying amounts of assets and liabilities reported in the acquired entity’s financial statements and the carrying amounts of assets and liabilities in the consolidated financial statements of the parent.” Retained earnings are adjusted for any excess debit or credit resulting from this revaluation.

Chapter 30—Non-Monetary Transactions

This chapter is identical to current U.S. GAAP.

Chapter 31—Foreign Currency Translation

The guidance in the chapter relates to situations when the reporting entity purchases or sells goods or services on credit, with settlement in a foreign currency. During the settlement period, the reporting entity has recorded a payable or receivable in that foreign currency.

For each monetary item denominated in a foreign currency at the statement of financial position date, the amount should be translated to reflect the exchange rate in effect at that date. An exchange

rate gain or loss exists when a foreign currency denominated monetary item is settled or translated at an exchange rate different from the one at which the transaction was previously recorded or carried.

PRACTICE GUIDE REPORTING

The following material illustrates review and compilation reports for SPF.

Tax Basis Reporting Issues for Reviews and Compilations

This section discusses review and compilation presentations based on the tax basis SPF. Overall, the basis of accounting has minimal impact on reporting requirements, although applying rules on modifications to the standard report can be less straightforward than it is for GAAP engagements.

The basic reporting requirements for SPF are the same regardless of the level of service:

- The financial statement titles mentioned in the report must correspond to the SPF titles used on the face of the financial statements.
- Instead of references to *presenting fairly in accordance with GAAP*, review reports refer to presenting fairly on *the basis of accounting described in Note X*. (Since no assurance is provided on compilations, there is no such reference.)

The following examples illustrate these requirements:

- Review report—tax basis
- Compilation report—tax basis—full disclosure
- Compilation report—tax basis—omitted disclosures

FIGURE 6.1: Review Report —Tax Basis

Independent Accountant's Review Report

To the Board of Directors or Partners:

We have reviewed the accompanying financial statements of Macklain Partnership, which comprise the statement of assets, liabilities, and partners' capital—tax basis as of December 31, 20XX, and the related statements of revenue and expenses—tax basis, and partners' capital—tax basis for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to partners' financial data and making inquiries of partnership management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Partners are responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the partnership uses for income tax purposes; this includes determining that the basis of accounting the partnership uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances. Partners are also responsible for the design, implementation, and maintenance of internal control

relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the partnership uses for income tax purposes. We believe the results of our procedures provide a reasonable basis for our conclusion.

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the basis of accounting the partnership uses for income tax purposes.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the partnership uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

FIGURE 6.2: Compilation Report—Tax Basis—Full Disclosure

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Stockholders:

Management is responsible for the accompanying financial statements of Macklain 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 (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

We draw attention to Note 1 of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

FIGURE 6.3: Example Compilation Report—Tax Basis—Omitted Disclosures

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Partners:

Management is responsible for the accompanying financial statements of Macklain Partnership, which comprise the statements of assets, liabilities, and partners' capital—tax basis as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—tax basis, and changes in partners' capital—tax basis for the years then ended in accordance with the tax basis of accounting, and for determining that the tax basis of accounting is an acceptable financial reporting framework. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

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

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

Material Uncertainties/Going Concern

Guidance on uncertainties in reports is no different for tax basis presentations than it is for GAAP. There is no such thing as a qualified report or disclaimer for compilations and reviews; the only possibility is including an emphasis-of-a-matter paragraph, which is generally optional.

Going concern was discussed earlier in these course materials. The fact that a reporting entity presents its financial statements using an SPF does not change the guidance previously discussed.

That said, going-concern uncertainties can be less obvious in tax basis presentations because of the recognition and measurement rules applied. In tax basis financial statements, accruals, reserves, and impairments may not be recorded; this serves to accelerate recognition of revenues and delay recognition of expenses, while causing assets to appear larger in relation to liabilities.

Questions often arise on how a modification to a compilation report can be optional when there are going concern issues on a compilation without disclosures. The justification for this is that the paragraph explaining the omitted disclosures warns that the financial statements are not intended for those who are not informed about matters significant to the company. However, the standards also provide that an accountant is not to prepare or compile financial statements that omit disclosures if the accountant has a concern that the intent of the omission is to mislead users of the financial statement. In the author's view, this is clearly the case where there are going-concern issues. Accordingly, the author strongly recommends that a selected disclosure be made of the going-concern matters. If the client refuses to make such disclosure, the author recommends withdrawing from the compilation engagement.

