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**PRACTICE ISSUES – PERSONAL FINANCIAL STATEMENTS,
PRO FORMA FINANCIAL INFORMATION, AND MORE
(COURSE #5415G/QAS5415G)**

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Practice Issues

Objectives:

- Discuss how the rules for personal financial statements are applied.
- Recognize the rules for supplementary information.
- Identify the changes in peer review and deficiencies found in peer review engagements.
- Explain how to tighten up engagement letters.

A. Personal Financial Statements and Prescribed Forms

CPAs are frequently asked to compile or review the personal financial statements of individuals or families applying for credit; perform income tax, retirement, gift, or estate planning; or provide public disclosure about their financial affairs (for example, individuals seeking public office).

1. Authority for Personal Financial Statements:

SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, establishes accounting standards for GAAP-basis personal financial statements. The statement:

- a) Requires that assets be stated at their estimated current values, and liabilities at their estimated current amounts.

The current value is the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.

The costs of disposal of assets, if material, should be deducted in computing current values.

- b) Required financial statements:

Statement of Net Worth – Required
Statement of Changes in Net Worth – Optional

- c) A hypothetical income tax must be presented in the liability section computed as follows:

Estimated FMV of net assets	xx
– Tax basis of net assets	<u>xx</u>
Hypothetical gain	xx
x Tax rate(s)	<u>xx%</u>
= Estimated income tax on difference between the fair value and tax basis of net assets	<u>xx</u>

[Presented as a liability on the statement of net worth]

What does the compilation or review report for personal financial statements look like?

The report is essentially the same as the traditional compilation or review report. However, if substantially all disclosures are omitted, the report must disclose that the assets are presented at their estimated current values and liabilities at their estimated amount. Generally this additional disclosure is placed in the first or last paragraph of the report.

Sample Report – Substantially All Disclosures Are Omitted

Fred and Mary Jones
20 Main Street
Winchester, MA 01890

We have compiled the accompanying statement of financial condition of Fred and Mary Jones as of December 31, 20XX, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. These financial statements are intended to present the assets of Fred and Mary Jones at their estimated current values and their liabilities at estimated amounts.

A compilation is limited to presenting, in the form of financial statements, information that is the representation of the individuals whose financial statements are presented. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The individuals whose financial statements are presented have elected to omit substantially all disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the individuals' assets, liabilities, and net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA

2. OCBOA Personal Financial Statements:

A client may present personal financial statements using an OCBOA (other comprehensive basis of accounting, such as cash, income tax basis, etc.) provided the financial statements or the report discloses the basis of accounting and how it differs from GAAP.

If this is the case, OCBOA titles must be used such as **Statement of Assets and Liabilities – Income Tax Basis.**

3. Personal Financial Statements Issued as Part of a Personal Financial Plan:

A CPA may be asked to include a personal financial statement as part of a personal financial plan. Must the statement be compiled or reviewed along with the related report being attached?

SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans*, may also apply to personal financial statement engagements. SSARS No. 6 provides an exemption from SSARS No. 1 (e.g., no compilation or review report is required nor the related procedures) for personal financial statements included in written personal financial plans if the following conditions are met:

- a) The CPA establishes an understanding with the client preferably in writing, that the financial statements:
 - Will be used solely to assist the client and the client's advisers in developing the client's personal financial goals and objectives.
 - Will not be used to obtain credit or for any purpose other than developing these goals and objectives.
- b) Nothing comes to the CPA's attention during the engagement that would cause the CPA to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.

Example of Report Issued in a Written Personal Financial Plan: SSARS No. 6:

*The accompanying Statement of Financial Condition of Susan and Joseph Miller, as of December 31, 20X1, was prepared **solely to help you develop your personal financial plan**. Accordingly, it may be incomplete or contain other departures from generally accepted accounting principles and **should not be used to obtain credit or for any purposes other than developing your financial plan**. We have not audited, reviewed, or compiled the statement.*

Each of the personal financial statements should include a reference to the accountant's report such as:

See Accountant's Report

4. Obtaining a Management Representation Letter for a Compilation of Personal Financial Statements:

If the CPA compiles personal financial statements, he or she may wish to obtain a management representation letter in which management represents the values assigned to various assets and liabilities.

5. Prescribed Form Compilations – SSARS No. 3:

SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, was issued in 1981. This Statement allows an alternative to a SSARS No. 1 compilation report **when departures from GAAP are required to comply with a prescribed form** required by a third party such as a bank's prescribed form financial statement.

In some instances, the third party's prescribed form does not comply with GAAP in terms of format and disclosures. Absent the flexibility allowed by SSARS No. 3, a standard compilation report would have to make reference to any GAAP departures. However, a prescribed form (such as a bank's financial statement form) assumes that the third party receiving the financial statements is fully aware of the GAAP departures.

What is a prescribed form?

A prescribed form:

- a) Is a **standard preprinted (financial statement) form** designed or adopted by the body to which it is to be submitted, such as a bank financial statement.
 - Examples may include a financial statement on a bank's preprinted form.
 - A prescribed form can include a prescribed form using an electronic format. Example: A bank requires financial information on a CD/diskette or sent electronically.
- b) It **does not** include:
 - 1) A form designed or adopted by the entity for whom the financial statements are being compiled. Example: A report package designed by a company to gather information for its divisions, stores, etc.
 - 2) A tax return, although it is a prescribed form, is not a financial statement and not covered by SSARS No. 3.
 - 3) A comprehensive set of instructions, directing a particular form, is not a standard reprinted form."

Sample of Prescribed Form Compilation Report: SSARS No. 3

To the Board of Directors
X Corporation
Boston, Massachusetts

We have compiled the balance sheet of X Corporation as of December 31, 20XX, and the statement of income and retained earnings for the year then ended included in the **accompanying prescribed form** in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

Our compilation was limited to presenting in the **form prescribed by No Loan Bank** information that is the representation of management. We have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the **requirements of No Loan Bank which differ from generally accepted accounting principles**. Accordingly, these financial statements are not designed for those who are not informed about such differences.

James J. Fox & Company

May prescribed form financial statements include departures from GAAP?

Response: It is assumed that a set of financial statements presented in accordance with a prescribed form may not be in accordance with GAAP. In fact, the prescribed form compilation report (above) makes reference to the fact that the statements may not be in conformity with GAAP.

Thus, there are no additional disclosures required nor any further report modifications beyond disclosures required to comply with the prescribed form.

In essence, **GAAP is replaced** with the rules governed by the third party requesting the prescribed form.

In certain situations, there may be a departure from the requirements of the prescribed form. In this case, the CPA must modify the compilation report by adding an additional paragraph as follows:

Sample of Prescribed Form Compilation Report: SSARS No. 3 – Departure

Board of Directors
No Chance Co.
Nowhere to Go, MA

We have compiled the balance sheet of X Corporation as of December 31, 20XX, and the related statements of income and retained earnings, cash flows and supplementary schedules for the year then ended included in the ***accompanying prescribed form*** in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

Our compilation was limited to presenting in the ***form prescribed by the No Loan Bank*** information that is the representation of management. We have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them. ***However, we did become aware of a departure from the requirements of the prescribed form as described in the following paragraph.***

The prescribed form requires that all investments be presented at appraisal value. The Company has presented its investments at cost. The effect of this departure has not been determined.

These financial statements (including related disclosures) are presented in accordance with the requirements of No Loan Bank, which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

James J. Fox & Company

Note: If the effect of the departure is known, it should be disclosed.

6. Prescribed Form Personal Financial Statements:

One of the more effective places to use prescribed form financial statements is when preparing personal financial statements for submission to a bank. In connection with many business or individual loans, a bank usually requires an annual personal financial statement to ensure the financial stability of the owner and/or guarantor of the loan. In this case, the CPA has several options:

- a) Prepare a personal financial statement in accordance with GAAP which usually includes a statement of financial condition and an optional statement of changes in net worth.
- b) Prepare the bank's prescribed form financial statement.

Many banks now require that the CPA and/or client submit their prescribed form instead of the CPA's compiled financial statement printed on his or her stationery. If this is the case, the CPA can prepare the bank's preprinted personal financial statement and attach a prescribed form compilation report similar to the one noted below.

Mr. Fred Jones
Burlington, MA

I have compiled the **personal financial statement of Fred and Sally Jones** as of December 31, 20XX, included in the **accompanying prescribed form** in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. I also have compiled the supplementary information presented in the prescribed form.

My compilation was limited to presenting in **the form prescribed by NoLoan Bank** information that is the representation of the individual whose financial statement is presented. I have not audited or reviewed the financial statement and supplementary information referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

The financial statement (including related disclosures) and the supplementary information are presented in accordance with the requirements of NoLoan Bank, which **differ from generally accepted accounting principles**. Accordingly, this financial statement and supplementary information are not designed for those who are not informed about such differences.

Jimmy Fox, CPA

Observation: Notice that the above report makes reference to supplementary information and related disclosures. Typically, the banks' prescribed form personal financial statement includes much more information than a statement of financial condition. For example, the traditional prescribed bank form usually includes a series of questions, a request for information on the purchase of investments and real estate, etc. This information should be considered as supplementary information and should be reported on accordingly. Further, because a prescribed form report is governed by the SSARs, each page of the prescribed form should state "See Accountant's Compilation Report."

B. Assurance Services – An Engagement Expansion Opportunity

The AICPA's Special Committee on Assurance Services reports that the market for traditional accounting and auditing and tax services is relatively flat. Given the great challenge that awaits the Profession if it does not expand into new services, the Committee has been developing new service opportunities for CPAs. One type of engagement that may drive growth opportunity is providing clients with information about their businesses in the form of performance measures. Such information would tell management whether it has achieved its performance objectives.

These new services could double or triple revenue from assurance services in the U.S.

1. Areas targeted for assurance services include:

- a) **Elder Care Services:** Such as investment portfolios, health care contracts and nursing home services, handling elderly clients' bill payments, making personal visits to check up on their well being, arranging transportation, tax preparation, etc.

Consider the breadth of this market:¹

- Approximately 20 million people are 75 years or older.
- \$11-13 trillion of wealth is held by peoples age 65 or older.
- The percentage of older people living by themselves is increasing at a significant rate – increasing the need for third party assistance.
- Annual market for eldercare services is \$2-7 billion.
- Estimated average fees for CPAs is \$300 to \$1,500 per month, per client.

- b) **Risk assessment:** The CPA prepares a report on the amount of risk borne by businesses in areas such as:

- Environmental practices
- Business processes
- Information systems

- c) **Entity performance engagements:** Dealing with the relevance of an entity's performance and the reliability of information systems, to be used by the client's management and other third parties.

Examples include systems reliability, electronic commerce and services to the health care and education industries, and financial management efficiencies.

Example: A company establishes an objective to reduce receivables collection time from 60 to 45 days by selling only to customers who meet certain criteria, and requests that the CPA assist in evaluating its objective.

Performance measure: The CPA performs the service of assessing whether the company does, in fact, reduce receivables to 45 days.

2. Criteria of a performance measure engagement – assurance services:

An assurance services engagement (e.g. performance measure engagement) has the following steps:

- a) Client determines what its current performance measures are and whether they are consistent with its overall business strategy and primary objectives.

For example, assume a client has a business strategy to expand market share of product X within the international market.

Management decides the primary objective is to maximize cash flows and current earnings or to build the value of the business for ultimate sale.

¹ Source of statistics: AICPA CPA ElderCare Services Alert.

Note: The CPA may be involved in assisting the client to determine its business strategy and objectives.

- b) CPA analyzes client's business by identifying all of its processes and focusing on key indicators for that business.

Examples include:

Volume and price	Relationship with suppliers
Collections	Product promotion
Cash flows	Financing
Quality of the product	Customer satisfaction

- c) CPA develops an understanding of client's strengths and weaknesses.
- d) CPA assists management in developing an action plan for achieving its objectives that includes:
- The required actions needed
 - Individuals responsible for those actions
 - Timing of those actions
 - Required resources such as outside specialists, advisors, etc.
- e) CPA assists management to develop performance measures to monitor the action plan.

C. Financial Statements Submitted in Litigation Support Engagements Involving Bankruptcy and Reorganization

CPAs may be required to prepare financial statements for submission to a court in connection with litigation services in the areas of bankruptcy and reorganization.

Example: A CPA, operating as a trustee or debtor in possession, submits a monthly operating report to a court in connection with a company in a Chapter 11 bankruptcy proceeding.

Generally, providing a monthly operating report and other similar financial presentations would be deemed a submission of financial statements subject to the requirements of SSARS No. 1.

Special Exception: Interpretation No. 20 of SSARS No. 1, *Applicability of Statements on Standards for Accounting and Review Services to Litigation Services*, **exempts** such financial statements from the applicability of SSARS No. 1 if the following apply:

- a) The statements are **submitted in conjunction with litigation services** that involve pending or potential formal legal or regulatory proceedings before a trier of fact (e.g., a court, regulatory body, or government authority, their agents, a grand jury, arbitrator or mediator of the dispute).
- b) The services are in connection with the resolution of a dispute between two or more parties.

- c) One of the **four** following criteria is met:
- The service consists of being an expert witness.
 - The service consists of being a trier of fact or acting on behalf of one.
 - The CPA's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.

Example: Parties-in-interest (e.g., creditors, debtors, lenders, stockholders, etc.) are provided with access to the financial statements submitted to the court, and they have the opportunity to analyze and challenge them.

- The CPA is engaged by an attorney to do work that will be protected by the attorney's work product privilege and such work is not intended to be used for other purposes.

Note: The exemption from SSARS No. 1 does not apply if the CPA is specifically engaged to compile the financial statements or, if others do not have the opportunity to analyze and challenge the CPA's work under the rules of the proceedings.

D. Campaign Reports

Question: What is a CPA's reporting responsibility when engaged to prepare a campaign report for a candidate running for public office where the following reports are required?

Preprinted forms consisting of the following information:

- Subtotals of each type of receipt, disbursement, and totals of each.
- A financial summary which reconciles funds on hand at the beginning of the period with the balance at the end of the period.

Response: Generally, such a presentation is considered a prescribed form financial statement that should be compiled in accordance with SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*.

A prescribed form is defined in paragraph 2 of SSARS No. 3 as:

Any standard preprinted form designed or adopted by the Body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

If a CPA is serving as a treasurer for the candidate or campaign committee, the CPA probably should not compile the financial statements. Why? Because a compilation report is used by an outside CPA to report on financial statements that are the representations of another party. As treasurer, the CPA is a member of management and should not report on his or her own representation. This is the case regardless of whether the CPA notes his or her lack of independence within the compilation report.

This opinion is based on Technical Practice Aid 22 which is non-authoritative. Conceivably, the treasurer could issue a compilation report and state the lack of independence in accordance with SSARS No. 1.

Example of a Prescribed Form Report for Campaign Reports:

We have compiled the statement of financial condition of Mr. Harry Jones as of December 31, 20X1 included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

Our compilation was limited to presenting in the form prescribed by _____ information that is the representation of the individuals whose financial statement is presented. We have not audited or reviewed the financial statement referred to above and, accordingly, do not express an opinion or any other form of assurance on it.

This financial statement is presented in accordance with the requirements of _____, which **differ from generally accepted accounting principles**. Accordingly, this financial statement is not designed for those who are not informed about such differences.

Jimmy Fox

Please see a further discussion of prescribed form reports elsewhere in this chapter.

E. Financial Statements Submitted Electronically

Regulatory bodies or other users of financial statements may request that financial statements that have been compiled or reviewed be **submitted** on a computer disk or through a data transmission network.

1) SSARSs **are applicable** to financial statements submitted on:

- Computer disk/CD
- Through a data transmission network (modem).

At a **minimum**, a CPA must at least compile the financial statements.

- The accountant's report may be included on the disk or transmitted electronically through the data transmission network.
- A hard copy of the financial statements and accountant's report **does not have to be submitted**. There is **no requirement that the report be signed** manually.

2) Submitting financial statements that are on a prescribed form, using an electronic format.

- The CPA should follow the requirements of SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*.

- A prescribed form is a standard preprinted form designed or adopted by the body to which it is to be submitted.

Examples: Forms used by industry trade associations, credit agencies, banks (personal financial statements), and governmental and regulatory bodies.

When financial statements are submitted electronically, should they be sent in a Word® or other word processing format, or in a PDF format?

Response: If financial statements are sent in a word processing format with the report presumably scanned onto the CPA firm's letterhead, there is the risk that the client could change the financial statements and report prior to submitting them to a third party. If, instead, the financial statements and report are scanned into a PDF format (using Adobe® Acrobat), and then sent electronically to the client, the documents are in a "read only" format, and cannot be changed without copying the PDF file into a word processing file. There is no authority as to which format is appropriate. The author believes that a practical approach should be applied toward sending information electronically. If a client's goal is to change the CPA's financial statements, that goal can be easily achieved regardless of the format in which they are received. This is the case whether the financial statements are in an electronic or paper format. Yes, it would be more prudent to send the financial statements in a PDF format; however, there is no requirement to do so.

How should the financial statements be signed if sent in an electronic version?

Response: There is no authority as to how a firm's signature should be adhered to the report. Obviously, use of a manual signature is not an option in an electronic format. Most firms scan the firm's signature into the Word® or PDF file.

Should the report include the firm's letterhead?

Response: Although professional standards do not require the CPA's report to be printed on the firm's letterhead, most firms print paper financial statements on their letterhead to add a level of formality to the presentation. The author recommends that the firm scan their letterhead into the report file. If the firm's letterhead is not scanned onto the report, a heading such as Accountant's Report may be useful to reduce any misunderstanding about the document.

F. Reporting on Budgets

At times, a CPA will be asked to present financial statements for the fiscal year along with budgeted financial statements on a comparative basis.

Example: Actual financial statements for the year ended June 30, 20X1 are presented with the budget for the year ended June 30, 20X1.

If a CPA is engaged to report on such a presentation, the budgeted information for the expired period should be treated as **supplementary information in accordance with paragraph 43 of SSARS No. 1.**

Example: CPA must identify responsibility for the supplementary information in his or her report.

Note: Although the budgeted information was once prospective information, it is no longer prospective information once the period has expired.

Example of Report When Compiled Financial Statements Are Accompanied by a Budgeted Income Statement for an Expired Period.

We have compiled the accompanying balance sheet of NXJ Company as of June 30, 20X1, and the related statements of income- **historical and budgeted**, retained earnings and cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. **The budgeted income statement information is presented for supplementary analysis purposes only.**

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements **(including the budgeted income statement information)** and, accordingly, do not express an opinion or any other form of assurance on them.

Jimmy Fox, CPA

Sample Statement of Income:

NXJ Company
Statement of Income- Historical and Budgeted
For The Six Months Ended June 30, 20X1
(See Accountant's Compilation Report)

	<u>Actual</u>	<u>Budgeted</u>	<u>Variance</u>
Net sales	\$xx	\$xx	\$xx
Cost of sales	xx	xx	xx
Gross profit on sales	xx	xx	xx
Operating expenses	xx	xx	xx
Net operating income	xx	xx	xx
Other income	xx	xx	xx
Net income before income taxes	xx	xx	xx
Income taxes	xx	xx	xx
Net income	\$xx	\$xx	\$xx

Prospective information presented for an unexpired period

If a CPA is asked to report on prospective financial information for an unexpired period, SSAE No. 10, *Attestation Standards*, would apply.

However, if budgeted financial information for an unexpired period is **presented along with historical financial statements**, there is a special provision found in the AICPA Audit and Accounting Guide entitled, *Guide for Prospective Financial Information*.

Under this provision:

- The CPA may report on the historical statements under SSARS No. 1, and
- **Disclaim** on the prospective budgeted financial information.

Further, the CPA is **not required to apply any procedures** typically required for prospective budgeted financial information as long as the information:

- a) Is labeled as budgeted,
- b) Does not extend beyond the current fiscal year, and
- c) Is presented with interim historical financial statements for the current year.

If the above criteria are met, the CPA **is not required** to:

- a) Apply compilation, agreed-upon, or examination procedures to the prospective budgeted financial information, even if the information is intended for third parties.
- b) Disclose significant assumptions or accounting policies that would ordinarily be required for prospective budgeted information, provided the omission of this information is not, to the CPA's knowledge, undertaken with the intention of misleading those who might use it.

The CPA issues a report indicating that he or she did not examine or compile the budgeted information, and **disclaiming an opinion** or any other form of assurance on the budget.

Example: A company issues historical financial statements for the six-month period ending June 30, 20X1 and prospective statements for the year ended December 31, 20X1. The report would look like this.

Compilation Report: Six Months Historical Financial Statements and Twelve Months Prospective Financial Statements

We have compiled the accompanying balance sheet of XYZ Corporation as of June 30, 20X1, and the related statements of income, retained earnings, and cash flows for the six-month period then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements, information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The **accompanying budget** of XYZ Corporation for the year ending December 31, 20X1, **has not been compiled or examined by me**, and, accordingly, **we do not express an opinion or any other form of assurance on it.**

Management has elected to **omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements.** If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the Company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

Harry Callahan, CPA

XYZ CORPORATION
STATEMENT OF INCOME
FOR THE SIX MONTH PERIOD ENDED
JUNE 30, 20X1 AND BUDGETED
INFORMATION FOR THE YEAR ENDED DECEMBER 31, 20X1
(See Accountant's Compilation Report)

	Six month period ended June 30, 20X1 (Compiled)	Year ended December 31, 20X1 (Budgeted)
Net sales	x	x
Cost of sales	x	x
Gross profit on sales	x	x
Operating expenses	x	x
Net income before income taxes	x	x
Income taxes	x	x
Net income	x	x

Example: Johnny Jones, CPA prepares a twelve-month budget for the year ended December 31, 20X1. After six months, Johnny compiles a six-month historical statement for the six-month period ended June 30, 20X1.

Conclusion: Johnny may present the six month June 30, 20X1 interim statements along with comparatively presenting the twelve-month unexpired budget for the year ended December 31, 20X1 provided:

- The budgeted information is labeled "budgeted",
- The budgeted information does not extend beyond the year ended December 31, 20X1, and
- The six-month interim statement ended June 30, 20X1 is presented along with the budgeted information.

Change the facts: Johnny's client requests that the six-month historical statements be presented along with a five-year budget.

Conclusion: Because the budgeted information **extends beyond the current year**, the special disclaimer **exception is not available**. Consequently, the CPA must comply with the provisions of SSAE No. 10 and compile the budgeted information, and issue a compilation report, along with presenting, at a minimum, a summary of significant forecast assumptions.

REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following is not true regarding SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements* (ASC 271):
 - a) SOP 82-1 requires that assets be stated at their estimated current values
 - b) SOP 82-1 requires that liabilities be stated at their estimated current amounts
 - c) the costs of disposal of assets, if material, should be deducted in computing current values
 - d) the Statement of Changes in Net Worth is required
2. Personal financial statements included in written personal financial plans:
 - a) do not require a compilation or review report
 - b) require a review report, but not a compilation report
 - c) require a compilation report, but not a review report
 - d) require either a compilation or review report under any circumstances
3. The following are excluded from prescribed forms covered by SSARS No. 3 except:
 - a) a form designed or adopted by the entity for whom the financial statements are being compiled
 - b) a tax return
 - c) a bank's preprinted form
 - d) a comprehensive set of instructions directing a particular form
4. The AICPA's Special Committee on Assurance Services reports that the market for traditional accounting and auditing and tax services is:
 - a) slowly increasing
 - b) dramatically decreasing
 - c) relatively flat
 - d) growing exponentially
5. Which of the following is not a step to be performed by the CPA in an assurance services engagement:
 - a) determining the current performance measures
 - b) analyzing the client's business by identifying all of its processes and focusing on key indicators for that business
 - c) developing an understanding of the client's strengths and weaknesses
 - d) assisting management in developing an action plan for achieving its objectives

6. Which of the following is not one of the four criteria that must be met for Interpretation No. 20 of SSARS No. 1 to apply:
- a) the service consists of being an expert witness
 - b) the service consists of being a trier of fact or acting on behalf of one
 - c) the CPA is engaged by an attorney to do work that will be protected by the attorney's work product privilege and such work is not intended to be used for other purposes
 - d) the CPA is specifically engaged to compile the financial statements
7. Which of the following is true regarding financial statements submitted electronically:
- a) SSARS are not applicable
 - b) at a minimum, a CPA must at least compile the financial statements
 - c) a hard copy of the financial statements and accountant's report must be submitted
 - d) the report must be signed manually
8. A CPA is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:
- a) is labeled as budgeted
 - b) does not extend beyond the current fiscal year
 - c) is presented with interim historical financial statements for the current year
 - d) all of the above

SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Assets must be stated at their estimated current values.
B: Incorrect. Liabilities must be stated at their estimated current amounts.
C: Incorrect. The cost of the disposal of assets, if material, should be deducted in computing current values.
D: Correct. The Statement of Net Worth is required, but the Statement of Changes in Net Worth is optional.
(See page 2 of the course material.)
2. **A: Correct.** According to SSARS No. 6, no compilation or review report is required if certain conditions are met.
B: Incorrect. According to SSARS No. 6, no compilation or review report is required if certain conditions are met.
C: Incorrect. According to SSARS No. 6, no compilation or review report is required if certain conditions are met.
D: Incorrect. According to SSARS No. 6, no compilation or review report is required if certain conditions are met.
(See page 4 of the course material.)
3. A: Incorrect. This form is not included as a prescribed form.
B: Incorrect. This form is not included as a prescribed form for purposes of SSARS No. 3.
C: Correct. A financial statement on a bank's preprinted form is a prescribed form.
D: Incorrect. This is not a standard preprinted form, and therefore not a prescribed form.
(See page 5 of the course material.)
4. A: Incorrect. The Committee reported that the market is relatively flat, not slowly increasing.
B: Incorrect. The Committee reported that the market is relatively flat, not dramatically decreasing.
C: Correct. The Committee reported that the market is relatively flat.
D: Incorrect. The Committee reported that the market was relatively flat, not growing exponentially.
(See page 7 of the course material.)

5. **A: Correct.** The client, not the CPA, is responsible for determining what its current performance measures are, and whether they are consistent with its overall business strategy and primary objectives.

B: Incorrect. This should be performed by the CPA.

C: Incorrect. This should be performed by the CPA.

D: Incorrect. This should be performed by the CPA.

(See pages 8 to 9 of the course material.)

6. A: Incorrect. This is one of the four criteria.

B: Incorrect. This is one of the four criteria.

C: Incorrect. This is one of the four criteria.

D: Correct. The SSARS No. 1 exemption does not apply if the CPA is specifically engaged to compile the financial statements.

(See page 10 of the course material.)

7. A: Incorrect. SSARSs are applicable to financial statements submitted on computer disk/CD and through a data transmission network (modem).

B: Correct. At a minimum, a CPA must at least compile the financial statements.

C: Incorrect. A hard copy of the financial statements and accountant's report does not have to be submitted in addition to the electronic submission.

D: Incorrect. There is no requirement that the report be signed manually.

(See page 11 of the course material.)

8. A: Incorrect. This is true, but is not the only correct answer.

B: Incorrect. This is true, but is not the only correct answer.

C: Incorrect. This is true, but is not the only correct answer.

D: Correct. If all of these criteria are met, the CPA issues a report indicating that he or she did not examine or compile the budgeted information, and disclaiming an opinion or any form of assurance on the budget.

(See page 14 of the course material.)

G. Peer Review Changes

Effective January 1, 2009, significant changes were made to the AICPA Peer Review program with the issuance of *AICPA Standards for Performing and Reporting on Peer Reviews* (PRP Section 100).

The new peer review model has as key objectives the promotion of consistency and efficiency, and improved transparency.

Key changes in the new model are noted below. The new model:

1. Reduces in the current model of three types of peer reviews down to two.
 - The system, engagement and report reviews have been reduced to only two types of reviews: *system* and *engagement* reviews.
 - The report review has been folded into the engagement review.
2. Eliminates certain terms used in the old peer review program such as the Letter of Comment (LOC) and use of the term “substandard.”
3. Introduces new terms to measure the quality of the peer review engagement:
 - Matter,
 - Finding,
 - Deficiency, and
 - Significant deficiency.
4. Establishes a new grading system that includes:
 - Pass,
 - Pass with deficiency, and
 - Fail.
5. Changes the timing of initial selection of engagements provided to the reviewed firm to no earlier than three weeks.
6. Creates of a more understandable, shorter and easier to use peer review report written in “plain English.”

The new two types of peer reviews:

The new program has reduced the previous three-types of peer reviews to two: a system review and engagement review as noted in the following chart:

Types of Peer Reviews	
Old Program	New Program
<ul style="list-style-type: none"> • System review 	<ul style="list-style-type: none"> • System review
<ul style="list-style-type: none"> • Engagement review • Report review 	<ul style="list-style-type: none"> • Engagement review*
* Report review has been folded into the engagement review.	

- **System Review** – This type of review is for firms that perform engagements under the SASs (audits) and/or examinations of prospective financial information under the SSAEs (attestation standards).

A system review focuses on a firm's accounting and auditing practice system of quality control design, policies and procedures in accordance with the quality control standards established by SQCS No. 7.

- **Engagement Review** – This type of review is for firms that are not required to have a system review (e.g., do not perform any audits (governmental or otherwise), engagements under the SSAEs).

The objective of an engagement review is to evaluate whether engagements submitted for review are performed and reported on in conformity with professional standards including *whether the reviewed firm's working paper documentation conforms with the requirements of SSARS applicable to those engagements in all material respects*. There is no opinion on the reviewed firm's system of quality control and therefore the reviewer is not opining on the firm's compliance with its own quality control policies and procedures or with quality control standards, just conformity with SSARS and the SSAEs. Some examples of the documentation referred to above on a review engagement include the management representation letter, the documentation of the matters covered in the CPA's inquiry and analytical procedures, etc.

Engagement reviews now include compilations that omit substantially all disclosures as well as management-use only compilations in which no compilation report is issued (SSARS No. 8 compilation).

The following table summarizes the current peer review structure:

Highest Level of Service Conducted by Firm	Type of Peer Review Required
Audits and/or examinations of prospective information (attestation engagements)	System review – An opinion given on the firm's system of quality control.
Firms that are not required to have a system review Example: <ul style="list-style-type: none"> • Reviews • Compilations including management-use only compilation engagements 	Engagement review – Similar to the old off-site review with some changes: <ul style="list-style-type: none"> • Separate report, letter of comments, technical review actions apply. • Committee acceptance and monitoring. <u>Additional requirements</u>: workpaper documentation is in conformity with the SSARSs and/or SSAEs. Examples include management representation letter, documentation of matters covered in the CPA's inquiry and analytical procedures, etc.

New measurement standards:

The new peer review program drastically changes both the terminology and means by which a reviewed firm is evaluated.

In particular, the previously used letter of comment (LOC) has been eliminated along with the term “substandard.”

The new program introduces terms to measure the quality of the peer review engagement:

- Matter,
- Finding,
- Deficiency, and
- Significant deficiency.

A peer reviewer identifies a *matter* as a result of his or her evaluation of the firm's system of quality control. A matter warrants further consideration by the reviewer and is documented on a Matter for Further Consideration (MFC) form.

System review:

A *finding* is one or more related matters that result from a condition in the firm's system of quality control or compliance with that system that provides more than a remote possibility that the firm would not perform and/or report in conformity with professional standards.

If there is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

A finding that does not rise to the level of deficiency or significant deficiency is documented on a Finding for Further Consideration (FFC) form and is not included in the final peer review report.

A deficiency is one or more findings that the peer reviewer concludes that taken as whole, could create a situation in which the firm would not have reasonable assurance of performing and/or reporting in conformity with professional standards on one or more important respects.

A significant deficiency is one or more deficiencies that the peer reviewer concludes results from a condition in the reviewed firm's system of quality control or compliance such that as a whole does not provide the firm with reasonable assurance of performing and/or reporting in conformity with professional standards in all material respects.

Engagement review:

A finding is one or more related matters that the reviewer concludes result in financial statements or information, accountant's report, or procedures performed, not being performed and/or reported on in conformity with the professional standards.

If there are one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

A deficiency is one or more findings that the peer reviewer concludes that taken as whole, are material to the understanding of the financial statements or information and/or related accountant's reports or that represent omission of a critical procedure, including documentation, required by professional standards.

A significant deficiency exists when the peer reviewer concludes that deficiencies are evident on all of the engagements submitted for review. The exception is when more than one engagement has been submitted for review, the exact same deficiency occurs on each of those engagements, and there are no other deficiencies, which ordinarily would result in a report with a peer review rating of pass with deficiencies.

There are three (3) types of final reviewer reports that can be issued:

Pass: There are no deficiencies or significant deficiencies.

Pass with deficiency: There were one or more deficiencies but no significant deficiencies.

Fail: There were one or more significant deficiencies.

Other changes:

There are several other important changes made by the new peer review program.

- a. The initial selection of engagements to be reviewed should be provided by the peer reviewer to the reviewed firm no earlier than three weeks prior to the commencement of the peer review procedures.
 - At least one engagement from the initial selection should be provided to the firm once the peer review begins and not provided in advance. The selection should be an audit or the next highest level of service.

- b. The reviewed firm must provide a representation letter to the peer reviewer.
- The representation regarding compliance is stipulated as negative assurance.
 - A firm's refusal to furnish the written representation letter to the reviewer constitutes a limitation of the peer review.
 - The letter must state that the accountant has submitted all engagements to the reviewer.
- c. A firm's due date for its initial peer review is 18 months from the date it enrolled in the program. Subsequent peer reviews have a due date of three years and six months from the year end of the previous peer review.

Illustrative Report: System Review with Pass Rating

To the Partners of XYZ CPA Firm
And the Peer Review Committee of the [name of applicable administering entity]

We have reviewed the system of quality control for the accounting and auditing practice of XYZ CPA Firm (the Firm) in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Review established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at www.aicpa.org/prsummary.

As required by the standards, engagements selected for review included (engagements performed under the Government Auditing Standards, audits of employee benefit plans, and audits performed under FDICIA).

In our opinion, the system of quality control for the accounting and auditing practice of XYZ CPA Firm in effect for the year ended June 30, 20XX, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. XYZ CPA Firm has received a peer review rating of *pass*.

Smith, Jones and Associates
[Name of team captain's firm]

Date:

Illustrative Report: Engagement Review with Pass Rating

To the Partners of XYZ CPA Firm

And the Peer Review Committee of the [name of applicable administering entity]

We have reviewed selected accounting engagements of XYZ CPA Firm (the Firm) in effect for the year ended June 30, 20XX. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Review established by the Peer Review Board of the American Institute of Certified Public Accountants. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to evaluate whether the engagements submitted for review were performed and reported on in conformity with applicable professional standards in all material respects. An Engagement Review does not include reviewing the firm's system of quality control and compliance therewith and, accordingly, we express no opinion or any form of assurance on that system. The nature, objectives, scope, limitations of, and the procedures performed in an Engagement Review are described in the standards at www.aicpa.org/prsummary.

Based on our review, nothing came to our attention that caused us to believe that the engagements submitted for review by XYZ CPA Firm for the year ended June 30, 20XX, were not performed and reported on in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency (ies)* or *fail*. XYZ CPA Firm has received a peer review rating of *pass*.

Smith, Jones and Associates

[Name of review captain's firm on firm-on-firm review or association formed review team]
or

John Brown, Review Captain

[Committee-appointed review team review]

Date:

Firm Representation Letter

As part of the new peer review standards, a reviewed firm must provide the reviewer with a representation letter. Following is the new representation letter that is included in the new standards.

Illustrative Representation Letter: No Significant Matters to Report to the Team Captain or Review Captain

December 3, 20XX
To the Team Captain/Reviewer

We are providing this letter in conjunction with the peer review of [firm name here] as of the date of this letter and for the year ended June 30, 20XX.

We understand that we are responsible for complying with the rules and regulations of state boards of accountancy and other regulators. We confirm, to the best of our knowledge and belief, that there are no known situations in which [firm name here] or its personnel have not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies rules and regulations, including applicable firm and individual licensing requirements in each state in which it practices for the year under review. For attestation engagements, including financial forecasts or projections, the list included those engagements with report dates during the year under review.

We have also provided [team captain or review captain] with any other information requested, including communications by regulatory, monitoring, or enforcement bodies relating to allegations or investigations in the conduct of its accounting, audit, or attestation engagements performed and reported on by the firm, whether the matter relates to the firm or its personnel, within three years preceding the current peer review year-end. In addition, there are no known restrictions or limitations on the firm's or its personnel's ability to practice public accounting by regulatory, monitoring, or enforcement bodies within three years preceding the current peer review year-end. We have also discussed the content of our PCAOB inspection report with the [team captain or review captain] (if applicable).

Sincerely

Name of reviewed firm

H. Peer Reviews: Recurring Deficiencies Noted in Compilation and Review Engagements

From time to time, the peer review committee of the AICPA published *Common Deficiencies Noted During Peer Reviews*.

Peer Review Reporting and Standards Deficiencies

Following are the deficiencies noted in peer reviews as published by the AICPA's peer review committee in its report entitled "*Common Deficiencies Noted During Peer Reviews*."

Significant engagement deficiencies – engagement is considered substandard	
<p>Failure to:</p> <ul style="list-style-type: none"> • Appropriately qualify an auditor's report for a scope limitation or departure from the basis of accounting used for the financial statements. • Issue a report on compliance and internal controls for audits subject to Government Auditing Standards. • Disclose the lack of independence in a compilation report. • Disclose the omission of substantially all disclosures in a compilation that omits disclosures. • Disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP. • Disclose an other comprehensive basis of accounting (OCBOA) for financial statements compiled without disclosures, where the basis of accounting is not readily determinable from reading the report. • Disclose, in the accountant's or auditor's report, a material departure from professional standards such as the omission of significant income tax provision on interim financial statements, significant disclosures related to defined employee benefit plans, etc. 	<ul style="list-style-type: none"> • Departures from standard wording where the report does not contain the critical elements of applicable standards. • Issuance of an audit or review report when the accountant is not independent. • Inclusion of material balances that are not appropriate for the basis of accounting used. • Significant departures from the financial statement formats prescribed by industry accounting and auditing guides. • Omission of the disclosures related to significant accounting policies applied (GAAP or OCBOA). • Omission of significant matters related to the understanding of the financial statements, such as the cumulative material effect of a number of deficiencies. • Improper accounting for a material transaction such as recording a capital lease as an operating lease. • Misclassification of a material transaction or balance. • Failure to include a summary of significant assumptions in a forecast or projection. • Failure to segregate the statement of cash flows into the categories of investing, operating and financing. • Omission of significant required disclosures related to material financial statement balances or transactions. • Failure to disclose the cumulative effect of a change in accounting principle.

<ul style="list-style-type: none"> • Include a material amount or balance necessary for the basis of accounting used (examples include omission of material accruals, failure to amortize a significant intangible asset, provide for material losses or doubtful accounts, or to provide for material deferred income taxes). 	<ul style="list-style-type: none"> • Omission of the statement of income and retained earnings when referred to in the report.
Minor engagement deficiencies	
<p><u>Supplementary information:</u></p> <ul style="list-style-type: none"> • Failure to report on supplementary information. • Supplementary information was not clearly segregated or marked. • Titles of supplementary information did not coincide with the descriptions and titles presented in the financial statements. <p><u>Reports:</u></p> <ul style="list-style-type: none"> • Minor departures from standard report language. • Report did not cover all periods presented. • Minor report dating departures. <p><u>Other:</u></p> <ul style="list-style-type: none"> • Failure to accrue income taxes where the accrual is not material. • Inclusion of the reference about the omission of the statement of cash flows for financial statements prepared under OCBOA. • Failure to reference the accountant's report on each page of the financial statements. • Failure to identify within the audit report the country of origin. 	<p><u>Disclosures:</u></p> <ul style="list-style-type: none"> • Omitted or inadequate disclosures related to minor account balances or transactions such as inventory, valuation allowances, long-term debt, related-party transactions, and concentrations of credit risk. <p><u>Financial statement display:</u></p> <ul style="list-style-type: none"> • Minor departures from the financial statement formats recommended by industry accounting guides. • Use of financial statement titles that are not appropriate for the basis of accounting used. • Failure to include the title "Selected Information – Substantially All Disclosures Required by GAAP Are Omitted." As appropriate for the presentation of certain selected disclosures. • Presentation of treasury stock in the financial statements of a company that is incorporated in a state that does not recognize treasury stock.

Audit procedures and documentation	
<p>Failure to:</p> <ul style="list-style-type: none"> • Use a written audit program. • Tailor audit programs for specialized industries or for a specific type of engagement, such as significant areas of inventory and receivable balances. • Request a legal representation letter, if an attorney was consulted. • Obtain a client management representation letter. • Include several components of a client management representation letter within the letter. • Document the auditor's consideration of the internal control structure. • Document key audit areas. • Document tests of controls and compliance for engagements subject to OMB Circular A-133. • Assess or document fraud risk. 	<p>Failure to:</p> <ul style="list-style-type: none"> • Perform essential audit procedures required by an industry audit guide. • Perform adequate tests in key audit areas. • Confirm significant receivables or document appropriateness and utilization of other audit techniques. • Assess the level of materiality and control risk. • Document the nature and extent of analytical procedures. • Review loan covenants. • Perform audit cut-off procedures. • Document communications between predecessor and successor auditors. • Perform a review of subsequent events. • Test for unrecorded liabilities. • Observe inventory when the amount is material to the balance sheet.
Compilation and Review (SSARS) procedures and documentation	
<p>Failure to:</p> <ul style="list-style-type: none"> • Perform analytical and inquiry procedures for a review engagement. • Document the matters covered in the accountant's inquiry and analytical procedures on a review engagement. 	<ul style="list-style-type: none"> • Obtain a client management representation letter for a review engagement. • Include the required language in an engagement letter on a SSARS No. 8 engagement for communicating the understanding of the engagement for financial statements that are prepared for management use only, except for the failure to refer to the level of responsibility on supplementary information, which is not a significant deficiency.

Attestation procedures and documentation	
<p>Failure to:</p> <ul style="list-style-type: none"> Obtain a client management representation letter for an examination of internal control or regarding managements' assumptions for a pro forma financial statement. Appropriately label pro forma financial information to distinguish it from historical financial information. 	
Specific common financial statement deficiencies	
<p>Assets:</p> <ul style="list-style-type: none"> Improper classifications between current and long-term assets. Investments in majority owned or controlled subsidiary not consolidated. Cash overdrafts shown as a negative balance in the current asset section. Accounts receivable shown on cash basis financial statements. Investments in debt and equity securities not classified or measured correctly. <p>Statement of Income:</p> <ul style="list-style-type: none"> Income tax provisions not recorded on interim financial statements. Reporting period not clearly identified. Significant components of income tax expense not disclosed. <p>Statement of Cash Flows:</p> <ul style="list-style-type: none"> Cash flow statement not categorized by operating, investing and financing activities. 	<p>Liabilities:</p> <ul style="list-style-type: none"> Improper classifications between current and long-term debt. Demand liabilities classified as long-term. Non-recognition of liability for compensated balances (e.g., vacation pay). Non-recognition of capital leases. Improper recognition of deferred revenue. Improper classification of deferred income taxes.

<ul style="list-style-type: none"> • Misclassification of activities, especially between investing and financing activities. • No disclosure of non-cash investing and financing activities. • No disclosure of interest and taxes paid for indirect method. • No reconciliation between net income and net cash flow from operations. • Certain amounts in the statement of cash flows did not agree with amounts calculated from the comparative balance sheets. • Cash flow statement not presented for each period that statement of income is presented. 	
Incomplete and missing disclosures	
<ul style="list-style-type: none"> • Significant accounting policies, such as revenue recognition. • Basis of accounting other than GAAP. • Concentrations of credit risk. • Disclosures about fair value of financial instruments. • Disclosures about risks and uncertainties. • Components of receivables. • Components of inventory. • Disclosure of five-year debt maturities. • Related party transactions. • Leases. 	<ul style="list-style-type: none"> • Information about concentrations of products, services, customers, and suppliers. • Inadequate subsequent event disclosure of significant unrealized stock market losses. • Interest expense. • Rent expense. • Investments. • Intangible assets. • Details related to long-term debt. • Preferred stock redemption requirements. • Details related to the components of capital stock. • Details related to components of retained earnings.

<ul style="list-style-type: none"> • Inadequate employee benefit plan disclosures. • Inadequate disclosure about deferred taxes. • Missing caption "Selected Information – Substantially All Disclosures Omitted", where applicable. • Modifications to cash basis of accounting. • Use of estimates. • Accounting policy on bad debts. • Nature of operations. 	<ul style="list-style-type: none"> • Restricted loan covenants. • Depreciation and amortization. • Cash equivalents. • Accrued compensation expense. • Advertising expense. • Income tax expense. • Terms and conditions of a commitment. • Details relating to pension plans.
Common functional area deficiencies – Engagement	
<p><u>Engagement performance:</u></p> <p>Failure to:</p> <ul style="list-style-type: none"> • Perform an adequate review of working papers and/or the accountant's/auditor's report and accompanying financial statements by the practitioner-in-charge of the engagement prior to the issuance of the auditor's/accountant's report. • Perform pre-issuance review of engagement working papers and/or reports and accompanying financial statements by an independent party not associated with the engagement as required by firm policy. • Utilize a disclosure and reporting checklist as required by firm policy. 	<ul style="list-style-type: none"> • Consult professional literature or with a source outside the firm on reporting for a specialized industry, which resulted in the issuance of an incorrect audit report, and/or financial statement disclosure or presentation. • Use accounting/auditing practice aids developed by third party providers as required by firm policy, which resulted in engagement deficiencies. • Use engagement letters for accounting/auditing engagements as required by firm policy.

<p><u>Personnel management:</u></p> <ul style="list-style-type: none"> • Failure of professional staff to take adequate CPE in accounting and auditing related subjects or specialized industries, which resulted in disclosure, reporting, and documentation deficiencies on engagements selected for review. <p><u>Monitoring:</u> Failure to:</p> <ul style="list-style-type: none"> • Adequately implement the firm's monitoring policies and procedures. 	<ul style="list-style-type: none"> • Document the firm's compliance with policies and procedures for its system of quality control as required by AICPA Quality Control Standards. • Perform an annual inspection, including the functional elements of quality control, as required by firm policy. • Extend monitoring policies and procedures to non-audit services such as compilation and/or review engagements.
Common deficiencies unique to specialized industries	
<u>Engagements subject to government auditing standards</u>	
<ul style="list-style-type: none"> • Missing reports for internal control or compliance. • Missing proper A-133 reports. • Required compliance testing not performed. • Compliance and control tests not adequately designed. • Inadequate or outdated reference materials used. 	<ul style="list-style-type: none"> • Report on financial statements does not refer to reports on controls and compliance. • Yellow Book CPE requirements not met. • Improper accounting for a certain fund. • Failure to restrict the use of the accountant's report to the proper governmental agency.
<u>Not-for-profit organizations</u>	
<p>Failure to:</p> <ul style="list-style-type: none"> • Identify a voluntary health and welfare organization. • Present a statement of cash flows. • Inadequate format, titles and presentation of financial statements. 	<ul style="list-style-type: none"> • Incorrect classification of contributions as unrestricted, temporarily restricted, or permanently restricted. • Inadequate audit procedures to support the statement of functional expenses. • Improper accounting for restricted funds.

<u>Employee benefit plans</u>	
<ul style="list-style-type: none"> • Inadequate testing of participant data and investments. • Inadequate or missing disclosures related to participant directed investment programs, investments and participant data. • Failure to understand testing requirements on a limited-scope engagement. • Inadequate consideration of prohibited transactions. 	<ul style="list-style-type: none"> • Incomplete description of the plan and its provisions. • Failure to properly report on a DOL limited-scope audit. • Improper use of the limited scope exemption because the financial institution did not qualify for the exemption. • Failure to properly report on the supplementary schedules for ERISA and the DOL.
<u>OCBOA financial statements</u>	
<ul style="list-style-type: none"> • Failure to state the basis of accounting and that the basis is other than GAAP. • Failure to appropriately modify the accountant's report to reflect financial statement titles that are appropriate for OCBOA. 	<ul style="list-style-type: none"> • Inadequate description of the basis of accounting and how it differs from GAAP.

I. GAAP Hierarchy: Compilation and Review

Although there are different reporting standards for compilation, review and audit engagements, **GAAP is the same for all engagements.**

Note 3 of SSARS No. 1 makes reference that the GAAP hierarchy presented in SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, also applies to compilation and review engagements.

Prior to 2008, the GAAP hierarchy was found in SAS No. 69.

In May 2008, the FASB issued FASB No. 162: *The Hierarchy of Generally Accepted Accounting Principles*, which replaced SAS No. 69.

In June 2009, the FASB issued FASB No. 168: *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. FASB No. 168 replaces FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. FASB No. 168 is codified in ASC 105.

The Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy).

The objective of FASB No. 168 is to replace FASB No. 162 and to establish the *FASB Accounting Standards Codification*[™] (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of GAAP financial statements. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

The new Codification has the following attributes:

- The Codification simplifies user access to all authoritative GAAP by reorganizing GAAP into approximately 90 accounting topics.
- Relevant portions of SEC and SEC Staff Interpretations have been included for reference only for public companies.
- Updates to the Codification issued after the effective date of FASB No. 168 will serve only to update the Codification.
- At the effective date of FASB No. 168, all nongrandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed nonauthoritative and no longer updated.

FASB No. 168 establishes a new U.S. GAAP which is now split into two levels:

- Authoritative GAAP Guidance
- Non-authoritative GAAP Guidance

Evolution of FASB No. 162 Hierarchy into New FASB No. 168 GAAP		
<u>Category under Previous FASB No. 162 Hierarchy</u>	NEW U.S. GAAP (FASB No. 168)	
	<u>Authoritative GAAP Guidance</u>	<u>Non-authoritative GAAP Guidance</u>
a	X	
b	X	
c	X	
d	X	X (1)
Other accounting literature		X (2)
(1) The subcategory “practices that are widely recognized and prevalent either generally or in the industry” found in the previous Category (d) is excluded from the Authoritative GAAP Guidance and considered Non-authoritative GAAP.		
(2) The entire category “other accounting literature” is considered non-authoritative GAAP under the new U.S. GAAP.		

- The following chart illustrates the items that are included in the authoritative and non-authoritative GAAP guidance:

Authoritative GAAP Guidance	Non-authoritative GAAP Guidance
1) FASB Accounting Standards Codification (FASB ASC).	1) GAAP that is not included as part of the new FASB Accounting Standards Codification (ASC). Sources of <u>non-authoritative accounting guidance and literature</u> include: <ul style="list-style-type: none"> • Practices that are widely recognized and prevalent either generally or in the industry (1) • FASB Concepts Statements (2) • AICPA Issues Papers (2) • International Financial Reporting Standards of the International Accounting Standards Board (IASB) (2) • Pronouncements of professional associations or regulatory agencies (2) • Technical Practice Aids (2), and • Accounting textbooks, handbooks, and articles. (2)
2) <u>SEC companies</u> : rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority. ²	
3) Certain grandfathered guidance having an effective date before March 15, 1992	
(1) Previously part of Category (d) GAAP per FASB No. 162 hierarchy. (2) Previously included in the “other accounting literature” category per FASB No. 162 hierarchy.	