Material uncertainty – Failure to adequately disclose a material uncertainty when there is a full disclosure compilation or review is a tax basis departure that requires a report modification.

If the accountant determines that the client's disclosure is adequate, but chooses to modify the compilation or review report with an emphasis of matter paragraph, the following language should be used:

As disclosed in Note A, the company is currently named as a defendant in a legal action. The company has determined that it is not possible to predict the eventual outcome of the legal action but has determined that the resolution of the action will not result in an adverse judgment that would materially affect the financial statements. Accordingly, the accompanying financial statements do not include any adjustments related to legal action under Topic 450, Contingencies.

Consistency

In GAAP presentations, exceptions to consistency normally arise because the reporting entity has voluntarily changed from one acceptable method to another preferable method, or because there has been a change in GAAP rules that were implemented during the period presented.

For tax basis, the most common consistency issue occurs when a reporting entity decides to change from GAAP to income tax or cash basis. Keep in mind that it is not appropriate to issue comparative financial statements on two different bases of accounting. Either single year financial statements can be issued, or the prior year must be restated to the new basis in comparative presentations.

TAKE NOTE

The 2017 Tax Cuts and Jobs Act contains changes in a number of areas of recognition and deduction. IRC §451 has established an “all events test” for tax recognition of sales for accrual taxpayers with greater than \$25 million in sales. This new recognition criterion greatly resembles GAAP revenue recognition as prescribed in Topic 606. This may come into play in comparative tax basis financial statements, and may complicate footnote disclosures.

Regardless of the level of service, a report paragraph for the change in basis of accounting is optional; there is no requirement to modify the report. If such a paragraph is used, it might read as follows:

FIGURE 6.4: Optional Paragraph for Change in Basis of Accounting—GAAP to Tax Basis

As discussed in Note X to the financial statements, in 20XX, the company adopted a policy of preparing its financial statements on the accrual method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. The financial statements for 20XX have been restated to reflect the accrual method income tax basis of accounting adopted in 20XX.

A common question that arises is whether a change in tax law results in a change in accounting principle for a reporting entity reporting on the income tax basis. Per the AICPA practice aid, the answer is *no*; however, disclosure of the change may be necessary.

Modifications to the Basic Report—Tax Basis Departures

Departures from the basis of accounting used must be mentioned in a separate paragraph of the report, regardless of the level of service.

For reviews, the limited assurance paragraph will include *except* for language. For compilations, wording is added to explain that the accountant became aware of a departure.

FRF for SME Reporting Issues for Reviews and Compilations

Specific guidance on review and compilation presentations based on the FRF for SME basis SPF is being developed by the AICPA. However, the basis of accounting has minimal impact on reporting requirements, although applying rules on modifications to the standard report can be less straightforward than it is for GAAP engagements.

While the financial statement titles mentioned in the report must correspond to the SPF titles used on the face of the financial statements, there must still be something to distinguish between GAAP and the FRF for SME framework to alert readers/users that the statements are not GAAP statements.

As with other SPF presentations, instead of references to *presenting fairly in accordance with GAAP*, review reports refer to presenting fairly on *the basis of accounting described in Note X*. (Since no assurance is provided on compilations, there is no such reference).

The following examples illustrate these requirements:

- Review report—FRF for SMEs basis
 - Compilation report—FRF for SMEs basis—full disclosure
 - Compilation report—FRF for SMEs basis—non-disclosure
-

FIGURE 6.5: Review Report—FRF for SME Basis

Independent Accountant's Review Report

To the Board of Directors or Partners:

We have reviewed the accompanying financial statements of Macklain Partnership, which comprise the statement of financial position as of December 31, 20XX, and the related statements of operations and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the AICPA Financial Reporting Framework for Small- and Medium-Sized Entities; this includes determining that the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities. We believe the results of our procedures provide a reasonable basis for our conclusion.

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting of the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

FIGURE 6.6: Compilation Report—FRF for SMEs Basis—Full Disclosure

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Stockholders:

Management is responsible for the accompanying financial statements of Macklain Company, which comprise the statements of financial position as of December 31, 20X2 and 20X1, and the related statements of operations and cash flows for the years then ended, and the related notes to the financial statements in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, and for determining that the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities is an acceptable financial reporting framework. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

FIGURE 6.7: Example Compilation Report—FRF for SMEs Basis—Omitted Disclosures

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Partners:

Management is responsible for the accompanying financial statements of Macklain Partnership, which comprise the statements of financial position as of December 31, 20X2 and 20X1, and the related statements of operations and cash flows for the years then ended in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, and for determining that the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities is an acceptable financial reporting framework. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities. 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]

Modifications to the Basic Report—FRF for SMEs Departures

Departures from the FRF for SMEs basis of accounting must be mentioned in a separate paragraph of the report, regardless of the level of service.