FASB No. 168 establishes a new Codification (FASB Accounting Standards Codification) (FASB ASC) as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities.

FASB Statement No. 168 is the final standard that was issued by FASB in an individual statement format.

² Note: In addition to the SEC's rules and interpretive releases, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements, and it utilizes SEC Staff Announcements and Observer comments made at Emerging Issues Task Force (EITF) meetings to publicly announce its views on certain accounting issues for SEC registrants.

The FASB ASC contains the authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

- a. Categories (a), (b), (c) and a portion of (d) of the FASB No. 162 hierarchy are included in the new FASB Codification.
 - 1) A portion of Category (d) related to “practices that are widely recognized and prevalent either generally or in the industry” and the “other accounting literature” are excluded from the FASB Codification and are considered nonauthoritative GAAP.
- b. The ASC is broken down by topics, rather than by pronouncements, segregated into five areas as follows:

FASB Codification (FASB ASC)		
<u>Area</u>	<u>Description</u>	<u>Topic Codes</u>
General Principles	Relates to conceptual matters and includes GAAP	105-199
Presentation	Relates to presentation matters	205-299
Financial Statement Accounts	Includes assets, liabilities, equity, revenue and expenses	305-700
Broad Transactions	Includes business combinations, derivatives and other	805-899
Industry	Relates to accounting that is unique to an industry or type of activity. Topics include airlines and financial services	905-999

- c. All FASB statements (FASB No. 1-168) and other GAAP in existence as of July 1, 2009 have been merged into the new FASB ASC.
 - 1) Previous GAAP has lost its identity and is now referenced by the new Topic Code and not the original FASB statement number. Example: FASB No. 140 is no longer referenced within the FASB ASC.

Note: Although the original FASB reference number has been eliminated and replaced with a Topic Code, there is a Cross Reference feature that allows a user to insert a FASB statement number and find the corresponding place within the Topic Codes where that statement information is located.

Note: If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, the entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider non-authoritative guidance from other sources.

An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events when those accounting principles either prohibit the application of the accounting treatment to the particular transaction or indicate that the accounting treatment should not be applied by analogy. The appropriateness of other sources of GAAP depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following is one of the two types of peer reviews under the AICPA peer review program:
 - a) system review
 - b) document review
 - c) findings review
 - d) report review
2. Firms that only perform compilations that omit substantially all disclosures:
 - a) require a system review
 - b) require an engagement review
 - c) require a report review
 - d) are not required to participate in the peer review program
3. Under the AICPA peer review program, which of the following engagements would require an engagement review to be performed assuming no other engagement is performed by the firm:
 - a) review
 - b) governmental audit
 - c) financial forecast
 - d) audit
4. A system review focuses on which of the following:
 - a) working paper documentation
 - b) management representation letter
 - c) the CPA's inquiry and analytical procedures
 - d) the CPA firm's system of quality control
5. Which of the following terms has been eliminated by the new AICPA peer review program:
 - a) term "substandard"
 - b) term "poor quality"
 - c) term "standard"
 - d) term "presents fairly"

6. If there is one or more findings, a peer reviewer may conclude that the finding(s) rises to the level of which of the following:
- a) matter
 - b) deficiency
 - c) violation
 - d) fraud
7. With respect to the *AICPA peer review program*, which of the following is true regarding the firm's representation letter:
- a) there is no requirement for the firm to provide a representation letter
 - b) a signed representation letter must include positive assurance that the firm is in compliance with state board or other regulatory requirements
 - c) a firm's refusal to furnish a written representation letter to the reviewer does not constitute a limitation of the peer review
 - d) a representation must be made that all client engagements with periods ending during the year under review and attestation engagements with report dates during the year under review were provided to the reviewer
8. The due date of a firm's initial peer review is:
- a) three years
 - b) 18 months
 - c) three years and six months
 - d) within one year of receiving notice from the state licensing board
9. Engagement deficiencies where the engagement is considered to be substandard include all of the following except:
- a) departure from standard wording where the report does not contain the critical elements of applicable standards
 - b) issuance of an audit or review report when the accountant is not independent
 - c) failure to indicate in the audit report the country of origin
 - d) omission of the disclosures related to significant accounting policies applied
10. Specific financial statement deficiencies noted in peer reviews related to the Statement of Income include all of the following except:
- a) income tax provisions not recorded on interim financial statements
 - b) reporting period not clearly identified
 - c) significant components of income tax expense not disclosed
 - d) errors in calculations of totals
11. Which of the following is not a deficiency listed for engagements subject to government auditing standards:
- a) missing reports for internal control or compliance
 - b) required compliance testing not performed
 - c) inadequate titles used on reports
 - d) inadequate or outdated reference materials used

12. Which of the following is correct as it relates to the evolution of FASB No. 162 GAAP hierarchy into the new FASB No. 168 hierarchy:
- a) FASB No. 162's Category (a) became non-authoritative GAAP
 - b) FASB No. 162's Category (d) became both authoritative and non-authoritative GAAP
 - c) FASB No. 162's Other accounting literature became part of authoritative GAAP
 - d) FASB No. 162's Category (b) became part of non-authoritative GAAP
13. Which of the following is an example of authoritative GAAP guidance:
- a) accounting textbooks
 - b) rules and interpretive releases of the SEC under federal securities laws
 - c) pronouncements of professional associations or regulatory agencies
 - d) Technical Practice Aids

SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** The two types are system and engagement reviews.

B: Incorrect. The two types are system and engagement reviews. Document review is not one of the three.

C: Incorrect. A findings review is not one of the two types of peer reviews.

D: Incorrect. Under the new peer review program, a report review is not one of the two types of reviews. A report review was a type of review under the previous AICPA peer review program but is not under the new program.

(See page 21 of the course material.)

2. A: Incorrect. This type of review is for firms that perform engagements under the SASs and/or examinations of prospective financial information under the SSAEs.

B: Correct. Under the new AICPA peer review program, a compilation with no disclosures falls under an engagement review.

C: Incorrect. A report review is no longer one of the types of reviews provided by the new AICPA peer review program.

D: Incorrect. Firms that perform any compilation engagements must participate in the peer review program.

(See page 22 of the course material.)

3. **A: Correct.** A review engagement would require a firm to be subject to an engagement review.

B: Incorrect. A governmental audit elevates the firm to the requirement that it be subject to a system review and not an engagement review.

C: Incorrect. A financial forecast, which is performed under the SSAEs, elevates the firm to the requirement that it be subject to a system review and not an engagement review.

D: Incorrect. An audit, which is performed under the SASs, elevates the firm to the requirement that it be subject to a system review and not an engagement review.

(See page 22 of the course material.)

4. A: Incorrect. Working paper documentation is the focus of an engagement review, not a system review.

B: Incorrect. Obtaining a management representation letter is an effort that a peer reviewer would consider in an engagement review and not a system review.

C: Incorrect. The CPA's effective use of inquiry and analytical procedures is an integral part of an engagement review and not a system review.

D: Correct. A system review encompasses opining of whether a firm is in compliance with its own quality control policies and procedures.

(See page 22 of the course material.)

5. **A: Correct.** The term substandard was part of the old AICPA peer review program and was eliminated in the new version.

B: Incorrect. The term "poor quality" was neither in the previous or new peer review program.

C: Incorrect. Although there was a term "substandard", there was no term "standard" used in the previous version of the program and there is no such term in the new program.

D: Incorrect. The term "presents fairly" is used in auditing literature but is not used in the peer review program.

(See page 23 of the course material.)

6. A: Incorrect. A matter is an item that warrants further consideration and is not a finding.

B: Correct. A finding(s) may result in either a deficiency or a significant deficiency.

C: Incorrect. The peer review program does not use the term "violation."

D: Incorrect. Fraud is used as a term in an audit but is not referenced in the AICPA peer review program.

(See page 23 of the course material.)

7. A: Incorrect. The reviewed firm must provide a signed representation letter to the reviewer that includes certain representations.

B: Incorrect. The representation regarding compliance is stipulated as negative assurance rather than positive assurance.

C: Incorrect. A firm's refusal to furnish the written representation letter to the reviewer constitutes a limitation of the peer review.

D: Correct. This is a listed required representation.

(See page 25 of the course material.)

8. A: Incorrect. Three years is not identified within the peer review standards.

B: Correct. A firm's due date is 18 months from the date it enrolled in the program.

C: Incorrect. The three years and six months date only applies to peer reviews subsequent to the initial review.

D: Incorrect. The standards do not mention a period of one year of receiving notice from the state licensing board.

(See page 25 of the course material.)

9. A: Incorrect. This is listed as a significant engagement deficiency in which the engagement is considered substandard.

B: Incorrect. This is listed as a significant engagement deficiency in which the engagement is considered substandard.

C: Correct. This deficiency is considered minor, and does not make the engagement substandard.

D: Incorrect. This is listed as a significant engagement deficiency in which the engagement is considered substandard.

(See page 28 of the course material.)

10. A: Incorrect. This is one of the deficiencies noted regarding the Statement of Income.

B: Incorrect. This is one of the deficiencies noted regarding the Statement of Income.

C: Incorrect. This is one of the deficiencies noted regarding the Statement of Income.

D: Correct. This is not a significant deficiency noted by peer reviewers regarding the Statement of Income.

(See page 31 of the course material.)

11. A: Incorrect. This is one of the deficiencies noted regarding engagements subject to government auditing standards.

B: Incorrect. This is one of the deficiencies noted regarding engagements subject to government auditing standards.

C: Correct. This is not a listed deficiency regarding engagements subject to government auditing standards.

D: Incorrect. This is one of the deficiencies noted regarding engagements subject to government auditing standards.

(See page 34 of the course material.)

12. A: Incorrect. Category (a) became part of authoritative GAAP.

B: Correct. Category (d) became both authoritative and non-authoritative GAAP with the “practices that are widely recognized and prevalent...” being placed as non-authoritative GAAP and the remainder of Category (d) being considered authoritative GAAP.

C: Incorrect. The “Other accounting literature” category became part of nonauthoritative GAAP.

D: Incorrect. Category (b) became part of authoritative GAAP.

(See page 36 of the course material.)

13. A: Incorrect. An accounting textbook is part of non-authoritative GAAP regardless of how prominent the author may be.

B: Correct. Rules and interpretive releases of the SEC under federal securities laws are sources of authoritative GAAP for SEC registrants.

C: Incorrect. Pronouncements of professional associations or regulatory agencies are non-authoritative GAAP.

D: Incorrect. Technical Practice Aids are part of non-authoritative GAAP.

(See page 37 of the course material.)

J. Simplifying the Reporting Process

With each passing GAAP change issued by the FASB, accountants are torn by the pressure placed on them to balance enhanced accounting disclosure requirements with the needs of their cost-conscious clients. The fact is that most of the changes required by GAAP have little usefulness to smaller closely held businesses. Yet, accountants still must comply with the changes.

Examples of GAAP changes that are typically not meaningful for smaller closely held businesses include:

- *Goodwill and other intangibles amortization*: FASB No. 142, *Goodwill and Other Intangible Assets* (ASC 350), requires that goodwill and indefinite lived intangibles not be amortized. Instead, an annual test for impairment on goodwill and certain other intangible assets must be made. For most smaller businesses, it is preferable to continue to amortize such intangibles and avoid performing the impairment test.
- *Consolidation of real estate leasing entities*: FIN 46R, *Consolidation of Variable Interest Entities* (ASC 810), requires a lessee operating company to consolidate a real estate lessor company if the real estate lessor is a variable interest entity and the operating company is a primary beneficiary. Most third parties, including lenders, do not find the operating company's consolidation of the real estate leasing entity meaningful even though GAAP requires such a consolidation.
- *Depreciation*: Many small businesses do not find the maintenance of two depreciation methods useful. Yet such businesses are precluded from using tax return depreciation as their GAAP depreciation.

For many small business owners, the issuance of financial statements is nothing more than a necessity to satisfy the bank or other third party user. Although the small business client may be willing to pay higher fees to accountants for effective tax planning or management consulting, most owners are unwilling to pay for a high-priced compilation or review engagement that is perceived as a commodity rather than a value-added service.

An accountant may wish to consider existing reporting options that offer practitioners a means to reduce the time spent on completing an engagement. Here is a list that may be useful depending on the client's needs and circumstances:

1. Compiling OCBOA statements (e.g., cash or income tax basis)
2. Compilation with no footnotes and statement of cash flows
3. Issue management-use financial statements in accordance with SSARS No. 8:
 - Compiled financial statements without a compilation report
 - Cannot be distributed to parties other than management (e.g., not to be issued to the bank)
 - Requires a written engagement letter or equivalent

4. Issue a compilation report with only selected footnotes:

SSARS No. 1 permits an accountant to report on financial statements under which a select few disclosures are included provided the notes are labeled:

“Selected Information-Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included.”

5. Use a compilation report at interim periods that list the departures from GAAP.

Example: Assume that a CPA prepares monthly financial statements for a client, and these statements consistently have certain GAAP departures such as missing accruals, allowance for bad debts, etc. The CPA may prepare a standard compilation that makes reference to the GAAP departures and can use this report, without modification, from month to month.

At year-end, the CPA may adjust the departures and issue a standard compilation, review or audit report.

6. Compile only one financial statement (e.g., balance sheet), and not the related financial statements (paragraph 18 or SSARS No. 1).
7. Apply options that are excluded from SSARS No. 1:
 - Provide selected monthly information requested by the client such as account balances (e.g., cash or accounts receivable) or operating information (e.g., number of meals served for the month).
 - Provide a client or other third party users with a copy of the client's tax return. An accountant is not required to report on a tax return.
8. Issue financial statements with one or more GAAP departures.

What are the best options for a company that wishes to avoid some of the more laborious GAAP changes?

From the list of options noted above, the author suggests accountants consider one or two options as the means to provide a “little GAAP” for their small business clients.

- Issue GAAP statements with one or more GAAP departures, or
- Issue OCBOA, income tax basis financial statements.

Issue GAAP statements with one or more GAAP departures

Perhaps the best approach to simplify reporting for small businesses, and thereby avoid many of the more difficult GAAP pronouncements, is to issue GAAP statements with one or more GAAP departures. Many third parties appear to favor this option when compared with the alternative of issuing OCBOA financial statements. Moreover, by having one or two departures, the essence of the statements is still GAAP while OCBOA statements (income tax basis financial statements) may have many differences when compared with GAAP.

The most common GAAP departures that may help simplify the effort required to prepare GAAP statements include:

1. Violate FASB No. 142 (ASC 350) by continuing to amortize goodwill and indefinite lived intangibles. FASB No. 142 precludes such goodwill and intangibles from being amortized and, instead, requires that an annual impairment test be done.
2. Violate FIN 46R (ASC 810) by not testing and consolidating a real estate leasing company into its operating company lessee.
3. Use income tax depreciation instead of GAAP depreciation.
4. Violate FASB No. 109 (ASC 740) by not recording deferred income taxes.

Although there are numerous GAAP departures that can simplify engagement time, the above four departures are the most common for mainstream companies.

Example:

Company X is a small manufacturing company.

Details regarding X follow:

- X has approximately \$1.5 million of goodwill.
- X leases its primary manufacturing facility from Company R, a related party real estate lessor.

X decides that the cost of implementing certain GAAP standards is too costly and decides on the following GAAP departures:

1. Amortization of goodwill: It will amortize goodwill over the 15-year tax life, resulting in amortization expense of \$100,000, which, net of the tax effect, is \$60,000. GAAP (FASB No. 142) does not permit goodwill to be amortized and, instead, requires goodwill to be tested annually for impairment.
2. Avoid test for consolidation of real estate leasing company (FIN 46R): X will not test Company R to determine whether R is a variable interest entity, nor will it consider consolidating R as R's primary beneficiary. FIN 46R requires X to test R to determine whether R is a variable interest entity and whether X is R's primary beneficiary that should consolidate R.

Following are the reports that would be issued to address the GAAP departures noted above.

Sample Report: Compilation with GAAP Departures: Substantially All Disclosures and Cash Flow Statement Omitted

**Sample Report: Compilation with GAAP Departures:
Substantially All Disclosures and Cash Flow Statement Omitted**

To the Board of Directors
Company X
Nowhere, Massachusetts

We have compiled the accompanying balance sheet of Company X as of December 31, 20X1, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements, information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, we did become aware of departures from generally accepted accounting principles that are described in the following paragraphs.

Generally accepted accounting principles do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if generally accepted accounting principles had been followed, goodwill would have increased by \$100,000 and net income and stockholders' equity would have increased by \$60,000, net of the tax effect.

Generally accepted accounting principles require that the company test a company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company's financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

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

James J. Fox & Company

Sample Review Report with GAAP Departures

To the Board of Directors
Company X
Nowhere, Massachusetts

We have reviewed the accompanying balance sheets of Company X as of December 31, 20X1, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Company X.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, with the exception of the matters described in the following paragraphs, 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 generally accepted accounting principles.

As disclosed in Note 2, generally accepted accounting principles do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if generally accepted accounting principles had been followed, goodwill would have increased by \$100,000 and net income and stockholders' equity would have increased by \$60,000, net of the tax effect.

As disclosed in Note 3, generally accepted accounting principles require that the company test a company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company's financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

James J. Fox & Company

Independent Auditor's Report

To the Board of Directors
Company X
Nowhere, Massachusetts

We have audited the accompanying balance sheet of Company X as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

As disclosed in Note 2, the company has recorded amortization expense related to goodwill. In our opinion, goodwill should not be amortized and, instead, should be tested annually for impairment in accordance with accounting principles generally accepted in the United States of America. If the financial statements were corrected for that departure from United States generally accepted accounting principles, goodwill would have increased by \$100,000 and net income and stockholders' equity would have increased by \$60,000, net of the tax effect.

As disclosed in Note 3, the Company has not performed a test to determine whether consolidation of a related party real estate leasing company is required. In our opinion, the company should perform the test and, if required by the test, should consolidate the real estate leasing company into the Company's financial statements. The effects on the financial statements of the preceding practice are not reasonably determinable.

In our opinion, except for the effects of amortizing goodwill and not testing for consolidation of a related party real estate leasing company, as discussed in the preceding paragraphs, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of Company X as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company

How many GAAP departures can you include in a report?

In most cases, a report may include one or two GAAP departures such as in the above example where the departures related to goodwill amortization and consolidation of variable interest entities.

But, the number of departures is not limitless.

If an audit is being performed, numerous GAAP departures may require the auditor to change his or her opinion to an adverse opinion.

Independent Auditor's Report

To the Board of Directors
Company X
Nowhere, Massachusetts

First paragraph: same

Second paragraph: same

As disclosed in Note 2, the company has recorded amortization expense related to goodwill. In our opinion, goodwill should not be amortized and, instead, should be tested annually for impairment in accordance with accounting principles generally accepted in the United States of America. If the financial statements were corrected for that departure from United States generally accepted accounting principles, goodwill would have increased by \$100,000 and net income and stockholders' equity would have increased by \$60,000, net of the tax effect.

As disclosed in Note 3, the Company has not performed a test to determine whether consolidation of a related party real estate leasing company is required. In our opinion, the company should perform the test and, if required by the test, should consolidate the real estate leasing company into the Company's financial statements. The effects on the financial statements of the preceding practice are not reasonably determinable.

In our opinion, ***because of the effects of the matters discussed in the preceding paragraphs***, the financial statements referred to in the first paragraph ***do not present fairly***, in conformity with accounting principles generally accepted in the United States of America, the financial position of Company X, as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

James J. Fox & Company

What about multiple GAAP departures in a compilation or review report?

With respect to compilation and review reports, there is no language that is similar to an adverse opinion for an audit.

Interpretation 7, SSARS No. 1, *Reporting When There are Significant Departures From Generally Accepted Accounting Principles*, provides the following limited guidance.

Question: When the financial statements include significant departures from generally accepted accounting principles or an other comprehensive basis of accounting, may the accountant modify his standard report under paragraph 41 of SSARS No. 1 to include a statement that the financial statements are not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting?

Response: No. Including such a statement in the accountant's compilation or review report would be tantamount to expressing an adverse opinion on the financial statements taken as a whole. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in a review report would confuse users because it would contradict the expression of limited assurance required by paragraph 33(e) of SSARS No. 1.

However, footnote 19 to paragraph 41 of SSARS No. 1 indicates that the accountant is not precluded from emphasizing in a separate paragraph of his report a matter regarding the financial statements. The accountant may wish, therefore, to emphasize the limitations of the financial statements in a separate paragraph of his compilation or review report, depending on his assessment of the possible dollar magnitude of the effects of the departures, the significance of the affected items to the entity, the pervasiveness and overall impact of the misstatements, and whether disclosure has been made of the effects of the departures. The separate paragraph which would follow the other modifications of his report might read as follows:

Because the significance and pervasiveness of the matters discussed above makes it difficult to assess their impact on the financial statements taken as a whole, users of these financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had access to revised financial statements, prepared in conformity with generally accepted accounting principles.

Inclusion of such a separate paragraph in the accountant's compilation or review report is not a substitute for disclosure of the specific departures or the effects of such departures when they have been determined by management or are known as a result of the accountant's procedures.

Example:

Company X has four GAAP departures as follows:

- Amortization of goodwill
- Does not test its related party leasing company for consolidation
- Uses MACRS for depreciation
- Does not use the allowance method to record bad debts.

The accountant believes that due to the four GAAP departures, he should emphasize the matter in the review report as follows:

Sample Review Report with Multiple GAAP Departures

To the Board of Directors
Company X
Nowhere, Massachusetts

We have reviewed the accompanying balance sheets of Company X as of December 31, 20X1, and the related statements of income and retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Company X.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, with the exception of the matters described in the following paragraphs, 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 generally accepted accounting principles.

As disclosed in Note 3, generally accepted accounting principles require that the company test a company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company's financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

As disclosed in Note 4, generally accepted accounting principles do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if generally accepted accounting principles had been followed, goodwill would have increased by \$100,000 and net income and stockholders' equity would have increased by \$60,000, net of the tax effect.

As disclosed in Note 5, generally accepted accounting principles require that fixed assets be depreciated over their estimated useful lives. Management has informed us that the Company has recorded depreciation using the Modified Accelerated Cost Recovery System required for federal income tax purposes, which does not result in an allocation of depreciation to expense over the estimated useful lives of the fixed assets. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

As disclosed in Note 6, generally accepted accounting principles require that an allowance for uncollectible accounts be recorded to reflect an estimate of trade receivables that will not be realized. Management has informed us that uncollectible accounts have been recorded on the direct writeoff method. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

Because the significance and pervasiveness of the matters discussed above makes it difficult to assess their impact on the financial statements taken as a whole, users of these financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had access to revised financial statements, prepared in conformity with generally accepted accounting principles.

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Observation: The author believes that in most cases, the inclusion of one or two GAAP departures in a report will not be considered so “significant and pervasive” that the additional emphasis of a matter paragraph is warranted.

For example, a small business client may choose to amortize goodwill and not test and consolidate a related party leasing company. When the number of GAAP departures is elevated to three, maybe four, the accountant may wish to consider whether the financial statements are so distorted, they are misleading and no longer purport to be GAAP.

Income Tax Basis Financial Statements – The Cash Basis Issue

Using income tax basis accrual financial statements is another option for avoiding traditional GAAP financial statements. However, there is a rule found in SSARS No. 15 that prevents many companies from using income tax basis accrual financial statements.

SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance into Statements on Standards for Accounting and Review Services* is the general authority for reporting on OCBOA (other comprehensive basis of accounting) financial statements. For compilation and review engagements, income tax basis financial statements are included within the OCBOA category. For audit engagements, SAS No. 62, *Special Reports*, is the authority for OCBOA financial statements.

SSARS No. 15 defines an OCBOA to include:

- 1) A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (e.g., a basis of accounting insurance companies use pursuant to the rules of a state insurance commission).
- 2) A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
- 3) The cash basis of accounting and modification of the cash basis having substantial support (e.g., recording depreciation on fixed assets).

Note: Ordinarily a modification would have substantial support if the method is equivalent to the accrual basis of accounting for that item and if the method is not illogical.

If modifications to the cash basis do not have substantial support, the accountant should modify his or her report. If the modifications are so extensive that the modified cash basis financial statements are, in the accountant's judgment, equivalent to the financial statements on the accrual basis, the statements should be considered GAAP basis. In such a case, the accountant may use the standard form of report modified as appropriate because of the departures from GAAP.

May an entity that uses the cash basis of accounting to prepare its federal income tax return use the income tax basis of accounting using the accrual basis?

SSARS No. 15 defines OCBOA to include income tax basis financial statements. However, the income tax basis is defined as "a basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements."

What this means is that the entity must use the basis used to prepare its tax return. Thus, if the tax return is prepared on the cash basis, the income tax basis financial statements (OCBOA) must also be on a cash basis. Further, if the entity wishes to prepare income tax basis financial statements on an accrual basis, it must file its income tax return on an accrual basis.

This situation is problematic for many companies who file their income tax return on a cash basis, yet wish to prepare income tax basis financial statements on an accrual basis, as it is more meaningful to do so. Such a scenario is not authorized by SSARS No. 15.

The solution – the income tax basis of accounting departure!

One way to issue income tax basis financial statements on an accrual basis, while continuing to file cash basis income tax returns, is to issue a report with an income tax basis of accounting departure, similar to a GAAP departure. The difference is that there is a departure from the rules for the income tax basis of accounting (found in SSARS No. 15) rather than GAAP. SSARS No. 15 requires the basis to be the same as the one used for filing the income tax return. By preparing accrual basis financial statements, the entity is violating SSARS No. 15.

Following are sample reports:

Compilation Report – Income Tax Basis of Accounting with Report Exception

To the Board of Directors
Company X
Nowhere, Massachusetts

We have compiled the accompanying statement of assets, liabilities and shareholders' equity-income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenues and expenses and retained earnings- income tax basis for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. **These financial statements have been prepared on the income tax basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.**

A compilation is limited to presenting information in the form of financial statements that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. ***However, we did become aware of a departure from the comprehensive basis of accounting other than generally accepted accounting principles that is described in the following paragraph.***

The comprehensive basis of accounting other than generally accepted accounting principles requires that financial statements prepared on income tax basis of accounting use the same basis used or expected to be used to file the Company's income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash basis of accounting. If the cash basis had been followed, net income and stockholders' equity would have decreased by \$100,000.

Management has elected to omit substantially all of the disclosures **ordinarily included** in financial statements prepared on the income 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 financial position and results of operations. Accordingly, these financial statements are not designed for those who are not informed about such matters.

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Review Report – Income Tax Basis of Accounting with Report Exception

To the Board of Directors
Company X
Nowhere, Massachusetts

We have reviewed the accompanying statement of assets, liabilities and stockholders' equity- income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenues, expenses, and retained earnings- income tax basis for the year then ended, in accordance with Statements for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of XYZ Company.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, ***with the exception of the matter described in the following paragraph***, 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 income tax basis of accounting, as described in Note 1.***

As described in Note 2, the comprehensive basis of accounting other than generally accepted accounting principles requires that financial statements prepared on income tax basis of accounting use the same basis used or expected to be used to file the Company's income tax return. Management has informed us that the company has prepared the accompanying financial statements on the accrual basis of accounting while it files its federal income tax return on the cash basis of accounting. If the cash basis had been followed, net income and stockholders' equity would have decreased by \$100,000.

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K. Using the Internet – An Accountant's Research Tool

Information on the Internet can be an effective tool for CPAs doing compilation and review work. In particular, auditors can access a variety of global business information such as SEC filings, professional news, state CPA society information, IRS information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, legislative and regulatory initiatives, and more. Usually, these materials can be obtained free of charge. CPAs can use the Internet to:

- Obtain accounting research information and texts.
- Discuss accounting issues with peers.
- Communicate with clients.
- Obtain information on professional associations.

To be effective, CPAs should learn effective use of search engines to bypass the mass of useless information.

Effective websites that may be useful are listed on the following table.

Selective Web Sites for CPAs and Auditors

Name	Content	Internet Address
AICPA	Recent auditing and accounting pronouncements and other professional standards as well as other AICPA activities.	www.aicpa.org
FASB	Recent accounting pronouncements and other FASB activities	www.fasb.org
GASB	Recent accounting pronouncements and other GASB activities.	www.gasb.org
GAO	GAO policy and guidance materials, reports on federal agency major rules.	www.gao.gov
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpanet.com
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.prenticehall.ca/accounting/sreatesthits/resource.html
U.S. Tax Code Online	Text of the U.S. Internal Revenue Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank- New York	Key interest rates	www.ny.frb.gov
Economy.com	Analysis, data, forecasts, etc. on the U. S. and world economies	www.economy.com
IASB	International Accounting standards	www.iasb.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Tax Analysts Online	Information on current tax developments	www.tax.org
International Federation of Accountants (IFAC)	Information on standards-setting activities on an international basis.	www.ifac.org
WebCPA	WWW magazine featuring news for accountants	www.webcpa.com
Source: AICPA Compilation and Review Alert		

L. Consulting on Complex Technical and Ethical Questions

SSARS No. 1 requires the CPA to possess or obtain a level of knowledge of the practices and principles related to the client's industry. A common problem challenged in litigation against CPA firms is the fact that the firm accepted an engagement within an industry within which it had limited knowledge and expertise. This has become a major issue as firms become less selective in accepting engagements in the wake of the competitive marketplace.

When it comes to dealing with complex technical and ethical issues, Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, states that firms should set up policies and procedures to address complex, unusual, or unfamiliar issues. Such policies may include consulting, on a timely basis, with individuals both within and outside the firm. An example of an outside consultant may be the AICPA's Technical Hotline and the Ethics Hotline.

If outside consultation is obtained, it is important that the CPA document the discussion in his or her working papers including who was consulted, description of the issue, conclusion reached, and the firm's final position on the issue.

M. Changes to Engagement Letters

In order to mitigate the effects of litigation against CPAs and auditors, more and more CPA firms are including protective language in their engagement letters. The engagement letter is the contract between the client and the auditor and should clearly reflect the understanding and responsibilities of both parties. In 1997, the Auditing Standards Board issued SAS No. 83, *Establishing an Understanding With The Client*, which provides a list of required and recommended language that should be included in an engagement letter for audits.

Strong engagement letters are needed for audit, review, compilation and write-up engagements with most of the same safeguards needed for all types of engagements. Of course, the CPA must weigh the benefits of having a strong engagement letter with those of alienating the client.

Engagement letters are not required for any engagement. However, both accounting and auditing literature requires that an accountant or auditor must obtain an understanding, *preferably in writing*. Without an engagement letter, the terms and conditions of the engagement and the expectations by the client are subject to interpretation without evidence in writing.

Based on results from peer reviews and litigation against CPAs, it is clear that most obtain engagement letters for reviews and audits. When it comes to compilations and writeup services, the percentage of firms that obtain letters drops off considerably.

Here are a few misnomers as to why CPAs do not obtain engagement letters from their clients.

It's only a compilation – where is the risk?

I have not obtained a letter for more than 10 years – My client will not understand why I need one now!

My client never sends back a signed copy even though I ask for it!

My client won't understand what's in the letter anyway!

Although all of the above comments may be true, there is tremendous risk from not obtaining an engagement letter for all engagements. In fact, the author believes that the greatest risk relates to the lowest level of service such as writeup and compilation engagements. The reason is because clients typically err on the side of a level of service that is too high. That is, clients continue to believe that accountants are auditors when, in fact, they are performing a compilation or review engagement. If, for example, a compilation engagement is being performed and an engagement letter is not obtained, it becomes the client's word against the accountant's in terms of ascertaining what type of service was contracted.

What are the SSARS requirements for engagement letters for compilation and review engagements?

SSARS No. 1 (as amended by SSARS No. 8) states:

“The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. However, if the engagement is to compile financial statements not expected to be used by third parties, a written communication is required.”

What SSARS No. 1 says is that an engagement letter is recommended, but not required for a traditional compilation or review engagement. If the engagement is a compilation of management-use only financial statements, a written communication is required, but does not have to be signed by the client.

For traditional compilation and review engagements, the engagement letter should include the following items at a minimum:

1. A description of the nature and limitations of the services to be performed.
2. A description of the report to be rendered.
3. A statement that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts.
4. A statement that the accountant will inform management of any material errors that come to the accountant's attention and any fraud or illegal acts that come to the accountant's attention, unless clearly inconsequential.

What clauses should be included in any engagement letter?

The Illinois Society of CPAs Engagement Letter Task Force *issued Report of the Engagement Letter Task Force* based on a study of what elements should be included in engagement letters. The study represents the most current one of its kind and was based on research into current professional literature, legal liability actions, claims experience, and current practice procedures used by CPA firms.

The following chart identifies some of the clauses that should be included in engagement letters. The chart is segregated into those items that absolutely should be in a letter, to those that are highly recommended, but difficult to obtain.

Language to Include in Engagement Letters

Should have in every letter	Highly recommended provisions	Highly recommended – difficult to obtain
Purpose of letter	Ownership of records and confidentiality of information	Limit on amount of damages in litigation and time to sue
Scope of work to be performed	Record retention policy	Use of report by third parties and limits on reproduction of report
Auditor's/accountant's responsibilities	Mediation clause	
Client's responsibilities	Indemnification arising from management misrepresentations	
Responsibility for fraud and internal control including communication of fraud and illegal acts		
Fees, billing rates, and collections, termination and timing of engagement		
Independence language – Interpretation 101-3		

In 2005, Ethics Interpretation No 101-3 and SSARS No. 12 became effective and each added new language to be included in engagement letters. These two documents add the following changes to the standard engagement letter:

1. Interpretation No. 101-3 requires that an accountant that performs nonattest services (e.g., tax return preparation, bookkeeping, payroll tax preparation, etc.) for an attest client (compilation, review or audit client) must document in writing certain communications with the client regarding the client's responsibility with respect to such nonattest services.

2. SSARS No. 12 requires additional language be inserted in the engagement letter related to the accountant's communication of fraud and illegal acts in either a compilation or review engagement.

In 2005, the ARSC issued new illustrative engagement letters for compilation and review engagements, the samples of which are found in Appendices C, D and E of SSARS No. 1 (AR section 100). These changes include the changes found in Interpretation No. 101-3 and SSARS No. 12, among others, and are reflected in the engagements letters that follow in this section of the course.

In 2008, the ARSC made further changes to the illustrative engagement letter by issuing SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services – 2008*.

ILLUSTRATIVE ENGAGEMENT LETTERS

The following are non-authoritative engagement letters for compilation, review and writeup services engagements, most of which are based on the nonauthoritative engagement letters published in Appendices C, D and E of SSARS No. 1.

In addition to language recommended by SSARS No. 1, the author has included several suggested paragraphs that may assist the CPA in protecting himself or herself against potential litigation. Of course, a CPA may wish to consult with his or her malpractice insurance provider prior to adopting an engagement letter format.

Following are clauses that a CPA may consider inserting into the engagement letter.

Required:

- i. SSARS No. 12 – The CPA's responsibility to report fraud and illegal acts to management.
- ii. Ethics Interpretation 101-3: Documentation in writing of client's responsibility with respect to nonattest services performed by the CPA.³

Highly recommended:

1. Ownership of records – peer review and regulatory review.
2. Record retention policy – if you have a policy.
3. Mediation clause.
4. Indemnity for legal fees from management misrepresentations.
5. Independence language – Ethics Interpretation 101-3.

Recommended but difficult to obtain from the client:

1. Use of the report by third parties and limits on reproduction of the report.
2. Limitation on amount and time to sue.

³ Interpretation 101-3 requires that an accountant document in writing the client's responsibility. Such documentation does not have to be included in the engagement letter even though the letter is the most logical place in which to present such documentation.

a. Required language:

1. SSARS No. 12 Language

An accountant must include in the engagement letter language outlining his or her responsibility for informing the appropriate level of management about fraud and illegal acts.

Sample language:

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

2. Ethics Interpretation 101-3 Language

Interpretation 101-3 requires an accountant that performs nonattest services for an attest client, to document in writing, certain information as to the client's responsibility with respect to the nonattest services performed. Examples of such services including tax return preparation, payroll tax preparation and bookkeeping services.

Sample language:

In addition to the performance of our review engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of any nonattest services, you will:

- 1. Continue to make all management decisions and perform all management functions,*
- 2. Designate an individual who possesses the skill, knowledge and experience to oversee the services,*
- 3. Evaluate the adequacy and results of the services,*
- 4. Accept responsibility for the results of our services, and*
- 5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.*

b. Highly recommended clauses:

1. Ownership of Records – Peer Review and Regulatory Review:

If a client's working papers may be subject to inspection by a peer reviewer or a regulatory reviewer, the CPA must have language in the engagement letter that authorizes the CPA to release those papers to the reviewer.

Sample language:

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.*
- b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.*

2. Record Retention Policy

If a firm has a record retention policy, most insurance companies recommend that the policy be noted in the engagement letter.

Sample language:

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

3. Mediation clause

Most commentators believe the inclusion of a mediation clause in the engagement letter assists the auditor. Mediation acts as an intermediate step before litigation during which there is the possibility that both parties can agree to terms before going the costly route of litigation. Also, mediation is not binding on either party.

Sample language:

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

What about an arbitration clause?

Generally, arbitration clauses are dangerous with respect to a professional engagement. Arbitration is legally binding and the process can restrict the accountant from proving his or her case. Arbitrators are known for “splitting the difference” and there are limitations on the extent of discovery that can be presented in the hearing. In a malpractice case, an accountant that has excellent workpapers may be precluded from presenting those papers as evidence.

Most insurance carriers state that an arbitration clause should be avoided and can be included only with respect to fee disputes, and not malpractice cases.

4. Indemnification for Management Misrepresentations

The AICPA's Code of Professional Conduct restricts the use of indemnification agreements between a client and an accountant. Ethics Ruling 102 deals with the issue from the other side in which an accountant agrees to indemnify a client for damages, losses, or costs arising from lawsuits, claims or settlements that relate, directly or indirectly, to client acts. Nevertheless, it concludes that such an agreement impairs the accountant's independence. It would appear that the same conclusion would be reached if the client agreed to indemnify the accountant for any losses incurred for any reason.

For example, the following clause would not be acceptable:

Not acceptable under Professional Ethics:

If we incur legal fees or other costs as a result of any claims against us by a third party for any reason, you agree to release and indemnify our Firm and its representatives and personnel from all claims, liabilities and expenses, including payment of all of our legal fees and related costs of defense.

However, Ethics Ruling 94 does permit an indemnification clause that provides for the client to indemnify the accountant for damages arising from known misrepresentations by management. In such a case, the clause is permissible and does not impair independence.

Sample language-Acceptable indemnification for management misrepresentations

If we incur legal fees or other costs as a result of our reliance on any false representation made by you, you agree to release and indemnify our Firm and its representatives and personnel from all claims, liabilities and expenses, including payment of all of our legal fees and related costs of defense.

c. Recommended but difficult to obtain

The following clauses are recommended but may not be amenable to clients.

1. Use of report by third parties and limits on reproduction of the report

Identifying those third parties to whom the auditor knows the report will be sent may assist the auditor if a claim is made by an unidentified third party. Yet, some commentators are against including such language on the grounds that the inclusion of third parties within the engagement letter may be construed to make them a party to the contract, thereby fortifying their claim against the auditor. This clause probably should not be included in those states that practice the privity standard where, by its inclusion, a third party could claim it had a contract with the auditor/CPA. Opinions on whether known third parties should be named in the engagement letter differ among malpractice insurance companies.

Restricting reproduction of the report is generally considered a vital clause that helps protect the CPA's privity.

Sample language:

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the reviewed financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

Or,

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the reviewed financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

2. Limitation on amount and time to sue

The limitations on amount and time of any claim against the auditor may be useful if the client is willing to agree to such a claim. Of course, whatever the client agrees to within the engagement letter does not bind a damaged third party.

Sample language:

There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

3. Other matters

In addition to the engagement letter provisions outlined above, a firm should be careful not to include any of the following items in any engagement letter:

1. Marketing information about the firm.
2. Absolutes, superlatives, or words that may be perceived as expanding responsibilities.
3. Any representation as to the quality of the firm's work or its level of expertise. Avoid statements like "We are experts in this area." or "We are well qualified to perform this work."
4. Legal and accounting jargon such as the terms GAAP or GAAS.

Following are sample engagement letters that include changes made by SSARS No. 17.

Sample Engagement Letter: Review

XYZ Corporation
250 West Nowhere Street
Everywhere, MA 03294

Dear Ladies and Gentlemen:

This letter is to confirm our understanding of the terms and conditions of our engagement and the nature of the limitations of the services we will provide.

We will perform the following services:

We will review the financial statements of XYZ Corporation as of December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a review engagement is to express limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in accordance with generally accepted accounting principles (or, if applicable an other comprehensive basis of accounting). We will not perform an audit of such financial statements, [language removed] and, accordingly, we will not express an opinion on them.

A review differs significantly from an audit of financial statements, in which the auditor provides reasonable assurance that the financial statements, taken as a whole, are free of material misstatement.

A review does not contemplate obtaining an understanding of the entity's internal control, assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); and other procedures ordinarily performed in an audit. Accordingly, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Therefore, a review provides only limited 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 generally accepted accounting principles (or, if applicable, with an other comprehensive basis of accounting).

[SSARS No. 12 Language]

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

[Independence – Interpretation 101-3 Language]

In addition to the performance of our review engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of nonattest services, you will:

1. Make all management decisions and perform all management functions,
2. Designate an individual who possesses the skill, knowledge and experience, preferably within senior management, to oversee the services,
3. Evaluate the adequacy and results of the services,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.

As part of our review procedures, we will require certain written representations from management about the financial statements and matters related thereto.

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

[Fees, Payment Terms, Termination and Timing]

We estimate that our fees for the above services will be approximately \$XXX for our review, and \$XXX for preparation of the tax returns. These fees are predicated on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during our review. If significant additional time is required, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. [In addition, we will bill you for travel and other reimbursements such as report production, typing, postage, etc.] Our invoices for these fees will be submitted to you monthly as work progresses and are payable upon presentation. We may suspend work if your account becomes 60 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, you will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of completion.

We will also prepare the federal and state income tax returns for your company for the year ended December 31, 20XX.

We will begin our review on or about November 15, 20XX and expect to issue our report no later than March 31, 20X1. We will complete your tax returns no later than September 15, 20X1.

[ADDITIONAL OPTIONAL PROVISIONS]

[Ownership of Records]

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.
- b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Use of Report by Third Parties]

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction. Or,

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

[Limits on Reproduction of Report]

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

[Mediation]

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]

If we incur legal fees as a result of our reliance on any false representation by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[Limit on Amount of Damages and Time to Sue]

There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

We will be pleased to discuss this letter with you at any time.

Very truly yours,

James J. Fox & Company

If you agree with the terms of our engagement as outlined in this letter, please sign the enclosed copy and return it to our office.⁴

XYZ Corporation:

Sam Slime, President

⁴ An accountant is not required to obtain a client acknowledgement in which case the request to sign the letter and return it would be replaced with language similar to, "This letter sets forth our understanding of the terms and objectives of our engagement."

Sample Engagement Letter: Compilation

XYZ Corporation
250 West Nowhere Street
Everywhere, MA 03294

Dear Ladies and Gentlemen:

This letter is to confirm our understanding of the terms and conditions of our engagement and the nature of the limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual balance sheet of XYZ Corporation as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended.

We will compile the financial statements and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. [language removed]. The objective of a compilation is to present in the form of financial statements, information that is the representation of management (owners). We will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Therefore, a compilation does not provide a basis for expressing any level of assurance on the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.⁵

[SSARS No. 12 Language]

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you

⁵ SSARS No. 12 requires that an accountant inform the appropriate level of management of any fraud or illegal acts.

any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.⁶

[Independence – Interpretation 101-3 Language – new in 2005]

In addition to the performance of our compilation engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of nonattest services, you will:

1. Make all management decisions and perform all management functions,
2. Designate an individual who possesses the skill, knowledge and experience, preferably within senior management, to oversee the services,
3. Evaluate the adequacy and results of the services,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.

The other data accompanying the financial statements are presented for supplementary analysis purposes and will be compiled from information that is the representation of management, without audit or review, and we do not express an opinion or any other form of assurance on such data.

[Insert additional language for omission of substantially all disclosures and the statement of cash flows]

If management elects to omit substantially all disclosures and the statement of cash flows from the financial statements, we will include an additional paragraph that will read as follows:

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

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

⁶ SSARS No. 12 requires that an accountant inform the appropriate level of management of any fraud or illegal acts.

We estimate that our fees for the above services will be approximately \$XXX for our services, and \$XXX for preparation of the tax returns. These fees are predicated on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during our compilation. If significant additional time is required, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. [In addition, we will bill you for travel and other reimbursements such as report production, typing, postage, etc.] Our invoices for these fees will be submitted to you monthly as work progresses and are payable upon presentation. We may suspend work if your account becomes 60 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, you will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of completion.

[Insert additional language if there is a lack of independence]

We are not independent with respect to the Company.

We will also prepare the federal and state income tax returns for your company for the year ended December 31, 20XX.

We will begin our compilation on or about March 1, 20XX and expect to issue our report no later than March 31, 20X1. We will complete your tax returns no later than September 15, 20X1.

[ADDITIONAL OPTIONAL PROVISIONS]

[Ownership of Records]

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.
- b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Use of Report by Third Parties]

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction. Or

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

[Limits on Reproduction of Report]

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

[Mediation]

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]

If we incur legal fees as a result of our reliance on any false representation by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[Limit on Amount of Damages and Time to Sue]

There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our compilation fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our compilation fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

We will be pleased to discuss this letter with you at any time.

Very truly yours,

James J. Fox & Company

If you agree with the terms of our engagement as outlined in this letter, please sign the enclosed copy and return it to our office.⁷

XYZ Corporation:

Sam Slime, President

⁷ An accountant is not required to obtain a client acknowledgement in which case the request to sign the letter and return it would be replaced with language similar to, "This letter sets forth our understanding of the terms and objectives of our engagement."

Sample Engagement Letter: Compilation
Not Intended for Third Party Use under SSARS No. 8

XYZ Corporation
250 West Nowhere Street
Everywhere, MA 03294

Dear Ladies and Gentlemen:

This letter is to confirm our understanding of the terms and conditions of our engagement and the nature of the limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual balance sheet of XYZ Corporation as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended.

We will compile the financial statements in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to present in the form of financial statements, information that is the representation of management (owners). We will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Therefore, a compilation does not provide a basis for expressing any level of assurance on the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.⁸

[SSARS No. 8 additional language]

The financial statements will not be accompanied by a report. Based upon our discussions with you, these statements are for management's use only and not intended for third-party use.

⁸ SSARS No. 12 requires that an accountant inform the appropriate level of management of any fraud or illegal acts.

[SSARS No. 8 additional language]

Material departures from generally accepted accounting principles (GAAP) or other comprehensive basis of accounting (OCBOA) may exist and the effects of those departures, if any, on the financial statements may not be disclosed. In addition, substantially all disclosures required by GAAP or OCBOA may be omitted. (Note: The accountant may wish to identify known departures but is not required to do so.) Notwithstanding these limitations, you represent that you have knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements that allows you to place the financial information in the proper context. Further, you represent and agree that the use of the financial statements will be limited to members of management with similar knowledge.

[SSARS No. 12 Language]

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

[Independence – Interpretation 101-3 Language]

In addition to the performance of our compilation engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of nonattest services, you will:

1. Make all management decisions and perform all management functions,
2. Designate an individual who possesses the skill, knowledge and experience, preferably within senior management, to oversee the services,
3. Evaluate the adequacy and results of the services,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.

The other data accompanying the financial statements are presented for supplementary analysis purposes and will be compiled from information that is the representation of management, without audit or review, and we do not express an opinion or any other form of assurance on such data.

[SSARS No. 8 additional language]

Should you require financial statements for third-party use, we would be pleased to discuss with you the requested level of service. Such engagement would be considered separate and not deemed to be part of the services described in this engagement letter.

[Insert additional language for omission of substantially all disclosures and the statement of cash flows]

If management elects to omit substantially all disclosures and the statement of cash flows from the financial statements, we will include an additional paragraph that will read as follows:

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

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

We estimate that our fees for the above services will be approximately \$XXX for our services, and \$XXX for preparation of the tax returns. These fees are predicated on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during our compilation. If significant additional time is required, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. [In addition, we will bill you for travel and other reimbursements such as report production, typing, postage, etc.] Our invoices for these fees will be submitted to you monthly as work progresses and are payable upon presentation. We may suspend work if your account becomes 60 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, you will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of completion.

[Insert additional language if there is a lack of independence]

We are not independent with respect to the Company.

We will also prepare the federal and state income tax returns for your company for the year ended December 31, 20XX.

We will begin our compilation on or about March 1, 20XX and expect to issue our report no later than March 31, 20X1. We will complete your tax returns no later than September 15, 20X1.

[ADDITIONAL OPTIONAL PROVISIONS]

[Ownership of Records]

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.
- b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Use of Report by Third Parties]

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction. Or,

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

[Limits on Reproduction of Report]

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

[Mediation]

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]

If we incur legal fees as a result of our reliance on any false representation by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[Limit on Amount of Damages and Time to Sue]

There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our compilation fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our compilation fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

We will be pleased to discuss this letter with you at any time.

Very truly yours,

James J. Fox & Company

If you agree with the terms of our engagement as outlined in this letter, please sign the enclosed copy and return it to our office.⁹

XYZ Corporation:

Sam Slime, President

Note: SSARS No. 8 permits an accountant to perform a compilation engagement for management use only without a compilation report being issued.

⁹ An accountant is not required to obtain a client acknowledgement in which case the request to sign the letter and return it would be replaced with language similar to, "This letter sets forth our understanding of the terms and objectives of our engagement."

Sample Engagement Letter: Monthly Bookkeeping and Compilation

XYZ Corporation
250 West Nowhere Street
Everywhere, MA 03294

Dear Ladies and Gentlemen:

This letter is to confirm our understanding of the terms and conditions of our engagement and the nature of the limitations of the services we will provide.

We will perform the following services:

Beginning with the month of _____, we will compile, from information you provide, the monthly balance sheet of XYZ Corporation, and related statements of income and retained earnings for the month then ended, and annual financial statements for the year ended December 31, 20XX.

We will compile the financial statements and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A compilation is limited to presenting in the form of financial statements information that is the representation of management. We will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

You agree to give us the following documents on a monthly basis at our office: bank statements, canceled checks, check stubs or register, payroll records, documents concerning asset acquisitions and dispositions, liabilities and notes payable, and other relevant documents. You must code all check stubs as to the proper account number for recording in the ledgers.

We will record all income and expenses, on a monthly basis, from the above documents you provide, in a computerized general-ledger system. Each month, we will give you a copy of the general-ledger account listing, which shows each check, deposit, and adjustment affecting each account during the month. You agree to review this general-ledger report each month and tell us of any changes necessary in the classification or distribution of expenses. Unless you tell us of the changes within 10 days, we will assume that all transactions have been properly coded and have been posted to the correct accounts. These ledgers will record, on a monthly basis, all cash receipts and cash disbursements. The ledgers will also include adjusting journal entries. These ledgers will be used in the preparation of the annual financial statements and income tax returns.