On reviews, the limited assurance paragraph will include *except* for language. On compilations, wording is added to explain that the accountant became aware of a departure.

Cash Basis Reporting Issues for Reviews and Compilations

The cash basis of accounting is defined in AU-C 800 as:

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

This section discusses review and compilation presentations based on the cash basis SPF. Overall, the basis of accounting has minimal impact on reporting requirements, although applying rules on modifications to the standard report can be less straightforward than it is for GAAP engagements.

The basic reporting requirements for SPF are the same as GAAP, regardless of the level of service.

- The financial statement titles mentioned in the report must correspond to the cash basis titles used on the face of the financial statements.
- Instead of references to *presenting fairly in accordance with GAAP*, review reports refer to presenting fairly on *the basis of accounting described in Note X*. (Since no assurance is provided on compilations, there is no such reference.)

The following examples illustrate these requirements:

- Review report—cash basis
- Compilation report—modified cash basis—full disclosure
- Compilation report—cash basis—non-disclosure

FIGURE 6.8: Review Report—Cash Basis

Independent Accountant's Review Report

To the Board of Directors or Partners:

We have reviewed the accompanying financial statements of Macklain Partnership, which comprise the statement of assets, liabilities, and partners' capital—cash basis as of December 31, 20XX, and the related statements of revenue and expenses—cash basis, and partners' capital—cash basis for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statement as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the cash basis. This includes determining that the cash basis is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the cash basis. We believe the results of our procedures provide a reasonable basis for our conclusion.

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the cash basis of accounting.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

FIGURE 6.9: Compilation Report—Modified Cash Basis—Full Disclosure

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Stockholders:

Management is responsible for the accompanying financial statements of Macklain Company, which comprise the statements of assets, liabilities, and equity—modified cash basis as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—modified cash basis for the years then ended, and the related notes to the financial statements in accordance with the modified cash basis, and for determining that the modified cash basis is an acceptable financial reporting framework. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the modified cash basis, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

FIGURE 6.10: Compilation Report—Cash Basis—Non-Disclosure

Independent Accountant's Compilation Report (Optional Header)

To the Board of Directors or Partners:

Management is responsible for the accompanying financial statements of Macklain Partnership, which comprise the statements of assets, liabilities, and equity—cash basis as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—cash basis, and changes in partners' capital—cash basis for the years then ended in accordance with the cash basis of accounting, and for determining that the cash 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 (SSARS) 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 or a conclusion nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the cash 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]

Modifications to the Basic Report—Cash Basis Departures

Departures from the basis of accounting used must be mentioned in a separate paragraph of the report, regardless of the level of service.

On reviews, the limited assurance paragraph will include *except* for language. On compilations, wording is added to explain that the accountant became aware of a departure.

Contractual Basis Reporting Issues for Reviews and Compilations

A report on financial statements utilizing the contractual basis is restricted for use to the parties bound by the guiding contract agreement.

FIGURE 6.11: Review Report—Contractual Basis

Independent Accountant's Review Report

To the Management of Macklain, Inc., and Finnigan, Inc.:

We have reviewed the accompanying financial statements of Macklain, Inc., which comprises the assets and liabilities—contractual basis as of December 31, 20X1, and the revenue and expenses—contractual basis, changes in equity—contractual basis, and cash flows—contractual basis for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the contractual basis of accounting. This includes determining that the contractual basis of accounting is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with the contractual basis of accounting. We believe the results of our procedures provide a reasonable basis for our conclusion.

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the contractual basis of accounting in accordance with the financial reporting provisions of Section L of the contract.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the contractual basis of accounting. The financial statements are prepared in accordance with the contractual basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

Restrictions on Use

Our report is intended for the information and use of Macklain, Inc., and Finnegan, Inc., and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Regulatory Basis Reporting Issues for Reviews and Compilations

The principal issues for the regulatory basis of accounting are found in the audit literature, and therefore, are outside the scope of this program.

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