Each month, we will reconcile your checking account with your bank statement and identify errors in the checkbook. *[However, we will not review any checks for comparison of payee and endorsement.]* We will make correcting entries directly in the checkbook and identify the specific source of each adjustment. We will tell you of these adjustments and make you aware of any corrections.

Beginning with the month of _____, we will prepare, on a quarterly basis, the federal and state payroll tax returns for the state of _____. You are responsible for making the federal and state payroll tax deposits. If there is payroll tax due with the quarterly report, we will notify you.

On an annual basis, we will reconcile all payroll tax returns with the payroll withholding records and prepare the year-end payroll tax returns, including federal and state unemployment tax returns, Forms W-2, W-3, 1099, and 1096, as required.

On a periodic basis, as needed, and at least four times each year, we will meet with you to discuss your accounting records and the management implications of your financial statements. These meetings are important to your financial well-being and should be held at least quarterly. *[We will notify you, in writing, of any matters that we believe you should be aware of, and will meet with you in our office, upon request.]*

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

[Independence – Interpretation 101-3 Language]

In addition to the performance of our compilation engagement, we will perform certain nonattest services including bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of nonattest services, you will:

1. Make all management decisions and perform all management functions,
2. Designate an individual who possesses the skill, knowledge and experience, preferably within senior management, to oversee the services,
3. Evaluate the adequacy and results of the services,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.

The other data accompanying the financial statements are presented for supplementary analysis purposes and will be compiled from information that is the representation of management, without audit or review, and we do not express an opinion or any other form of assurance on such data.

[Insert additional language for omission of substantially all disclosures and the statement of cash flows]

If management elects to omit substantially all disclosures and the statement of cash flows from the financial statements, we will include an additional paragraph that will read as follows:

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

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

We estimate that our fees for the above services will be approximately \$XXX for our services, and \$XXX for preparation of the tax returns. These fees are predicated on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during our compilation. If significant additional time is required, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. [In addition, we will bill you for travel and other reimbursements such as report production, typing, postage, etc.] Our invoices for these fees will be submitted to you monthly as work progresses and are payable upon presentation. We may suspend work if your account becomes 60 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, you will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of completion.

[Insert additional language if there is a lack of independence]

We are not independent with respect to the Company.

We will also prepare the federal and state income tax returns for your company for the year ended December 31, 20XX.

We will begin the annual compilation on or about March 1, 20X1 and expect to issue our report no later than March 31, 20X1. We will complete your tax returns no later than September 15, 20X1.

[ADDITIONAL OPTIONAL PROVISIONS]

[Ownership of Records]

All working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties:

- a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.
- b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

[Record Retention Policy]

It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

[Use of Report by Third Parties]

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction. Or,

It is our understanding that our report is intended for your use and benefit. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the compiled financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

[Limits on Reproduction of Report]

You further agree that you will not reproduce our report for any reason without obtaining our written consent.

[Mediation]

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

[Indemnification for Management Misrepresentations]

If we incur legal fees as a result of our reliance on any false representation by you, you agree to reimburse us for all of our legal fees and related costs of defense.

[Limit on Amount of Damages and Time to Sue]

There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our compilation fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence errors or omissions committed by us will be limited to XX times the amount of our compilation fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

We will be pleased to discuss this letter with you at any time.

The terms of our engagement outlined in this letter will continue in effect from month to month until canceled by either party.

Very truly yours,

James J. Fox & Company

If you agree with the terms of our engagement as outlined in this letter, please sign the enclosed copy and return it to our office.

XYZ Corporation:

Sam Slime, President

N. Liability to Accountants Who Perform Bank Reconciliations

The author wishes to thank Camico Insurance (camico.com) for providing the author with valuable information on claims used to write this section.

The irony is that most accountants believe that their engagement risk is the greatest in performing an audit, and least risky for compilation and write-up engagements.

Yet, nothing could be further from the truth. The courts are lined with cases against accountants who performed compilation or bookkeeping services for their clients.

Specifically:

1. In performing bookkeeping engagements, accountants are being sued by clients who have higher engagement scope expectations than those actually being performed.
2. Accountants who perform bank reconciliations are not adequately communicating the scope and limits of their services to clients.
3. Accountants, in general, are not obtaining engagement letters in bookkeeping engagements.

4. Courts are holding accountants who perform bookkeeping services to a higher level of responsibility when there is employee embezzlement because clients misunderstand:

- a. The different levels of accounting services

Example: They believe the accountant is an auditor

- b. The accountant's role in performing the service

- c. Basic terminology such as "bank reconciliation"

Mitigating the risk of liability

The best way to mitigate the risk associated with performing bookkeeping services is to prepare a well-written engagement letter that outlines the specific procedures that will be performed.

- a. If bank reconciliations are prepared, the engagement letter should include specific language stipulating that the accountant is not responsible for fraud/embezzlement.

Suggested language about bank reconciliations to be included in an engagement letter includes:

Insert in engagement letter:

Each month we will reconcile XYZ Company's books and records of the following bank accounts with the bank statements for proper account balance and to identify reconciling items that may require adjustments to your books and records.

Bank of America 30304044

Bank of America 54044040

We will not be analyzing cancelled checks to determine whether signatures or payments are authorized or for any other purpose, but we will briefly scan them to confirm the amounts match those recorded by the bank on the statement. By your signature below, you acknowledge that you understand and agree that our services are limited in scope and they are not designed to detect employee embezzlement or other fraudulent activities involving your bank accounts. Should you wish us to expand our procedures to include additional work and investigations, we will arrange this with you in a separate engagement letter.

Source: Camico Insurance Co. (camico.com)

REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Most changes required by GAAP:
 - a) are important to the smaller closely held businesses
 - b) cause little cost differences for practitioners preparing reports
 - c) have little usefulness to smaller closely held businesses
 - d) are equally as significant to the smaller closely held business as large corporations
2. Which of the following is not one of the four most common GAAP departures that can simplify engagement time:
 - a) violate FASB No. 142 (ASC 350) by continuing to amortize goodwill and indefinite lived intangibles
 - b) eliminate the Statement of Cash Flows
 - c) use income tax depreciation instead of GAAP depreciation
 - d) violate FASB No. 109 (ASC 740) by not recording deferred income taxes
3. Per the author, how many GAAP departures can you generally include in a compilation or review engagement without an additional emphasis of a matter paragraph:
 - a) none; you cannot have GAAP departures and issue a report without modification
 - b) one or two departures
 - c) up to five departures
 - d) limitless
4. According to SSARS No. 15, which of the following is true:
 - a) all companies can issue income tax basis accrual financial statements
 - b) an entity must use the basis of accounting that it uses to prepare its tax return
 - c) authorizes companies that file their income tax return on a cash basis to prepare income tax basis financial statements on an accrual basis
 - d) an entity cannot issue income tax basis accrual financial statements

5. Which of the following is not true regarding a CPA's use of the Internet:
- a) CPAs can access a variety of global business information
 - b) most information the CPA may want to access for compilation and review work is free of charge
 - c) there is a very limited amount of information available to the CPA on the Internet
 - d) to be effective, CPAs should learn effective uses of search engines to bypass the mass of useless information available on the Internet
6. Which of the following provisions should be in every engagement letter:
- a) limit on amount of damages in litigation and time to sue
 - b) responsibility for fraud and internal control including communication of fraud and illegal acts
 - c) record retention policy
 - d) ownership of records and confidentiality of information
7. Which of the following should be included in an engagement letter:
- a) mediation clause
 - b) arbitration clause
 - c) both a and b above
 - d) none of the above
8. Which of the following is true regarding engagement risk:
- a) audits contain much greater risk than either compilations or bookkeeping services
 - b) clients cannot sue accountants who only perform bookkeeping services
 - c) courts are holding accountants who perform bookkeeping services to a higher level of responsibility when there is employee embezzlement
 - d) accountants are required to obtain an engagement letter in bookkeeping engagements

SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Generally, the GAAP changes are not useful for smaller closely held businesses.

B: Incorrect. Implementing GAAP changes can be costly for the practitioner of smaller closely held businesses, with little or no added value.

C: Correct. Generally, most of the changes required by GAAP have little usefulness to smaller closely held businesses, such as goodwill and other intangibles amortization, consolidation of real estate leasing entities, and depreciation.

D: Incorrect. Many GAAP changes are not as significant to a smaller closely held business for whom the issuance of financial statements is nothing more than a necessity to satisfy a bank or third party user.

(See page 46 of the course material.)

2. A: Incorrect. This is one of the listed GAAP departures noted.

B: Correct. This is not a GAAP departure that is recommended for simplifying engagement time.

C: Incorrect. This is one of the listed GAAP departures noted.

D: Incorrect. This is one of the listed GAAP departures noted.

(See page 48 of the course material.)

3. A: Incorrect. Departures from GAAP are permitted without it being considered so “significant and pervasive” that the additional emphasis of a matter paragraph is warranted.

B: Correct. In the author’s opinion, one or two GAAP departures will generally not distort the financial statements in such a way to require a separate paragraph.

C: Incorrect. According to the author, when the number of GAAP departures is elevated to three, maybe four, the accountant may wish to consider whether the financial statements are so distorted, they are misleading and no longer purport to be GAAP.

D: Incorrect. According to the author, when the number of GAAP departures is elevated to three, maybe four, the accountant may wish to consider whether the financial statements are so distorted, they are misleading and no longer purport to be GAAP. Therefore, the number is not limitless.

(See page 52 of the course material.)

4. A: Incorrect. There is a rule found in SSARS No. 15 that prevents many companies from using income tax basis accrual financial statements.

B: Correct. Under the provisions of SSARS No. 15, the definition of an other comprehensive basis of accounting (OCBOA) includes a basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

C: Incorrect. SSARS No. 15 specifically requires a company to issue OCBOA financial statements on the same basis as it prepares its tax return.

D: Incorrect. SSARS No. 15 specifically requires a company to issue OCBOA financial statements on the same basis as it prepares its tax return. Therefore, the entity can only issue income tax basis financial statements on an accrual basis if it files its tax return on the same basis.

(See page 56 of the course material.)

5. A: Incorrect. There is information regarding SEC filings, professional news, state CPA society information, IRS information software downloads, and more available.

B: Incorrect. Most of the information is available free of charge.

C: Correct. There is not a limited amount of information. There is so much information available, the CPA should learn to use search engines effectively in order to pare down the information to what they want.

D: Incorrect. In order to bypass the mass of useless information, the CPA should learn to use search engines effectively.

(See pages 58 to 59 of the course material.)

6. A: Incorrect. This provision is highly recommended, but difficult to obtain, and therefore is not in every engagement letter.

B: Correct. This provision should be found in every engagement letter.

C: Incorrect. This provision is highly recommended, but is not necessarily found in all engagement letters.

D: Incorrect. This provision is highly recommended, but is not necessarily found in all engagement letters.

(See page 62 of the course material.)

7. **A: Correct.** Most commentators believe the inclusion of a mediation clause in the engagement letter assists the auditor. Mediation is not binding on either party.

B: Incorrect. Generally, arbitration clauses are dangerous with respect to a professional engagement. It is legally binding and the process can restrict the accountant from proving his or her case. Most insurance carriers state that an arbitration clause should be avoided and can be included only with respect to fee disputes, and not malpractice cases.

C: Incorrect. Both mediation and arbitration clauses should not be included.

D: Incorrect. One of the two clauses should be included.

(See pages 65 to 66 of the course material.)

8. A: Incorrect. Nothing could be further from the truth. The courts are lined with cases against accountants who performed compilation or bookkeeping services for their clients.

B: Incorrect. The courts are lined with cases against accountants who performed compilation or bookkeeping services for their clients.

C: Correct. This is because clients misunderstand the different levels of accounting services, the accountant's role in performing the service, and the basic terminology.

D: Incorrect. Accountants are not required to obtain an engagement letter, and in general, they are not obtaining them for bookkeeping services.

(See pages 87 to 88 of the course material.)

O. Changes in Independence Rules that Affect Compilation and Review Engagements – *Revision of Interpretation 101-3 – Performance of Nonattest Services*

1. General

In September 2003, the Professional Ethics Executive Committee of the AICPA issued a revision to Interpretation 101-3 entitled *Performance of Nonattest Services*. The Interpretation was further amended in 2006 with the new changes effective on February 28, 2007.

The revisions focus on restricting the accountant's ability to perform certain nonattest services for attest clients as well as improving the communication between the accountant and the client for whom such services are conducted.

In addition, the revised Interpretation integrates the AICPA independence rules with those of other authoritative regulatory bodies, such as the SEC, by noting that a violation of independence rules of a regulatory body that is more restrictive than the AICPA rules would constitute a violation of AICPA independence.

For years, there has been confusion as to when a CPA performs management services for an attest client to the extent that he or she is no longer independent with respect to that client. This issue has become more important as CPA firms have expanded consulting services directed at existing compilation, review and audit clients. For example, today, many firms offer their services to clients as part-time controllers whereby they perform most of the functions as a controller one or two days per week. Such tasks may include managing accounting personnel, signing checks, negotiating with the banks or investors, etc. Do these functions impair the independence of the CPA with respect to that client? At a simpler level, a CPA may perform write-up services and wish to perform a compilation, review or audit on that same client. Is the write-up service a management function?

The general rule is that a CPA is precluded from issuing a review or audit report on the financial statements of any entity to which he or she is not independent. SSARS No. 1 carves out a special exception for a CPA who performs compilation engagements. That CPA may compile financial statements if he or she is not independent, provided he or she disclaims independence within the compilation report with the following language added to that report:

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

The CPA is not permitted to disclose the reason for the lack of independence. In 2011, SSARS No. 19 permits a CPA to disclose the reason for the lack of independence.

In 1999, the AICPA Professional Ethics Executive Committee issued Ethics Interpretation 101-3, *Performance of Other Services*. The purpose of this interpretation was to clarify when a CPA who performs certain services violates his or her independence. The 1999 version of Interpretation 101-3 provided guidelines on independence segregated into:

- Bookkeeping (including payroll and other disbursements)
- Benefit plan administration
- Investment advisory and management services

- Corporate finance, consulting and advisory services
- Appraisal, valuation, and actuarial services
- Executive or employee service
- Business risk consulting
- Information systems design, installation, and integration

In 2006, the Committee further amended Interpretation 101-3, effective February 28, 2007.

Specific changes made in the 2006 amendment include whether any of the following activities impair independence:

- Compliance services, including preparing a tax return, transmitting the tax return and related payment to the taxing authority.
- The signing and filing of a tax return on behalf of a client.
- Forensic accounting services, including litigation and investigative services.

In the following sections, wherever there is reference to the term "member", the Interpretation is referring to a member of the AICPA. The author uses the terms "CPA", "accountant" and "member" interchangeably within the remainder of this chapter.

Moreover when referring to an attest engagement, the author refers to the following types of engagements:

- Audit of financial statements
- Review of financial statements
- Compilation with no disclaimer for independence
- Attestation engagement under SSAE No. 10

a. General requirements for performing nonattest services for an attest client:

The revised interpretation establishes *three requirements* that must be satisfied in order for a member to perform nonattest services for an attest client:

1. *Member (accountant) may not perform management functions or make management decisions:*

The member should not perform management functions or make management decisions for an attest client.

Exception: The member may provide advice, research materials, and make recommendations to assist management in performing its own functions and making decisions provided the member does not make those decisions.

2. *Client must agree to perform certain functions:*

The client must agree to perform the following functions in connection with the engagement to perform the nonattest services:

- Make all management decisions and perform all management functions,
- *Designate an individual who possesses suitable skill, knowledge, and/or experience*, preferably within senior management, to oversee the services,
- Evaluate the adequacy and results of the nonattest services performed,
- Accept responsibility for the results of the nonattest services, and
- Establish and maintain internal controls, including monitoring ongoing activities.

- a) The member must be satisfied that the client can meet all of the above criteria and can make an informed judgment as to the results of the member's nonattest services. In assessing whether the designated individual possesses the suitable skill, knowledge, and/or experience, the member should be satisfied that the individual understands the services to be performed sufficiently to oversee them. ***However, the individual is not required to possess the expertise to perform or re-perform the services.***
- b) If the client were unwilling or unable to assume the responsibilities noted above (such as the client does not have an individual with suitable skill, knowledge, and/or experience to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's performance of the nonattest services would impair his or her independence.

What if the client does not have an individual with the necessary skill, knowledge, and/or experience to oversee the nonattest services?

Note: The Ethics Committee stated that in establishing the requirement to assess the competency of the client's designated employee, it intended for the employee to have a sufficient level of understanding of the results of the services rendered so that he or she could effectively oversee them, including making any necessary management decisions related to the nonattest service. In all cases, the skill, knowledge, and/or experience level should be sufficient to allow the employee to understand the nonattest service to be rendered and allow him or her to make all management decisions and perform all management functions associated with that service, and to evaluate the adequacy and results of the service, accept responsibility for those results, and establish and maintain internal controls, including monitoring activities, over the subject matter of the service. Note further that the individual is not required to have any expertise regarding the services being performed.

Example: A member is hired by an attest client to perform bookkeeping services. The client designates an employee with suitable skill, knowledge, and experience to oversee the bookkeeping services.

Conclusion: The designated employee should be able to understand the bookkeeping service to be rendered and to perform all management functions related to that bookkeeping service, including understanding the adequacy of the member's services performed. In doing so, for example, the employee should be able to assess the journal entries and general ledger account classifications proposed by the member. This would suggest that the employee must, at a minimum, have a general understanding of the accounting function in order to understand the entries and classifications proposed by the member.

Observation: It would appear that in most small business scenarios, there is someone within the entity who can take responsibility as a designated employee. In the worst case, the owner/manager should be able to act as the designated employee as that person usually has enough overall knowledge

of the business to be considered to have suitable skill, knowledge, and/or experience to oversee the services performed. Also, although the Interpretation suggests that it is preferable for a senior manager to play the role as a designated employee to oversee the nonattest function, there is no requirement to do so. That means that a bookkeeper or controller could be assigned the role as the designated employee.

If an owner/manager has an inadequate knowledge of accounting to approve the accountant's proposed entries and general ledger classifications, that owner/manager still could be the designated employee by having the bookkeeper or controller review the entries and classifications for the owner/manager.

Must the designated person be an employee?

No. One change made to Interpretation 101-3 is the removal of the term "employee" and replace it with the term "individual" so the client must designate an individual who may or may not be an employee. By doing so, an owner or individual outside the company such as an outsourced bookkeeper or controller, can act as the designated individual.

3. *Written establishment and documentation with client.*

Before performing the nonattest services, the member should establish and document in writing his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:

- Objectives of the nonattest engagement
 - Nonattest services to be performed
 - Client's acceptance of its responsibilities
 - Member's responsibilities
 - Any limitations of the engagement
- a) The documentation of the understanding can be in the form of:
- *An engagement letter to the client*, or
 - *An internal memorandum* to the member's file that is not issued to or signed by the client.
- b) The documentation requirement does not apply to certain routine activities performed by the member including providing advice and responding to the client's technical inquiry as part of the normal client-member relationship.
- c) The member's failure to prepare the required documentation would not impair independence, provided the member did establish the understanding with the client.

Example: Mary CPA is hired by her attest client to perform bookkeeping services. Mary meets with the client and establishes an understanding of the services to be provided including:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

Mary forgets to document the understanding either in an engagement letter or in a memorandum to her file. One year later, the failure to document the understanding is discovered while Mary goes through a peer review. She immediately documents the understanding upon discovery of her failure to do so.

Conclusion: Mary's independence is not impaired with respect to the attest client. Mary's failure to document the understanding does not impair independence because she established an understanding with the client.

b. Written establishment and documentation with client:

As discussed above, before performing a nonattest service (e.g., bookkeeping service) the accountant (member) should establish and document in writing his or her understanding with the client (such as the board of directors, audit committee, or management) regarding:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The documentation of the understanding can be in the form of:

- An engagement letter to the client, or
- An internal memorandum to the member's file that is not issued to or signed by the client.

The author suggests *two options* in which to document the understanding with the client as follows:

1. Include reference to the nonattest service within the attest engagement letter assuming one is obtained for the engagement.
2. Prepare an internal memorandum to be placed in the accountant's file and not to be distributed to the client.

Following are examples of each of the two documents.

OPTION 1: Include reference to the nonattest service within the attest engagement letter.

The clearest way by which to document the client's understanding of the nonattest services to be performed for an attest client is to simply include reference to the nonattest service in the attest engagement letter.

Example: An accountant is hired to perform a review engagement for a company, as required by the company's bank. The client has no bookkeeper and seeks to hire the accountant to perform bookkeeping services prior to performing the review engagement including:

- Coding all checks and deposits for the year
- Posting all cash receipts and disbursements to the general ledger
- Making adjusting entries to convert the general ledger to the accrual basis of accounting

Conclusion: The accountant should document the client's understanding of the nonattest services to be provided. One way to do so is to include language in the review engagement letter that clarifies the:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

Following is the author's nonauthoritative language that can be placed in the engagement letter.

Prior to our review engagement, we will perform certain bookkeeping services. We will also perform certain payroll-tax services. We may propose journal entries and general ledger classifications for certain transactions. We will not perform any management functions or make management decisions on your behalf with respect to any bookkeeping or other services we may provide.

You agree that in connection with our performance of any bookkeeping and payroll-tax services, you will:

1. Continue to make all management decisions and perform all management functions including approving all journal entries and general ledger classifications when they are submitted to you,
2. Designate a competent person to oversee our services,
3. Evaluate the adequacy and results of the services we perform,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services we may perform.

OPTION 2: Prepare an internal memorandum to be placed in the accountant's file and not to be distributed to the client.

Interpretation 101-3 requires that there be *written documentation* of the client's understanding of the nonattest services to be performed for an attest client. That documentation does not have to be in the form of an engagement letter signed by the client. Instead, the accountant can draft a memorandum of the understanding and place it in his or her file.

The author has drafted the following non-authoritative memorandum.

James J. Fox & Company, CPA
Memorandum on Performance of Non Attest Services
for an Attest Client- Interpretation 101-3 (revised)

Client name: _____ Year end of attest engagement: _____

Type of attest engagement:

____ Review ____ Audit ____ Attestation – SSAE No. 10 ____ Compilation with no disclaimer for lack of independence

Type of nonattest services to be performed:

____ Bookkeeping
 ____ Payroll tax prep/other disbursements
 ____ Benefit plan services
 ____ Investment advisory/management
 ____ Corporate finance/consulting/advisory
 ____ Tax return preparation

____ Appraisal, valuation or actuarial services
 ____ Business risk consulting
 ____ Information systems
 ____ Other: _____

Comments: nonattest services:

	Yes	No	Comments
1. Is the client aware of the objectives of the engagement?			
2. Does the client understand the type of nonattest services the accountant is about to perform?			
3. Has client accepted responsibility for the nonattest services including:			
a. Has management agreed to continue to make all management decisions and perform all management functions?			
b. Has management designated an individual who possesses suitable skill, knowledge, and/or experience, (preferably someone within senior management), to oversee the nonattest services? Name: _____			
c. Has management agreed to evaluate the adequacy and results of the nonattest services performed?			
d. Does management accept responsibility for the results of the nonattest services?			
e. Does management take responsibility to establish and maintain internal controls, including monitoring ongoing activities, over the subject matter of the nonattest engagement?			

4. Does management understand the accountant's responsibilities for the engagement and that the accountant cannot perform any management functions or make any management decisions related to the nonattest engagement?			
5. If applicable, has management been informed of any limitations of the engagement and their impact on the nonattest engagement?			
6. Is the accountant satisfied that the client can meet all of the above criteria and can make an informed judgment as to the results of the nonattest services?			
7. Has the accountant assessed the skill, knowledge, and/or experience of the client's designated individual (in 3(b) above) and satisfied that the designated individual understands the nonattest services to be performed sufficiently in order to oversee them? Note: In order to have the skill, knowledge and/or experience, the designated individual must have a sufficient level of understanding of the results of the services rendered so that he or she could effectively oversee them, including making any necessary management decisions related to the nonattest service.			
Conclusion: _____ The accountant has documented an understanding with the client with respect to the nonattest services to be performed. Independence is not impaired based on the Interpretation 101-3 requirements. _____ The requirements of Interpretation 101-3 have not been satisfied. By performing the nonattest service, the firm's independence will be impaired. Comments:			

AICPA Q&A – Interpretation 101-3

In 2004, the AICPA issued guidance on implementing Interpretation 101-3. The guidance was updated in January 2005. Following are excerpts from that guidance, some of which has been modified by the author.

What clients are affected by the documentation requirement?

The documentation requirement applies to any nonattest service (such as bookkeeping, tax or consulting services) performed by the member for an attest client. An attest client is any client for which the member performs any service for which independence is required such as a (an):

- Audit
- Review of financial statements
- Compilation in which the compilation report does not disclose lack of independence
- Attestation under the SSAEs

Where a member only provides nonattest services to a client, the requirements of the interpretation, including the documentation requirement, are not effective until the client becomes an attest client.

Example: A member provides only tax planning and bookkeeping services for a client and is subsequently asked to perform a review of the client's financial statements.

Conclusion: The member could perform the tax planning and bookkeeping services if, upon acceptance of the review engagement, he or she prepares the required documentation and can demonstrate that he or she has complied with the other general requirements of the Interpretation during the period covered by the financial statements, including the requirement to establish an understanding with the client regarding the matters identified above.

What form of documentation is required?

The rule requires that the understanding with the client be in writing, but leaves the form of such documentation to the member's discretion. The method of documentation is not as important as the content of the documentation.

Example: A member performs a consulting engagement for an audit client.

Conclusion: The member may decide to document the required elements of the consulting engagement in the audit engagement letter. Alternatively, the understanding could be documented in a separate engagement letter specific to the consulting engagement, in a memo to the audit files, or in a checklist that is completed as part of the audit.

If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member's billing or correspondence files (e.g., separate from the client work paper files).

Would independence be impaired if a member establishes an understanding with the client but failed to document that understanding with the client about a nonattest service to be performed?

No. The Interpretation states that the failure to prepare the required documentation would not impair independence provided the member did establish an understanding with the client. However, it would be considered a violation of Rule 202, *Compliance with Standards*.

Definition of suitable skill, knowledge and/or experience:

The Interpretation requires that the client agree to perform certain functions in connection with the engagement to perform nonattest services. One of those requirements is that the client designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the services.

What does “suitable skill, knowledge and/or experience” mean in the context of the Interpretation?

Suitable skill, knowledge, and/or experience means that the designated individual has the ability to understand the nature, objective and scope of the nonattest service.

To oversee the services, the employee is not required to supervise the member in the day-to-day rendering of the services. Instead, the employee should:

- Agree on the nature, objectives and scope of the services
- Receive periodic progress reports where appropriate
- Make all significant judgments
- Evaluate the adequacy and results of the service
- Accept responsibility for the service results
- Ensure that the resulting work product meets the agreed-upon specifications.

The skill, knowledge, and/or experience needed will vary depending on the nature of the nonattest service performed.

Example: The skill, knowledge, and/or experience needed to oversee a payroll service can be expected to be different than the skill, knowledge, and/or experience needed to oversee a complex tax service.

Moreover, the requirement for the client employee to possess suitable skill, knowledge and/or experience, does not, however, require that the individual possess the technical expertise that the member possesses or the competence of performance or to re-perform the services.

Why must an individual possess suitable skill, knowledge and/or experience under the Interpretation?

If a designated employee does not possess suitable skill, knowledge and/or experience to oversee the nonattest service, there would be no one, other than the member, to make significant judgments that are needed during the delivery of the service or to discharge the other client responsibilities under the Interpretation. Performing those activities on behalf of the attest client would be inconsistent with the member's requirement to be independent of the client.

How should a member assess the skill, knowledge and/or experience of an individual designated by a client to oversee a nonattest service?

The assessment might include factors such as the individual's:

- Understanding of the nature of the service,
- Knowledge of the client's business,
- Knowledge of the client's industry,
- General business knowledge,
- Education, and
- Position at the client.

Certain factors might be weighed more than others, depending on the nature of the service.

Example: A client employee who understands the nature of the service and possesses sufficient knowledge of the client's business and industry, may have the skill, knowledge and/or experience to oversee the nonattest service, regardless of the level of education he or she possesses.

Example: Many small business owners know their company's operations and financial position better than any other person, and they understand the nonattest services to be performed by the member and what those services are expected to accomplish. Because they are business owners, they regularly make important decisions about all matters affecting their business. Consequently, members might conclude that those individuals possess the skills, knowledge and/or experience to understand the services being performed, make any management decisions, and determine whether the results of the services meet the agreed-upon specifications.

Who at the client could serve as the designee?

The designee will depend on the structure of the client's organization and the nature of the nonattest engagement being performed.

In an owner-managed business, that person will often be the owner. However, it could also be a controller, bookkeeper, another employee, or a third-party not employed depending on the nature of the nonattest services and the qualifications of other client employees.

Example: Assume there is a nonattest engagement where the member has been asked to provide investment advisory services, including recommendations on the allocation of funds that the client should invest in various asset classes based on the client's desired rate of return and risk tolerance. Assume further that the owner makes all investment decisions related to the allocation of funds and investment selections and accepts responsibility for the resulting investment plan.

Conclusion: With respect to the nonattest engagement, the member may conclude that the owner possesses the skill, knowledge and/or experience to oversee the service.

Change the facts: Assume the engagement involves the installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format for a small business client. The owner is traveling and designates the office manager to oversee the installation service. The office manager performs routine clerical and receptionist functions, has a limited understanding of the company's operations, and has never used accounting or financial software such as the application being installed by the practitioner. Further, because the company hires a part-time bookkeeper to maintain the general ledger and subsidiary records, the office manager has no understanding of the company's books and records and financial statements.

Conclusion: For purposes of the performance of the nonattest engagement (installation of off-the-shelf accounting software and the set up of a chart of accounts and financial statement format), it is unlikely that the office manager would be deemed to possess the skill, knowledge and/or experience as he or she is not in a position to understand the services being performed sufficiently to oversee them and accept responsibility for the resulting accounting system.

May a client contract with a third party who is not an employee of the client to oversee or advise on the member's performance of the nonattest service?

Yes. The client may contract with a third party to advise management about the nature of the services and the evaluation of the adequacy and results of the services in order to enable management to oversee the services, perform all management functions, make management decisions, accept responsibility for the services performed, and maintain internal controls over the services.

If the client outsources employee functions to a third party, that third party may serve as the individual who possesses the skill, knowledge and/or experience, functions in a capacity equivalent to that of a client employee, and has the authority to make decisions on behalf of the client.

How can a member be satisfied that the client designee understands the nonattest services performed and the work product?

Members must utilize their professional judgment and experience to recognize which individuals are able and willing to fulfill the client responsibilities. Practitioners should be able to assess whether the designated client employee possesses the skill, knowledge and experience to effectively oversee the nonattest services. This can be accomplished through interaction with the client owner or individual.

What are examples of nonattest services and the level of understanding that the client designee should possess to be considered competent under the Interpretation?

Bookkeeping services: If bookkeeping services are performed for an audit, review or compilation client, the member should be satisfied that the designated individual understands the reason why the journal entries are being proposed and the effect on the financial statements.

Recurring/standard entries: For recurring or standard journal entries (such as depreciation), the client may require no explanation as to the reason for the entry if the member has previously discussed the entries with the individual.

More complex journal entries: For more complex entries such as those related to deferred income taxes, the member may need to explain the reason for the entry and the basis for the entry and its impact on the financial statements. The individual should be in the position to approve the proposed entries and to accept responsibility for its financial statements.

Tax services: For tax return preparation engagements, the individual does not have to understand tax law. Instead, the member should have the individual review the tax return with emphasis on the key tax positions taken and be satisfied that the individual understands the company's tax situation, and has a general understanding of how the amounts on the tax return were determined. The individual must also make all decisions regarding significant tax positions taken in the return.

Valuation services: For permitted valuation services, the member may need to explain to the individual the valuation methodologies used and all significant assumptions. The individual should approve all significant assumptions and accept responsibility for the resulting valuation.

Avoiding Interpretation 101-3 – Compilation with Lack of Independence

Some firms that perform compilation engagements may choose to ignore the documentation requirements of the Interpretation by simply disclaiming independence in the compilation report. By not satisfying the documentation requirement, the accountant is not independent.¹⁰ However, such an option is not available for review and audit engagements.

Observation: The author notes that, as a matter of policy, some firms are planning to disclaim independence in all of their compilation reports to ensure that they do not violate the documentation requirements of the Interpretation. In doing so, such firms avoid having to spend additional time to document under the Interpretation with the sole risk that a client or third party might challenge the lack of independence. As a practical point, few third parties or clients will care whether the firm is independent or not with respect to a compilation engagement.

Dealing with the Preparation of Tax Returns for an Attest Client

Under the Interpretation, an accountant who prepares tax returns or performs tax consulting for an attest client must comply with the requirements of the Interpretation as they relate to nonattest services. Those requirements include:

1. The accountant may not perform management functions or make management decisions as they relate to the tax return or tax positions taken.

¹⁰ A failure to prepare the required documentation does not impair independence but does violate AICPA ethics Rule 202, Compliance with Standards.

2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - Make all management decisions and perform all management functions,
 - *Designate an individual who possesses the skill, knowledge, and/or experience*, preferably someone within senior management, to oversee the nonattest tax services,
 - Evaluate the adequacy and results of the nonattest tax services performed,
 - Accept responsibility for the results of the nonattest tax services, and
 - Establish and maintain internal controls, including monitoring ongoing activities.
3. *Written establishment and documentation with client.* The member should establish and *document in writing* his or her understanding with the client with respect to:
 - Objectives of the nonattest tax engagement
 - Nonattest tax services to be performed
 - Client's acceptance of its responsibilities
 - Member's responsibilities
 - Any limitations of the engagement

In many instances, there may be several nonattest services being performed for the same attest client. They may include performing bookkeeping, payroll tax preparation and income tax return preparation for the same attest client.

For all three nonattest services (e.g., bookkeeping, payroll tax preparation, and income tax return preparation), the accountant must obtain written establishment and documentation of the nonattest services to be performed. That documentation can be included in an engagement letter, tax file memorandum, or other memoranda. Because the documentation should be obtained prior to performing the nonattest service, including language in the representation letter is not an option.

The author believes that where possible, the best place in which to document the understanding with the client is in the engagement letter.

Following is an example of standard language that can be placed in an engagement letter to deal with several types of nonattest services performed for a nonattest client.

Example: Assume an accountant is hired to perform the following services for Company X for the year ended December 31, 20X1:

- Review engagement
- Federal and state income tax returns for X
- Bookkeeping services
- Payroll tax return preparation

Conclusion: The accountant can include the following language in the review engagement letter:

In addition to the performance of our review engagement, we will perform certain nonattest services including *bookkeeping services, payroll tax return preparation, and the preparation of the Company's federal and state income tax returns.*

We, in our sole professional judgment, reserve the right to refuse to do any procedure or take any action that could be construed as making management decisions or performing management functions, including determining account codings and approving journal entries.

We will advise you, with regard to tax positions taken in the preparation of the tax returns, but you must make all decisions with regard to those matters.

You agree that in connection with our performance of any bookkeeping, payroll-tax and tax return preparation services, you will:

1. Continue to make all management decisions and perform all management functions,
2. Designate an individual who possesses the skill, knowledge and experience to oversee the services,
3. Evaluate the adequacy and results of the services,
4. Accept responsibility for the results of our services, and
5. Establish and maintain internal controls, including monitoring ongoing activities related to the services.

Observation: The above language is generic and satisfies the requirements of Interpretation 101-3.

c. Activities that impair a member's independence:

One of the requirements in Interpretation 101-3 is that the accountant *may not perform management functions or make management decisions*. The member should avoid certain activities that will be considered performing management functions or making management decisions, and thus impair his or her independence. The following are some general activities that Interpretation 101-3 states **would impair** a member's independence.

- Authorizing, executing or consummating a transaction, otherwise exercising authority on behalf of a client or having the authority to do so (for example, negotiating a transaction)
- Prepare source documents,¹¹ in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities

¹¹ A source document is defined as the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.

- Determining which recommendations of the member should be implemented
- Report to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member's independence. These examples presume that the *three general requirements have been met* and are not intended to be all-inclusive of the types of nonattest services performed by a member.

Items in ***bold italic*** represent changes made in the 2003 revised version of Interpretation 101-3.

TYPE OF OTHER SERVICE	INDEPENDENCE WOULD NOT BE IMPAIRED	INDEPENDENCE WOULD BE IMPAIRED
Bookkeeping	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client <i>provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.</i> 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents. • Make changes to source documents without client approval.
Non-tax Disbursement*	<ul style="list-style-type: none"> • Using payroll time records provided and approved by the client, generate unsigned checks or process client's payroll. • Transmit client approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.¹² 	<ul style="list-style-type: none"> • Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Approve vendor invoices for payment.

¹² Footnotes removed.

Benefit Plan Administration¹³	<ul style="list-style-type: none"> • Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document. • Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member's electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium. 	<ul style="list-style-type: none"> • Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence. • Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
Investment Advisory & Management	<ul style="list-style-type: none"> • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. • Perform record keeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third party benchmarks. • Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are: (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles. • Transmit a client's investment selection to a broker dealer or equivalent provided the client has authorized the broker dealer or equivalent to execute the transaction. 	<ul style="list-style-type: none"> • Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. • Execute a transaction to buy or sell a client's investment. • Have custody of client assets, such as taking temporary possession of securities purchased by a client.

¹³ When conducting an audit of a plan subject to ERISA, the Department of Labor (DOL) regulations must be followed which may be more restrictive. Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality. Accordingly, the member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

Corporate Finance Consulting or Advisory	<ul style="list-style-type: none"> • Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers or capital sources. • Assist in drafting an offering document or memorandum. • Participate in transaction negotiations in an advisory capacity. • Be named as a financial adviser in a client's private placement memoranda or offering documents. 	<ul style="list-style-type: none"> • Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter, underwriter, broker dealer, guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Appraisal, Valuation or Actuarial	<ul style="list-style-type: none"> • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would not be <i>material to the financial statements</i>, and the appraisal, valuation, or actuarial service does not involve a <i>significant degree of subjectivity</i> such as an actuarial valuation of a client's pension or postemployment benefit liabilities. • Appraisal, valuation, and actuarial services performed for nonfinancial statement purposes that otherwise meet all other requirements of the Interpretation, including those performed for tax compliance, estate and gift taxation and divorce proceedings. 	<ul style="list-style-type: none"> • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would be <i>material to the financial statements</i>, and the appraisal, valuation, or actuarial service involves a <i>significant degree of subjectivity</i> such as a those in connection with employee stock ownership plans, business combinations, or appraisals of assets or liabilities.
Executive or Employee Search	<ul style="list-style-type: none"> • Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g. required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity. 	<ul style="list-style-type: none"> • Commit the client to employee compensation or benefits arrangements. • Hire or terminate client employees.
Business Risk Consulting	<ul style="list-style-type: none"> • Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements. 	<ul style="list-style-type: none"> • Make or approve business risk decisions. • Present business risk considerations to the Board or others on behalf of management.

Information Systems Design, Installation & Integration	<ul style="list-style-type: none"> • Install or integrate a client's <i>financial</i> information system, <i>that was not designed or developed by the member (e.g., an off-the-shelf accounting package).</i> • <i>Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system.</i> • <i>Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records.</i> • <i>Provide training and instruction to client employees on an information and control system.</i> 	<ul style="list-style-type: none"> • <i>Design or develop a client's financial information system.</i> • <i>Make other than insignificant modifications to source code underlying a client's existing financial information system.</i> • Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system.
<p>Source: Interpretation 101-3 (revised), as modified by the Author. *Change made by the 2006 amendment to Interpretation 101-3.</p>		

Each of the categories of nonattest services is addressed in the following section.

1. Performing bookkeeping services for an attest client

Perhaps the most common nonattest service conducted by accountants for their attest clients is the performance of bookkeeping services. The revised Interpretation 101-3 offers a framework for conducting bookkeeping services and clarifies those bookkeeping functions that impair independence from those that do not.

Specifically, bookkeeping services include the performance of any of the following:

- Recording (cash receipts and disbursement) transactions to the general ledger
- Reconciling cash accounts
- Prepare financial statements based on information in the trial balance
- Proposing and/or posting standard, adjusting, or correcting entries to a client's trial balance

Although the above list includes services categorized as bookkeeping nonattest services, the performance of some bookkeeping services taint independence, while others do not.

The key factor in determining whether the performance of bookkeeping services impairs an accountant's independence is *whether the accountant makes management decisions or performs management functions in performing those services*. For example, if a client determines the general ledger accounts in which to post transactions and the accountant merely posts those transactions to the client-selected general ledger accounts, the accountant is simply recording transactions authorized by the client. Conversely, if the accountant selects the general ledger accounts to post checks and deposits, the accountant is making a decision in the capacity of management and, thus, impairs his or her independence.

A quick summary is that in order for an accountant to perform bookkeeping services for an attest client without impairing his or her independence, the *client (not the accountant) must*:

- Approve all standard, journal, correcting, and audit entries,
- Approve all general ledger account classifications,
- Prepare all source documents,
- Oversee the accountant's bookkeeping service by a designated employee,
- Accept responsibility for the results of the nonattest services, and
- Establish and maintain internal controls over the bookkeeping service, including monitoring ongoing activities.

The accountant can initially prepare entries and make decisions as to general ledger account classifications of income and expense items. However, those journal entries and account classifications *must ultimately be reviewed and approved by the client*. Moreover, with respect to proposed journal entries, the accountant must be satisfied that management *understands the nature of the proposed entries and the impact they have on the financial statements*. Another issue that is critical with respect to bookkeeping is that the accountant may not prepare or alter any source documents. To do so means the accountant is acting in the capacity as a member of management. A source document is defined by Interpretation 101-3 as a document upon which evidence of an accounting transaction is initially recorded. Examples include payroll time cards, customer orders, purchase orders. Checks are not source documents, so an accountant may prepare a check but may not sign it on behalf of the client.

Can a client approve the journal entries and account classifications after the accountant performs the bookkeeping services?

The Interpretation does not address the timing of any approval. Presumably, an accountant can complete his or her bookkeeping services and then submit the general ledger and entries to the client for approval. Otherwise, there would be a logistical challenge in that the accountant would be precluded from preparing any proposed journal entries or account classifications until the client approved each such entry and classification.

Example: An accountant is hired to perform bookkeeping services for an attest client. He receives the bank statements from the client that include all checks and deposits for the fiscal year. The client has not coded the checks or deposits with general ledger account classifications. The accountant selects the general ledger accounts to which to post the checks and deposits and also makes a series of journal entries to adjust the trial balance to accrual basis GAAP. All source documents such as invoices, sales orders, etc. have been prepared by the client, not the accountant. Upon completion, the accountant prints out the general ledger and all journal entries and submits them to the client to review. The client reviews the categorization of the checks and deposits, and journal entries, and approves them. The accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Conclusion: The accountant's *independence is not impaired* by his performance of bookkeeping services for an attest client. First, the client approves all journal entries and account classifications even though that approval is done after the accountant performs

his bookkeeping function. Further, the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

How must an accountant obtain evidence that a client has approved the accountant's journal entries and general ledger account classifications?

There is no answer. The author recommends that the accountant ask the client to review the final adjusted general ledger and to initial it, indicating approval. The accountant can send a transmittal letter to the client that looks something like this:

Mr. Jimmy Smith
Smith's Silly Biscuits
Boston, MA

Dear Mr. Smith:

In accordance with our engagement letter dated January 18, 20X2, we have performed certain bookkeeping services for Smith's Silly Biscuits as of December 31, 20X1 and for the year then ended.

Enclosed please find the company's general ledger for the year ended December 31, 20X1, that reflects our proposed account classifications for transactions we recorded, and general journal entries we recommend be made.

Please review the enclosed general ledger and note your approval or disapproval of all account classifications and general journal entries. [If we do not receive your response by March 15, 20X2, we will assume you have reviewed the enclosed documents and are approving the classifications and entries.]¹⁴

We also assume that you understand the nature of the proposed entries and the impact they have on the financial statements.

We would appreciate you indicating approval of all transactions and entries by initialing the first page of both the general ledger and schedule of general journal entries, and returning both to our office. Any exceptions should be highlighted. Upon receiving your approved documents, we will begin our review engagement.

Please call my office with questions.

Very truly yours,

Mary Macky, CPA
Macky, Wacky and Daffy, LLP

¹⁴ The author is suggesting that a negative confirmation of the client's approval is acceptable. The Interpretation does not address the use of a negative confirmation of client approval.

May the client approval be noted in management's representation letter for the review or audit engagement?

Theoretically, the answer is no. Practically, the answer is yes. In many instances a bookkeeping service is performed in conjunction with the attest service. That is, an accountant might perform bookkeeping services while he or she is also conducting his or her review or audit engagement. For example, a portion of the adjustments made by an accountant during an attest engagement might be entries that are actually part of the bookkeeping service such as adjustments of accruals, prepaid expense accounts, or adjustments to convert standard journal entries to actual. Such entries are actually part of bookkeeping which is interrelated with the review or audit engagement. It may not be practical for a client to approve such entries until the accountant has completed the review or audit engagement. If the accountant wishes to document that management has approved the entries and classifications, one way to do so is to include the client approval in the representation into the management representation letter obtained for the engagement.

The author suggests that the following language can be inserted into the representation letter:

We have reviewed all journal entries and account classifications proposed by you (the accountant) and approve them. We understand the nature of the proposed entries and the impact the entries have on the financial statements. We also take responsibility for the journal entries and account classifications proposed and for establishing and maintaining internal controls over your bookkeeping services performed as part of your review (audit) engagement.

Observation: Some individuals conclude that approval of the entries and classifications cannot be included in the management representation letter. Their opinion is based on the assertion that management must approve all entries and classifications *before* the attest engagement begins. Otherwise, the accountant is reviewing or auditing his own work. The author believes that in theory, client approval should be obtained prior to commencing the review or audit engagement. However, in practice, there is not necessarily a clear cut delineation between the end of bookkeeping services and the beginning of the review or audit engagement. The reason is because some bookkeeping services might be performed during the review or audit engagement.

Must management's approval for the entries and classification be in writing?

There is no requirement that management note its approval for the entries and classifications in writing. However, absent such a written confirmation, the accountant has no evidence that management has, in fact, given approval.

The author believes that in substance, management approves journal entries by recording them. That is, if an accountant submits proposed entries to a client and that client or his/her bookkeeper/controller records the proposed entries, the recording could be considered an approval and acceptance of those entries.

Is the preparation of financial statements from a client trial balance a nonattest bookkeeping service?

Yes. The Interpretation specifically states that the preparation of financial statements from a client trial balance is a bookkeeping service subject to the Interpretation requirements. The good news is that the preparation of financial statements does not impair independence provided the documentation requirements of the Interpretation are met.

Is a written understanding required if an accountant performs nonattest services (e.g., bookkeeping services) as part of a compilation engagement?

Yes. The written documentation requirement of Interpretation 101-3 applies in situations in which nonattest services are performed for an attest client (e.g., review, audit, or compilation that does not disclaim independence). Therefore, written documentation is required.

Moreover, the same issues regarding independence apply to a compilation engagement as they do an audit or review. If an accountant performs bookkeeping services for a client for whom he or she also performs a compilation engagement, the accountant will violate his or her independence by making management decisions or performing management functions in performing the bookkeeping service.

Therefore, the accountant cannot:

- Authorize transactions on behalf of the client
- Prepare any source documents
- Have custody of client assets (e.g., is a signator in a bank account)
- Supervise client employees in the performance of their normal recurring activities
- Determine which recommendations of the member should be implemented
- Report to the board of directors on behalf of management
- Serve as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

If bookkeeping services are performed, the client (rather than the accountant) must:

- Approve any standard, journal, correcting, and audit entries,
- Approve any general ledger account classifications,
- Prepare any source documents,
- Accept responsibility for the results of the nonattest services, and
- Establish and maintain internal controls over the bookkeeping service, including monitoring ongoing activities.

If the accountant performs any of the above functions, his or her independence would be impaired and he or she would have to disclaim independence in the compilation report as follows:

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

Although not required by Interpretation 101-3, nothing precludes an accountant from documenting the client's understanding in writing in a compilation engagement letter.

Example: Fred CPA is hired to perform monthly write-up and bookkeeping services and prepares quarterly payroll tax returns and the annual W-2s. Fred also issues a monthly compilation report with no footnotes. The bookkeeping services will include:

- Coding all checks and deposits
- Posting all cash receipts and disbursements to the general ledger
- Posting adjusting entries to convert the general ledger to the accrual basis of accounting

Conclusion: The accountant is performing a nonattest service for an attest client. The reason is because the accountant is coding checks and deposits and posting cash receipts and disbursements in developing a cash basis trial balance. Transactions performed to bring a trial balance to a cash basis are considered a nonattest service, subject to Interpretation 101-3. Posting adjusting entries to convert the general ledger to the accrual basis, if performed during the compilation engagement, are not considered a nonattest service.

Because the accountant is performing some nonattest services for an attest client, the accountant is required to comply with the Interpretation 101-3 requirements, including documenting the client's understanding of the nonattest services to be provided (bookkeeping services).

Additionally, the accountant must comply with the independence rules of Interpretation 101-3 in that the accountant may not:

- Authorize transactions on behalf of the client
- Prepare any source documents
- Have custody of client assets (e.g., is a signator in a bank account)
- Supervise client employees in the performance of their normal recurring activities
- Determine which recommendations of the member should be implemented
- Report to the board of directors on behalf of management
- Serve as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

With respect to the bookkeeping services performed, the client (rather than the accountant) must:

- Approve any standard, journal, correcting, and audit entries,
- Approve any general ledger account classifications,
- Prepare any source documents, not the accountant,
- Accept responsibility for the results of the nonattest services, and
- Establish and maintain internal controls over the bookkeeping services, including monitoring ongoing activities.

AICPA Q&A on bookkeeping services

The AICPA has issued a Q&A related to the performance of bookkeeping services for an attest client. Following are excerpts from that Q&A, as modified by the author:

Example 1:

A member records journal entries while performing monthly bookkeeping services without obtaining client approval. Is independence impaired?

Yes. The client must review and approve the journal entries and the member must be satisfied that management understands the nature of the proposed entries and their impact on the financial statements.

Example 2:

In performing bookkeeping services, the following services are performed:

- The client approves the invoice for payment and notes the appropriate general ledger account classification.
- The member receives approved invoices from the client.
- The member prepares the client's checks for payment and records the transactions in the client's general ledger system, and returns the checks to the client for approval and signature.
- The member has no signature authority.

Is the member's independence impaired?

No. The reason is because management determined and approved the appropriate account classifications, approved the invoices for payment, and reviewed and signed the prepared checks.

Example 3:

In performing monthly bookkeeping services, the following services are performed:

- The member discusses with the client the need to record recurring journal entries (such as depreciation) each month in the general ledger.
- The client approves the recurring entries and makes any necessary decisions, such as the useful lives of the assets.
- The member records the entries in the client's general ledger each month.
- The member is satisfied that the client understands the general nature of the entries and their impact on the financial statements.

Is the member's independence impaired?

No. Because the client approves the entries and understands the general nature of the entries and their impact on the financial statements, independence is not impaired.

Example 4:

In performing monthly bookkeeping services, the following services are performed:

- The client records all disbursements in its checkbook and identifies the type of expense (such as telephone, rent, etc.) on the checkbook stubs.
- The member assigns the general ledger account number based on the type of expense identified by the client on the checkbook stub) and the member records the cash disbursements in the client's accounting system.

Is the member's independence impaired?

No. The client coded the transactions on the check stubs. In doing so, the client approved the classification of the cash disbursements. The member merely recorded the client's classifications in the client's accounting system.

Example 5:

A member is engaged to perform an audit, review or compilation of the client's financial statements. During the course of the engagement, the member proposes audit adjustments to the financial statements as follows:

- Current tax accrual
- Deferred tax adjustment
- Depreciation and amortization adjustment

The client reviews the entries and understands their impact on the financial statements and records the adjustments in the client's general ledger.

Is the proposal of such entries a nonattest service subject to Interpretation 101-3?

No. Proposing entries as a result of the member's engagement is a normal part of the engagement and does not constitute a nonattest bookkeeping service subject to Interpretation 101-3.

Example 6:

Same facts as Example 5 except the proposed adjustments relate to converting the general ledger from the cash basis to accrual basis, including:

- Adjusting accruals and prepaid accounts to actual.
- Recording accounts receivable to actual.
- Recording accounts payable to actual.

Is the proposal of such entries a nonattest service subject to Interpretation 101-3?

No. Proposing entries required to convert the client's general ledger from a cash basis to an accrual basis *as part of the member's audit, review or compilation*, does not constitute a bookkeeping service subject to Interpretation 101-3. Instead, such entries are considered part of the audit, review or compilation engagement.

A client's books and records need to be substantially complete and current to conduct the attest engagement of those books and records. If the member performs a service to bring those books and records current or complete (such as reconciling subsidiary

information such as an accounts receivable and accounts payable, or performing cash receipt and disbursement transactions), the service does constitute a nonattest service subject to Interpretation 101-3.

Further, the Interpretation would also apply if the member is engaged to perform a stand-alone engagement to perform bookkeeping services for the client (e.g., cash receipts and disbursements), such as in the case where a member is engaged to perform monthly bookkeeping services, including the preparation of monthly compiled financial statements.

Example 7:

A member performs year-end tax planning and prepares the tax returns for an attest client.

Are these tax services considered nonattest services subject to Interpretation 101-3?

Yes. Tax services are considered nonattest services and are therefore subject to the general requirements of Interpretation 101-3, including the member's understanding with the client with respect to the tax services being documented in writing.

Example 8:

A member prepares a bank reconciliation of a client's bank account in connection with monthly bookkeeping services. The client reviews and approves the reconciliation.

Are these services considered nonattest services subject to Interpretation 101-3?

Yes. The performance of bookkeeping services for an attest client is considered a nonattest service subject to Interpretation 101-3.

Is the member's independence impaired?

No. Because the client reviews and approves the bank reconciliation, and understands the service being performed, the member's independence is not impaired.

Example 9:

With respect to the performance of a nonattest service for an attest client, Interpretation 101-3 requires a member to establish and document in writing his or her understanding with the client about the a) objectives of the engagement, b) services to be performed, c) client's acceptance of its responsibilities, d) member's responsibilities, and e) any limitations of the engagement.

Is the member in compliance with this requirement if the documentation comes in the form of a) an engagement letter, b) an audit planning memorandum, or c) a memo of understanding in the member's billing files?

Yes. All of the above forms would be in compliance. However, the general requirements of the Interpretation only require that the member document in writing his or her understanding. It does not suggest any specific method of documentation. As a result, the above methods would be appropriate, along with other methods that are not identified.

Example 10:

During 20X6, a member performs only nonattest services for a client for the year ended December 31, 20X6. In February 20X7, the member is asked to perform a review of the client's year-end 2006 financial statements.

Is independence impaired because the firm did not comply with the documentation requirement under Interpretation 101-3 with respect to the nonattest services performed in 20X6?

No. The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client. However, once the member accepts the review engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements of Interpretation 101-3 during the period covered by the financial statements (January 1 to December 31, 20X6).

Example 11:

A member performs bookkeeping services recording adjusting and reclassification entries and compiles preliminary financial statements. The member delivers the financial statements and compilation report to the client and provides the client with copies of the general ledger, journals and adjusting entries, which contain a description of the nature of each entry.

The member asks the client to review the entries and then asks whether the client has any questions about any of the entries. The client has no comments or questions.

Are the requirements of Interpretation 101-3 met?

Yes, they are met. The client has reviewed the entries and approved them. Provided the member is satisfied that the client understands the nature and impact of the entries, the requirements of the Interpretation are met.

Example 12:

A member prepares proposed journal entries.

Must the member review them with the client and explain their impact on the financial statements in person, or can the review take place by phone, fax, mail, or email?

The review can take place in person, by phone, fax, mail, e-mail, or any combination thereof. Regardless of the method used, the member must be satisfied that the client understands the nature and impact the entries have on the financial statements.

Example 13:

In performing a nonattest service, a member prepares journal entries to be reviewed and approved by the client.

Must the member document the review and approval of the entries by the client?

No. Interpretation 101-3 does not require that the member document the client's review and approval of the entries. However, the member may wish to document the name of

the client representative who reviewed and approved the journal entries and the date of his or her review and approval to provide evidence that such review and approval took place.

Example 14:

Interpretation 101-3 requires that the client designate a competent employee, preferably within senior management, to oversee the nonattest service.

Which individual at the client is expected to possess the skill, knowledge and experience (e.g., the owner(s), controller, bookkeeper)?

The designated individual(s) will likely depend on the nature of the client's organization and the nature of the nonattest engagement. In an owner-manager business, it will often be the owner. But depending on the nature of the nonattest services and the skill, knowledge and experience of other client employees or individuals, it could be the controller, bookkeeper or an outside individual. In larger organizations, a senior officer might be designated to oversee the services.

Regardless of the selection, the designated individual needs to understand the services sufficiently to oversee them, but does not need to possess the technical qualifications to perform or reperform the services.

Example 15:

As part of a bookkeeping service, a member prepared journal entries related to a tax provision involving deferred income taxes. In obtaining the client's approval of the entries, the member is concerned the client does not understand the nature and impact the deferred income tax entries have on the financial statements.

What must a client know about deferred income taxes in order to meet the competency requirement under Interpretation 101-3?

Interpretation 101-3 does not require that the client possess a level of technical expertise commensurate with that of the member. In connection with deferred income taxes, the client should understand the general basis for the deferred income taxes and their impact on the financial statements.

Is the member permitted to assist the client in understanding the nature of the adjusting entries related to deferred income taxes and their impact on the financial statements?

Yes. The member may assist by explaining the accounting principles giving rise to the adjustments, as well as their impact on the financial statements.

Example 16:

Interpretation 101-3 requires that a client take certain responsibilities with respect to the member's performance of nonattest services for an attest client. One of those responsibilities is that the client must establish and maintain internal controls over the bookkeeping service, including monitoring ongoing activities.

A member's clients consist of very small businesses with informal control environments and an insufficient number of employees to achieve a proper segregation of duties.

How can such clients establish and maintain internal controls as required by the Interpretation?

The requirement for the client to establish and maintain internal controls, including monitoring ongoing activities, precludes the member from performing internal control activities, including monitoring activities. Consequently, a member cannot authorize, execute or consummate transactions, maintain custody of client assets, supervise client employees, or make management decisions. Regardless of the size of the entity, the client must establish and maintain internal control related to the member's services. These controls are often supervisory controls, such as a client reviewing and approving a bank reconciliation prepared by a member.

Example 17:

A member prepares tax returns for its attest client. As a matter of practice, a member does not require its clients to sign engagement letters for tax return preparation services.

How does the documentation requirement under Interpretation 101-3 apply with respect to these nonattest services?

Tax services are nonattest services subject to Interpretation 101-3. As a result, the documentation requirement applies where the member provides tax services to a client for which the member also provides attest services. However, the method of documentation is not stated within the Interpretation. Ways in which such documentation could be made include, but are not limited to:

- Documentation in the engagement letter of the attest engagement
- A tax organizer or attest service working papers memorandum

Example 18:

A member prepares personal tax returns for the owners of an attest client.

Does Interpretation 101-3 apply?

No. If the personal returns are prepared without having to rely on representations of the client, the Interpretation does not apply. Also, the mere fact that the client pays for the services also does not cause the Interpretation to apply.

Example 19:

A member provides temporary controllership services and other types of accounting services for clients during client maternity leaves, illness, and sudden departures.

Are these services subject to Interpretation 101-3?

Yes. These services are subject to the Interpretation.

Do these activities impair independence under Interpretation 101-3?

Perhaps. If the member performs controller-type activities, independence is impaired since such activities usually involve the performance of management functions or the supervision of client employees. However, if the member performs temporary accounting and other services in compliance with the requirements of the Interpretation (including

documentation of the understanding with the client), and does not perform management functions or make any management decisions, independence is not impaired. The key is that the member not perform any management functions or make any management decisions while he or she is performing the controller-type activities. Moreover, the member should ensure that he or she does not have the title of controller as such a title would clearly impair independence based on the assumption that such a title holds with it, the authority to perform management functions and the performance of management services.

Example 20:

As part of performing bookkeeping services, a member records adjusting and reclassification entries and prepares the client's preliminary financial statements. The member does not review each and every journal entry with the client but rather, the member describes the nature of the journal entries and their impact on the preliminary financial statements. The client approves the preliminary financial statements and issues them to the bank.

Would the requirements of Interpretation 101-3 be met?

Yes, provided all of the other requirements of the Interpretation are met.

Example 21:

The Interpretation states that a member should not perform management functions or make management decisions for the attest client.

What are some examples of management functions for purposes of the Interpretation?

A management function would generally include doing or having the authority to:

- Make decisions on behalf of the client
- Authorize, execute or consummate client transactions
- Supervise, hire or terminate client employees
- Oversee or manage any aspect of the client's business
- Set policy for the client
- Have access to or custody of client assets
- Sign or co-sign client checks
- Establish or maintain internal controls for the client

Providing advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions do not constitute the performance of a management function.

The confusion over when bookkeeping services are performed

In reading Interpretation 101-3 and the related Q&A, there appears to be an inconsistency among the two documents.

Specifically, Interpretation 101-3 states that bookkeeping services are a nonattest service subject to the Interpretation's documentation and other requirements. Included in the list of bookkeeping services identified in the Interpretation are the following:

Bookkeeping Services Subject to Interpretation 101-3
<ul style="list-style-type: none">• Record transactions for which management has determined or approved the appropriate account classification or post coded transactions to a client's general ledger.• Prepare financial statements based on information in the trial balance.• Post client approved entries to a client's trial balance.• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Included in the list of bookkeeping services is the accountant proposing and/or posting standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the accountant is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

If an accountant performs any of the above bookkeeping functions, the accountant must comply with the documentation requirements of Interpretation 101-3 including:

1. The accountant may not perform management functions or make management decisions as they relate to the bookkeeping services.
2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - Make all management decisions and perform all management functions,
 - *Designate an individual who possesses the skill, knowledge and/or experience*, preferably someone within senior management, to oversee the nonattest services,
 - Evaluate the adequacy and results of the nonattest services performed,
 - Accept responsibility for the results of the nonattest services, and
 - Establish and maintain internal controls, including monitoring ongoing activities.
3. *Written establishment and documentation with client*: The member should establish and *document in writing* his or her understanding with the client:
 - Objectives of the nonattest engagement
 - Nonattest services to be performed
 - Client's acceptance of its responsibilities
 - Member's responsibilities
 - Any limitations of the engagement

Now the confusion!

The AICPA Q&A offers examples (see Examples 5 and 6 in the Q&A noted above), that provide that proposing or posting adjustments *during an audit, review, or compilation engagement does not constitute a bookkeeping function*. In fact, the Q&A examples state that any of the following adjustments made *during an attest engagement* are part of the attest engagement and not a bookkeeping service subject to 101-3.

- Adjustments to convert the general ledger from cash to accrual basis, such as those related to accruals, prepaid items, accounts payable and receivable
- Current tax accrual
- Deferred tax adjustment
- Depreciation and amortization adjustment

What this means is that all entries to a cash basis trial balance proposed and/or posted *during* an audit, review or compilation engagement, do not represent a bookkeeping service. Instead, those entries are deemed to be part of the audit, review or compilation engagement being performed and are not subject to the requirements of Interpretation 101-3, including the documentation requirements thereto.

The Q&A does state that:

“a client’s books and records need to be substantially complete and current to conduct the attest engagement of those books and records. If the member performs a service to bring those books and records current or complete (such as reconciling subsidiary information such as an accounts receivable and accounts payable, or performing cash receipt and disbursement transactions), the service does constitute a nonattest service subject to Interpretation 101-3.”

Thus, all adjustments and transactions made to bring a trial balance *to a cash basis* (such as posting cash receipts and disbursements) are a bookkeeping service, while those made during the engagement to convert *from* a cash basis trial balance to accrual basis does not represent a bookkeeping service and are not subject to Interpretation 101-3.

What is the impact of entries proposed during an attest function that are not a bookkeeping service part of Interpretation 101-3?

If entries are proposed and/or recorded during an attest engagement, Interpretation 101-3 does not apply so that the accountant does not have to document the client’s responsibilities for the nonattest services performed, as required by 101-3.

Must the accountant still have the client approve the entries as required by 101-3?

The requirement to have entries approved by the client applies to bookkeeping services that are subject to Interpretation 101-3. If such entries are not part of a bookkeeping function, Interpretation 101-3 does not apply.

However, there is a broader requirement that applies. AICPA Interpretation 101-C states that during the period covered by the financial statements or during the period of the professional engagement, a partner or professional employee of the firm cannot be a *“member of management.”*

If an accountant is proposing and/or booking entries *during an engagement that are not approved by the client*, that accountant violates Interpretation 101-C in that the accountant is deemed a member of management. Even though the proposed entries during an attest engagement do not represent a bookkeeping service subject to Interpretation 101-3, the service is still subject to the broader requirement of Interpretation 101-C in that the accountant cannot be a member of management.

To avoid the violation of independence in Interpretation 101-C, the accountant must have the client approve the entries even though the documentation requirements of 101-3 do not apply.

The following chart summarizes the interrelation of Interpretations 101-3 and 101-C:

Bookkeeping function subject to Interpretation 101-3	Entries part of the attest engagement not subject to 101-3
Propose and/or post standard, adjusting, or correcting journal entries <i>not during</i> an audit, review or compilation engagement, or in a separate engagement.	Propose and/or post standard, adjusting, or correcting journal entries <i>during</i> an audit, review or compilation engagement.
Interpretation 101-3 applies	Interpretation 101-3 does not apply Interpretation 101-C applies
<p>1. <i>Accountant may not be a member of management:</i> The accountant may not perform management functions or make management decisions as they relate to the bookkeeping services</p> <ul style="list-style-type: none"> Proposed standard, adjusting, or correcting journal entries must be reviewed (and approved) by the client and the accountant must be satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements. 	<p>1. <i>Accountant may not be a member of management:</i> The accountant may not perform management functions or make management decisions as they relate to the bookkeeping services</p> <ul style="list-style-type: none"> Proposed standard, adjusting, or correcting journal entries must be reviewed (and approved) by the client and the accountant must be satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.
<p>2. The client must agree to perform certain functions in connection with the nonattest tax services such as:</p> <ul style="list-style-type: none"> Make all management decisions and perform all management functions <i>Designate a competent employee</i>, preferably someone within senior management, to oversee the nonattest services Evaluate the adequacy and results of the nonattest services performed Accept responsibility for the results of the nonattest services, and Establish and maintain internal controls, including monitoring ongoing activities. 	Not applicable under 101-C
<p>3. <i>Written establishment and documentation with client:</i> The member should establish and document in writing his or her understanding with the client.</p>	Not applicable under 101-C

The conclusion is that under all circumstances, an accountant is required to have a client approve all proposed and/or booked entries regardless of whether such entries are made during the attest engagement or before it in a separate engagement.

However, for entries made during the engagement (those entries made from the cash basis trial balance forward), the accountant is not required to satisfy the documentation requirements by having the client agree to take responsibility for the services performed and documenting the understanding in writing.

2. Tax Compliance and Preparation Services, including Payroll Services

Accountants may provide a variety of payroll-related services for attest clients that include:

- a. Payroll-related services, including:
 - Preparing payroll returns for client signature.
 - Performing all aspects of the payroll cycle, including preparing and signing payroll checks and returns, and arranging for payroll depositories.
- b. Preparation of federal and state income tax returns, including transmitting the tax returns and related tax payment to the taxing authority electronically.

Tax compliance services:

An amendment to Interpretation 101-3 clarifies whether an accountant who provides tax compliance services for attest clients impairs his or her independence with respect to that client.

For purposes of the Interpretation, tax compliance services include:

- Preparation of a tax return.¹⁵
- Transmittal of a tax return and transmittal of any related tax payment to the taxing authority.
- Signing and filing a tax return.
- Authorized representation of clients in administrative proceedings before a taxing authority.

As with all other non-attest services performed on an attest client, an accountant who performs non-attest services for an attest client must follow three steps to maintain his or her independence with respect to the attest client:

1. The accountant may not perform management functions or make management decisions as they relate to the tax return or other tax compliance services performed.
2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - Make all management decisions and perform all management functions,

¹⁵ A tax return includes informational tax forms (such as estimated tax vouchers, extension forms, and Forms 990, 5500 and W-2) filed with a taxing authority or other regulatory agencies.

- *Designate an individual who possesses the skill, knowledge, and/or experience*, preferably someone within senior management, to oversee the nonattest tax services,
 - Evaluate the adequacy and results of the nonattest tax services performed,
 - Accept responsibility for the results of the nonattest tax services, and
 - Establish and maintain internal controls, including monitoring ongoing activities.
3. *Written establishment and documentation with client:* The accountant should establish and *document in writing* his or her understanding with the client with respect to:
- Objectives of the nonattest tax engagement.
 - Nonattest tax services to be performed.
 - Client's acceptance of its responsibilities.
 - Member's responsibilities.
 - Any limitations of the engagement.

Observation: In most instances, a client does not have an individual who has any expertise in taxation. Consequently, how could a person be designated to possess the skill, knowledge, and experience to oversee the accountant's preparation of tax returns? In general, in complying with Interpretation 101-3, the designated individual should have a general understanding of how the amounts presented on the tax return were obtained, through the general ledger, etc. Moreover, the individual should understand basic, significant tax positions taken such as whether the company is on the accrual basis, and whether equipment purchases were expensed under Section 179 of the IRC. The individual should also approve those significant tax positions. What the individual is not required to do is have a technical understanding of the tax law and its regulations. That skill belongs to the accountant and is the reason why the accountant is hired in the first place.

In an earlier Q&A published by the Ethics Committee of the AICPA, the Q&A makes reference to an individual who hires an electrician to perform work on the individual's home. That individual would oversee the electrician by having a general understanding of the work that he or she wants the electrician to perform and a basic knowledge of how electricity works (e.g., turn on a switch and the lights go on). However, the individual does not have to have technical expertise as to how to wire the house or fix the electrical problem at hand.

With respect to tax compliance services, when is an accountant deemed to perform management functions and make management decisions (step 1) thereby impairing his or her independence?

The rules found in the amendment to Interpretation 101-3 address the issue of an accountant making management decisions and performing management functions in conducting tax compliance services for an attest client. How far can an accountant go in performing tax compliance services beyond which he or she is deemed to perform management functions and make management decisions, thereby impairing independence?

The rules are as follows:

- a. Preparing a tax return and transmitting the tax return and related tax payment to a taxing authority (in paper or electronic form) would not impair independence provided the accountant does not have custody or control¹⁶ over the client's funds and the individual designated by the client to oversee the tax services:
 - Reviews and approves the tax return and related tax payment, and
 - If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.
- b. The signing and filing of a tax return on behalf of client management impairs independence, unless the accountant has the legal authority to do so, and
 - 1) The taxing authority has prescribed procedures in place for a client to permit an accountant to sign and file a tax return on behalf of the client and such procedures meet, at a minimum, standards for electronic originators and officers outlined in IRS Form 8879,

Examples:

Form 8879 for *IRS e-file Signature Authorization*, or
Form 8453: *U.S. Individual Income Tax Declaration for an IRS e-file Return*

or,

- 2) An individual in client management who is authorized to sign and file the client's tax return provides the accountant with a signed statement that clearly identifies the return being filed and represents that:
 - Such individual is authorized to sign and file the tax return,
 - Such individual has reviewed the tax return, including accompanying schedules and statements, and it is true, correct and complete to the best of his or her knowledge and belief, and
 - Such individual authorizes the accountant or another named individual in the accountant's firm to sign and file the tax return on behalf of the client.

Observation: An accountant who signs a tax return on behalf of a client impairs his or her independence unless certain conditions are satisfied. The term "on behalf" means signing the return under a power of attorney or similar document. It does not apply to a situation in which an accountant signs a return as a preparer, which would not, by itself, impair independence.

- c. Authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.
 - 1) Representing a client in a court or in a public hearing to resolve a tax dispute would impair an accountant's independence.

¹⁶ Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client's funds.

What is the definition of a tax return under the Interpretation?

The Interpretation defines a tax return to include informational tax forms, such as estimated tax vouchers and extensions, and tax forms such as Forms 990, 5500, W-2, 1120, 1120S, and 1065, among others. The list is not all inclusive and presumably extends to other related tax forms such as Forms 941, 940, and W-3.

What if the accountant signs an extension to file?

Typically, an accountant files an extension in the capacity as a paid preparer. The Interpretation states that preparing a tax return and transmitting the tax return and related tax payment to a taxing authority would not impair independence provided the accountant does not have custody or control¹⁷ over the client's funds and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment, and
- If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.

Assuming the accountant does not have custody or control over client funds (e.g., he or she is not a signatory on the cash account), the signing of an extension does not impair independence provided the client reviews and approves the extension and related payment. Thus, an accountant should send a copy of an extension to a client for review and approval.

Example 1: Joe CPA performs a review on Company X. Joe also prepares paper form federal and state tax returns, and sends them to the client for review, signature and payment.

Conclusion: Joe has not performed management functions or made management decisions with respect to the preparation of the tax returns. The client reviews and approves the tax returns and related payments, and signs the return. Provided Joe complies with the other requirements of Interpretation 101-3 (e.g., the client agrees to perform certain functions in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

Example 2: Same facts as Example 1 except that the following actions occur:

- Joe prepares the federal and state tax returns.
- Joe sends a copy of the returns to Mary, who is Company X's controller and the individual designated by X to oversee the tax services. Mary reviews and approves the tax returns.
- Company X (Mary) signs a Form 8879 authorization for e-filing and returns it to Joe.
- Joe files the tax returns and related tax payments electronically with each taxing authority.
- Joe does not have custody or control over the client's funds.

¹⁷ Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to a taxing authority and signed by the client would not be considered having custody or control over a client's funds.

Conclusion: Joe has not performed management functions or made management decisions with respect to the preparation and filing of the tax returns and related tax payments.

The reasons are as follows:

- Joe does not have custody or control over the client's funds even though Joe has filed the tax payment electronically along with the filing of the tax return.
- Mary reviewed and approved the tax return and related payment.
- Mary signs Form 8879 prior to Joe filing the tax return.

Provided Joe complies with the other requirements of Interpretation 101-3 (e.g., the client agrees to perform certain functions in connection with the tax services and there is a written understanding of the services), Joe has not impaired his independence with respect to Company X.

Example 3: Same facts as Example 2 except that Joe is also a signatory to Company X's bank account.

Conclusion: The fact that Joe is a signatory to the bank account means Joe has custody over X's funds. As a result, Joe's independence is impaired with respect to Company X regardless of all other factors related to his tax service.

Example 4: Elisa, CPA performs a review engagement for Company Y. Elisa represents Company Y in an IRS audit and receives a power of attorney from the client.

Conclusion: Elisa's independence is not impaired provided Elisa obtains agreement from Y prior to committing Y to a specific resolution with the IRS.

The same conclusion would be reached if Elisa represented Y in an IRS appeal conference as it is an administrative proceeding. Interpretation 101-3 states that authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.

Change in facts: Assume Elisa represents Y in tax court.

Conclusion: Elisa's independence is impaired regardless of all other factors. Representing a client in court or in a public hearing to resolve a tax dispute impairs an accountant's independence.

Payroll services:

Similar to other nonattest functions, an accountant impairs his or her independence if he or she acts like a member of management by having authority to consummate payroll transactions, has custody of company assets, or prepares source documents.

With respect to payroll services, an accountant *impairs independence* if he or she:

- Authorizes and approves payment of payroll and payroll taxes, or
- Has custody or control over client funds by being a signer or cosigner of payroll checks or payroll tax disbursements, or
- Signs a payroll tax return on behalf of a client without the client reviewing the return and approving it in advance.

Independence is *not impaired* if the accountant:

- Processes client payroll and generates unsigned checks from the client approved payroll time records.
- Transmits client-approved and reviewed payroll tax returns and tax payments.
- Signs a payroll tax return on behalf of a client after the client has reviewed and approved the return and authorized the signing and submission of the return and related payment.

Observation: An accountant should ensure that he or she does not have custody of any client assets such as being a co-signer on a payroll or checking account, having custody of investments, etc. To do so automatically impairs the accountant's independence. Many accountants perform payroll services for their clients. The Interpretation gives examples of payroll functions that do and do not impair independence. The general rule is that independence is impaired in a payroll function if the accountant can authorize payment of funds for payroll, is a signer or co-signer of checks, maintains a client's payroll account, signs payroll tax returns, or approves any payroll records for payment. Again the key point is authorization and custody of assets. However, the Interpretation permits an accountant to execute or record transactions that have been reviewed and approved by a client, including submission of tax returns and related payments. The Ethics committee took the position that the accountant's ability to make electronic payroll tax payments or other client-approved transmittals does not impair independence provided the client reviews and approves the transaction in advance. With such a limit, the accountant actually does not have authority and, instead, is merely executing a previously approved client transaction. Further, signing a payroll or other return in the capacity as an outside accountant, rather than management, does not impair the accountant's independence.

What if an accountant is a signator on a client's bank account?

In some instances, a client may ask an accountant to be a backup signator on the company's bank account. The reason may be to allow the accountant to sign checks in the client's absence. If the accountant is a signator on an attest client's bank account, he or she has custody of client assets (the bank account) and authority, and is acting in the capacity as a member of management. Therefore, he or she is not independent with respect to the attest client. This is the fact even if the accountant never actually signs checks and merely acts as a backup signator for emergency purposes only.

What if an accountant prepares the payroll tax returns (Forms 941, 940, W-3, etc.) and transmits the tax return and related tax payments directly to the taxing authority (IRS, state tax bureau, etc.)?

The amended Interpretation states that preparing a tax return and transmitting the tax return and related tax payments to the taxing authority, in paper or electronic form, would not impair independence provided:

- a. The accountant does not have custody or control over the client's funds, and
- b. The client (designated individual of the client) reviews and approves the tax return and related payment, and, if required for filing, signs the tax return prior to the accountant transmitting the return to the taxing authority.

What this means is that an accountant may prepare the payroll tax returns (e.g., Forms 941, 940, W-3, and state forms) and may submit them electronically along with the tax payment as long as the accountant does not sign the payroll tax check(s) and the client reviews and approves the returns before they are submitted. If the payroll taxes are filed electronically, the accountant is required to give the client a copy of the returns any way, and the client is required to file an e-file authorization. The e-file authorization signed by the client states that the client has examined a copy of the payroll tax returns filed. The result is that the standard electronic filing procedures for payroll tax returns do not impair an accountant's independence with respect to that e-file client.

Doesn't the fact that the accountant is making the electronic payments to the IRS or state agency mean the accountant has custody or control over the client's funds?

No. Footnote 12 to Interpretation 101-3 states:

"Making electronic tax payments under a taxing authority's specified criteria or remitting a check payable to the taxing authority and signed by the client would not be considered having custody or control over a client's funds."

The key is that the accountant is merely executing the transfer of the funds from the client's account to the taxing authority. In such a situation, the accountant's control is limited to defining the amount of the funds transferred with no discretion over where the funds are transferred. Thus, the Interpretation considers control or custody to be limited as the accountant does not have full decision-making over the funds being transferred.

What if the accountant signs and files the payroll tax returns on behalf of the client, and not as a tax preparer?

The Interpretation states that the signing and filing of a tax return on behalf of a client impairs independence unless the accountant has legal authority to sign the return, and either:

1. The taxing authority has procedures in place for a client to permit the accountant to sign and file the return on behalf of the client (similar to a Form 8879 being filed), or
2. The individual in client management provides the accountant with a signed statement that clearly identifies the return filed and states that:
 - The individual is authorized to sign and file the return,
 - The individual has reviewed the tax return and believes it is correct and complete, and
 - The individual authorizes the accountant to sign and file the return on behalf of the client.

Both of the above requirements are almost the equivalent of the accountant having power of attorney to sign on behalf of the client. The one key difference is that in either case, the client has reviewed and approved the return prior to the accountant signing and filing on behalf of the client. In requirement 1 above, procedures are similar to those found on Form 8879 (the e-filing authorization form) that require the client to certify that he or she has reviewed the tax return and believes it is correct and accurate. In the second requirement, the client is authorizing the accountant to sign the return on its

behalf, but only after the client has reviewed the return for correctness and completeness. Thus, in both cases, responsibility for reviewing and approving the tax return prior to filing rests with the client, not the accountant.

Consider the following difference. If an accountant has power of attorney to sign a tax return on behalf of a client, the accountant is acting in the capacity of management and impairs his or her independence. Change the facts. If, instead, the accountant has power of attorney to sign on behalf of the client, but the client is required to review and approve the return first, then the client, and not the accountant, retains his or her capacity as management.

Examples illustrating the application of revised Interpretation 101-3

The author has drafted the following examples to illustrate his understanding of Interpretation 101-3 as it relates to bookkeeping and payroll transactions.

Example 1:

Harry is an accountant who performs bookkeeping services for his client and has been asked to perform a review engagement. Harry satisfies all three of the general requirements for performing nonattest services for an attest client including obtaining, in writing, an engagement letter from the client establishing an understanding of the services to be performed and each party's responsibilities. In that letter, the client has agreed to:

- Make all management decisions and perform all management functions with respect to the bookkeeping function,
- Designate its owner as the employee who will oversee the bookkeeping function,
- Evaluate the adequacy and results of the bookkeeping services to be provided,
- Accept responsibility for the results of the services, which are the financial statements, and
- Establish and maintain internal controls over the bookkeeping.

In performing the bookkeeping function, Harry receives a shoebox of source documents (e.g., bills, receipts, deposit slips), check stubs and bank statements, all of which are prepared by the client. From the bank statements, Harry performs the following functions:

- a. Enters the checks and deposits into the computer and develops a cash basis general ledger and trial balance. On most of the checks, the client has a notation describing the type of expense to which the check relates. Each deposit slip has a description of the source of the deposit. For those checks and deposit slips that are missing notations or descriptions, Harry calls the client who tells him what the checks or deposits relate to and the general ledger account to which each unidentified item should be posted.
- b. Makes a series of general journal entries to adjust the general ledger from a cash to an accrual basis.
- c. Sends the journal entries and general ledger to the client and receives client approval.

The accountant believes that the client understands the nature of the entries and the impact the entries have on the financial statements.

From the adjusted trial balance, the accountant performs review engagement procedures and prepares financial statements and notes.

Conclusion:

First, does Interpretation 101-3 apply? Yes. Harry is performing nonattest services for an attest client. Those nonattest services consist of entering the checks and deposits into the computer and developing a cash basis general ledger and trial balance. The entries to convert from cash to accrual basis are also a bookkeeping service because these entries were made prior to the review engagement being performed. Had the adjusting entries been made as part of the review engagement, they would not have been considered a nonattest bookkeeping service subject to Interpretation 101-3.

Second, is Harry independent with respect to the bookkeeping service?

According to Interpretation 101-3, Harry's independence is not impaired and he may perform a review engagement. The client (not the accountant) has approved the journal entries, and approved all general ledger account classifications by coding the checks. Further, the client prepared all source documents, not the accountant.

Through the signing of the engagement letter, the client has agreed to:

- Make all management decisions and perform all management functions with respect to the bookkeeping function,
- Designate its owner as the individual who possesses the skill, knowledge and experience to oversee the bookkeeping function,
- Evaluate the adequacy and results of the services performed,
- Accept responsibility for the results of the nonattest services, which is a set of financial statements, and
- Establish and maintain internal controls over the bookkeeping service, including monitoring ongoing activities.

Example 2:

Same facts as Example 1, except that Harry receives the bank statements from the client along with the deposit slips. None of the checks are coded, few have descriptions and there are no descriptions on the deposit slips. Because Harry is familiar with his client's business including vendors and customers, he is able to code most of the checks and deposit slips without asking the client. There are only a few items that he is unable to classify for which he asks the client for clarification.

Harry does not submit the journal entries and general ledger to the client for approval.

Conclusion:

Harry's independence is impaired and he is precluded from performing a review engagement. By performing the functions of account coding and classification of transactions without obtaining the client's approval, Harry is deemed to be performing management functions. Thus, his independence is impaired.

Change the facts:

Assume that Harry's independence is impaired in Example 2. Is Harry permitted to perform a compilation engagement noting that he is not independent?

Conclusion:

Under existing authority, SSARS No. 1 permits Harry to issue a compilation report as long as he notes that he is not independent in his compilation report.

Example 3:

Mary is an accountant who performs payroll-related services for an attest client.

Mary obtains an engagement letter from her client noting the understanding of the nonattest service (e.g., payroll services) to be provided for the attest client.

Specifically, Mary receives weekly time sheets from the client with the number of hours worked, the pay rate and required withholdings elections. She calculates the payroll and related withholdings, by employee and prepares unsigned checks and payroll tax returns and depositories, all of which are delivered to the client for signature and distribution. Mary also performs a review engagement on the client's financial statements.

Conclusion:

Mary's independence is not impaired with respect to the attest client. Specifically, Interpretation 101-3 states that the processing of payroll and preparation of unsigned checks are functions that do not impair independence because neither function involves the use of authority or acting in the capacity of management. Therefore, Mary may perform a review engagement.

Example 4:

Same facts as the previous example except that unsigned checks, payroll tax returns and depositories are not delivered to the client. Instead, Mary sends the payroll information to a bank who prepares the payroll checks for delivery back to the client and distribution. The bank calls the client for approval before issuing the checks. Mary makes the electronic tax payments from the client's account. The client has instructed the bank to limit the amounts and payees of the checks and to limit the payee of electronic payments to the taxing authorities. Mary prepares the payroll tax returns for delivery to the client for signature and mailing. Mary prepares a review of the client's financial statements.

Conclusion:

Independence is not impaired. Interpretation 101-3 permits an accountant to transmit payroll information to a financial institution and to process electronic tax payments provided the accountant is merely processing client-authorized transactions. Specifically, the client must restrict the amount and payee of such transactions that are processed by the bank. In this example, the client continues to authorize the transactions, not the accountant.

Example 5:

Mary is processing the payroll as noted in the previous examples. However, the owner of the company suddenly becomes ill and is required to take an emergency vacation for six months in Bora Bora from September 30 to March 31. During this time, the client gives Mary control over all aspects of the payroll function. The company manager sends to

Mary the weekly payroll information (e.g., hours and rates, by employee). Mary prepares the payroll checks and co-signs each check, delivering the batch back to the company manager for a second signature and distribution to the employees. Mary also prepares and executes the electronic tax payments and the transfer from the main checking account to the payroll account to cover the payroll. She also prepares the quarterly payroll returns, signs them and sends them to the taxing authorities.

Mary also performs a review of the client's December 31 year-end financial statements while the owner is on vacation. When the owner returns, Mary is removed from the payroll functions and is involved with only processing payroll that is authorized by the owner.

Is Mary's independence impaired with respect to the client while she is performing the review of the financial statements?

Conclusion:

Yes. Clearly, Mary is performing functions in the capacity as a member of management. First, she is co-signing checks. Second, she is signing payroll tax returns. Third, she is transferring funds from the main checking account to the payroll account. None of these functions are subject to the owner's authorization. Thus, she is acting as if she were part of management and her independence is impaired, precluding her from issuing a review report.

Change the facts:

Assume that the owner returns from vacation on January 31 and immediately removes Mary from having authority to process payroll transactions. Mary starts her review engagement on February 15.

Is Mary's independence impaired?

Is Mary's independence impaired two years later?

Conclusion:

The fundamental issue is when does an accountant's independence become impaired and whether, once impaired, an accountant can regain independence.

Interpretation 101-3 states:

In cases where the requirements have not been met during the period of the professional engagement or the period covered by the financial statements, the member's independence would be impaired.

The determination of independence is based on a "snapshot" in time. An accountant must be independent during the period covered by the financial statements up through the date that the engagement report is issued.

In the above example Mary's independence is impaired because her independence was impaired during the year of the financial statements. This is the case despite the fact that she was independent during the period that she conducted the review engagement and at the time she issued her review report.

What happens two years later when Mary is performing a review engagement? The fact that Mary was once not independent has nothing to do with whether she is independent two years later. Upon performing the review engagement two years later, Mary has to

determine whether she was independent during the period of the financial statements, the engagement period, and at the time of issuing the review report. If so, Mary's independence is not impaired.

Observation: An example that parallels the above-noted one is where an accountant is not independent because a client owes several years of accounting/auditing fees. Once the fees are paid, the accountant regains independence and the fact that he or she was once not independent has no impact on future independence.

3. Investment Functions Performed for the Client

As it relates to investment functions, Interpretation 101-3 states that an accountant may not:

- Have custody of the client's portfolio
- Make investment decisions

However, the accountant may:

- Record or execute transactions that are approved by the client
- Review the manner in which a client's portfolio is being managed
- Recommend the allocation of funds among various funds
- Prepare and transmit participant statements to plan participants

For example, if an accountant acts as an investment advisor for a company's investment portfolio, the accountant's independence would not be impaired if the client first decides the investment transactions to make and the accountant merely executes the transaction. Conversely, if the accountant makes the investment decisions without client approval, the accountant's independence would be impaired with respect to that company.

Another issue is whether the independence rules apply to the owners or retirement plan of the company that the accountant reviews or audits. The independence rules that we are discussing apply to the company that the accountant audits, reviews or compiles. They do not apply to the owner of the company or to the company's retirement plan. That means that the accountant could manage the owner's personal portfolio or the assets of the company's 401(k) plan and not taint his or her independence with respect to the company.

Example 1:

Ralph is an outside accountant for a company owned by Fred. Ralph audits the financial statements of the company. Ralph is also a CFP and a registered securities advisor who performs personal financial and tax planning for Fred's company on a fee basis. The investments are processed through Charles Schwab. Ralph recommends to the company certain asset allocations that are in line with the company's investment objectives and risk level. Ralph also maintains all investment records on behalf of the company. However, the client executes all transactions directly with Schwab and has the investment statements sent directly to Ralph.

Is Ralph independent with respect to Fred's company?

Conclusion: Yes. Ralph merely advises the client of investment transactions and does not have authority to execute transactions on behalf of the client.

Change the facts: Ralph not only advises Fred about investment decisions, but also transmits the funds to the Schwab broker after it is approved and called into the broker by the client.

Conclusion: Ralph is still independent. The reason is that Ralph is only transmitting the transactions on behalf of the client. Ralph has no authority to execute transactions without client approval.

Change the facts again: Ralph advises the company of transactions and then is authorized to execute the transactions directly with the broker on behalf of the company.

Conclusion: Ralph is not independent. The fact that he can execute transactions for the company impairs independence unless the execution is merely transmitting the paperwork after the company authorizes the transaction directly with the broker. In this case, the client has no direct correspondence with the broker and is, thus, out of the authorization process.

Change the facts again: Ralph manages the investment portfolio of Harry, the owner of a company. Ralph advises Harry of transactions and then is authorized to execute the transactions directly with the broker on behalf of the client. Ralph deals with Harry's personal portfolio only and has nothing to do with the company's portfolio.

Conclusion: Ralph's independence with the company is not affected by the fact that he manages the personal portfolio of the company's owner. The same result would apply if Ralph managed the investment portfolio of the company's 401(k) plan as long as he is not auditing, reviewing or compiling the financial statements of the 401(k) plan.

4. Major Changes to Appraisal, Valuation and Actuarial Services

The revised Interpretation 101-3 provides significant restrictions to an attest accountant's ability to perform appraisal, valuation, or actuarial services for an attest client.

Under the rules, an accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- a. The results of the service, individually or in the aggregate, would be material to the financial statements, and
- b. The service requires a significant degree of subjectivity.

Valuations performed that generally require a significant degree of subjectivity include:

- ESOPs
- Business combinations
- Appraisals of assets or liabilities

If material, these types of valuations are likely to impair independence.

Exceptions for certain appraisal, valuation, and actuarial services:

The Interpretation provides two exceptions under which the performance of an appraisal, valuation or actuarial service for an attest client does not impair independence with respect to that attest client.

1. Valuation services that typically produce reasonably consistent results and do not require a significant degree of subjectivity, such as:
 - An actuarial valuation of a client's pension or postemployment benefit liabilities.
2. Appraisal, valuation, and actuarial services performed for nonfinancial statement purposes such as:
 - Tax planning or compliance
 - Estate and gift taxation
 - Divorce proceedings
 - Cross purchase, buy-sell agreement among shareholders or partners.

For both exceptions not to impair independence, all other requirements of the Interpretation should be met, including having a written documentation of the understanding with the client as to the nonattest service to be performed.

Observation: An accountant might be asked to perform a business valuation of an attest client for estate and gift taxation or divorce purposes. The performance of such a valuation is one of the two exceptions under which the accountant does not impair independence. However, the general requirements in Interpretation 101-3 must be satisfied including the accountant documenting in writing the understanding with the client about the nonattest services to be performed.

Example: Ed is an accountant who is also a business valuation specialist. Ed is asked to perform a business valuation of the common stock of Company X for gift tax purposes. Ed's firm also issues a review report on the company. In performing the valuation, all significant assumptions are approved by the client.

Conclusion: Ed's independence is not impaired with respect to the attest client. Interpretation 101-3 states that when an accountant performs valuation services for nonfinancial statement purposes, the accountant's independence is not impaired. Examples of nonfinancial statement purposes include tax planning or compliance, estate and gift taxation, and divorce proceedings. The accountant still must satisfy all of the general requirements of the Interpretation including having the client approve all significant assumptions and matters of judgment used in the valuation.

The dilemma for valuation of GAAP statement components

The FASB has as its goal to move toward fair value accounting. Over the past decade, several important FASB statements have been issued, all of which have, as their basis, the requirement to determine fair value of the reporting entity or selected assets.

Examples include:

<ul style="list-style-type: none"> FASB No. 141R: <i>Business Combinations (ASC 805)</i> 	Requires that fair value be used in allocating the purchase price to net assets in a business combination
<ul style="list-style-type: none"> FASB No. 142: <i>Goodwill and Other Intangible Assets (ASC 350)</i> 	Requires that fair value be used in performing an annual test of impairment of goodwill and other intangible assets
<ul style="list-style-type: none"> FASB No. 144: <i>Accounting for the Impairment or Disposal of Long-Lived Assets (ASC 360)</i> 	Requires that fair value be used to test the impairment of long-lived assets if certain criteria are met
<ul style="list-style-type: none"> FASB Interpretation No. 46R: <i>Consolidation of Variable Interest Entities (ASC 810)</i> 	Requires that fair value be used to determine whether an entity is a variable interest entity (VIE) that should be consolidated
<ul style="list-style-type: none"> FASB Interpretation No. 45: <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (ASC 460)</i> 	Requires that fair value be used to measure the value of a guarantee obligation

The above list is just the beginning of what is likely to be a much more active use of fair value. In fact, the FASB has on its docket a fair value project that will provide specific guidance on using fair value. To date, it has resulted in the issuance of two statements with more to come. It is only a matter of time before the entire historical cost model is replaced with one based principally on fair value.

To no surprise, the FASB requires companies to measure fair value yet gives little guidance on exactly how to do it. Larger publicly held companies can hire valuation specialists to determine fair value. Yet, it is usually not cost effective for smaller closely held businesses to obtain an outside valuation. Further, many closely held businesses look to the outside accountant to comply with GAAP and are unwilling to spend additional funds to obtain an outside valuation particularly when there is no financial gain to doing so other than satisfying the bank's need to issue GAAP financial statements.

Does an accountant impair his or her independence if he or she computes fair value for a client?

An accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- The results of the service, individually or in the aggregate, would be material to the financial statements, and
- The service requires a significant degree of subjectivity.

This means that an accountant cannot be involved in a valuation if that valuation involves an element(s) that will be material to the financial statements, and the valuation has a significant degree of subjectivity.

Note: In discussions with the AICPA Ethics Division staff, the author determined that the staff is taking a general position that a valuation performed by an accountant for a client in connection with the requirements of FASB Nos. 141, 142, or FIN 46R would require a significant degree of subjectivity. If the item being valued is material to the financial statements, independence would be impaired.

Example: Joe accountant is hired to review the financial statements of Company X. Company X has goodwill and is required to perform an annual test of goodwill for impairment in accordance with FASB No. 142. Because X does not have expertise in valuation, X asks its outside accountant to compute the entity's fair value for purposes of performing the goodwill test. The accountant did the fair value test for the client. Goodwill is material to the financial statements.

Conclusion: The accountant is not independent with respect to X. The reason is two-fold:

An accountant may not perform appraisal, valuation and actuarial services for an attest client if two factors exist:

- a. The results of the service, individually or in the aggregate, would be material to the financial statements, and
- b. The service requires a significant degree of subjectivity.

Both of these factors have been met.

Observation: The independence issue related to valuation has come to the forefront due to the issuance of FASB Interpretation (FIN) 46R. Specifically, FIN 46R deals with the consolidation of variable interest entities (VIEs) and can result in a related party real estate lessor being consolidated into an operating company lessee.

More particularly, under certain tests, FIN 46R requires that a valuation be done of the fair value of the real estate leasing entity. Depending on the results of that valuation, the entity might be categorized as a VIE and, thus, consolidated into the operating company.

Because of the complexity in valuing the real estate lessor, many small businesses will look to their accountants to perform an informal valuation to test under FIN 46R.

It appears that if an accountant does perform a valuation under FIN 46R, the accountant impairs his or her independence because:

- a. The results of the valuation would be material to the financial statements as they would result in the consolidation of another entity, and
- b. The service requires a significant degree of subjectivity.

One possible solution

The author has received a rather positive response from the AICPA Ethics Division as to whether an accountant can perform a valuation test along with the client so that the client, rather than the accountant, is actually performing the test. In doing so, the accountant would have to explain the methodology, assumptions and computations used and ensure that the client takes responsibility for those items.

The problem with this approach is that it assumes the client has the skill, knowledge and experience needed to oversee this process. The Interpretation states that the member must be satisfied that the client can meet all of the criteria required and can make an informed judgment as to the results of the member's nonattest services. With respect to a valuation it is difficult to assume a client can make an informed judgment as to the results of the valuation services performed.

The author believes this approach is more form over substance in that most closely held businesses lack anyone with even minimal skill to oversee a valuation. The reality is that the valuation is the accountant's, not the client's regardless of the window dressing.

5. Information Systems – Design, Installation, or Integration Services

The revised Interpretation 101-3 makes significant changes to the types of information systems nonattest services that can be performed for an attest client. In particular, under the revised Interpretation, an accountant may not design and develop a client's financial information system, while he or she may participate in certain installations of systems.

Specifically, an accountant's independence is impaired if he or she:

- Designs or develops a client's financial information system,
- Makes more than insignificant modifications to source code underlying a client's existing financial information system,
- Supervises client personnel in the daily operation of the client's information system, or
- Operates a client's local area network (LAN) system.

Conversely, an accountant is permitted to perform certain information system services for an attest client without impairing independence. Those services include:

- Installing or integrating a client's financial information system that was not designed or developed by the accountant, such as an off-the-shelf accounting package
- Assisting in setting up a chart of accounts and financial statement format
- Designing, developing, installing, or integrating a client's system that is unrelated to the client's financial statements
- Providing training and instruction to client employees on the information and control system

Example: An accountant is hired by his client to install QuickBooks® accounting software and to assist the client in setting up the chart of accounts and financial statement format on the new accounting package. The accountant also audits the client.

Conclusion: The accountant's independence is not impaired. The accountant is only involved in installing off-the-shelf software and assisting the client in setting up the chart of accounts and financial statements on the new system. These functions do not impair independence in accordance with Interpretation 101-3.

The AICPA issued a Q&A related to the performance of information technology services for an attest client. Following are excerpts from that Q&A, as modified by the author:

Question: Why does Interpretation 101-3 indicate that independence is impaired if a member is operating a client's local area network (LAN) system?

Reply: Operating a client's LAN is considered a management function that violates the general requirements of the Interpretation.

Question: Would outsourcing a client's entire network operation and independently operating the client's LAN system impair independence?

Reply: Yes.

Question: Would performing network maintenance (such as updating virus protection, applying updates and patches, or configuring user settings consistent with management's request) impair independence?

Reply: No. Performing network maintenance is not considered to be operating a client's network and does not impair independence provided a competent client employee is making all decisions and approving all activities.

Question: Does assisting a client with a server project (such as installing, migrating or updating a network operating system, adding equipment and users, or copying data to another computer) impair independence?

Reply: No, provided the member does not make other than insignificant modifications to the source code underlying the client's financial information system.

Question: Does the supervising of client personnel in the daily operation of the client's information system impair independence?

Reply: Yes. By supervising client personnel, the member is performing management duties which impair independence.

Question: Does assisting a client with procuring and securing Internet access impair independence?

Reply: No, provided a competent client employee makes all decisions as to the Internet provider and services to be provided.

Question: The Interpretation provides that it does not apply to designing, developing, installing, or integrating a client's system that is unrelated to the client's financial statements. What criteria should a member use to determine whether a client's information system is unrelated to the financial statements or accounting records?

Reply: Information systems that produce information that is reflected in the amounts and disclosures in the client's financial statements, used in determining such amounts and disclosures, or used in effecting internal controls over financial reporting are considered to be related to the financial statements and accounting records. However, information systems that are used only in connection with controlling the efficiency and effectiveness of operations are considered to be unrelated to the financial statements and accounting records.

Question: What factors should a member consider in determining whether the modifications made to source code underlying a client's financial information system are "other than significant"?

Reply: If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be other than insignificant.

6. Forensic Accounting Services

One significant change made by the 2006 amendment to Interpretation 101-3 is to address the independence issues related to the performance of forensic accounting services for an attest client.

Forensic accounting services are defined as non-attest services that involve the application of special skills in accounting, auditing, finance, quantitative methods, and certain areas of law, research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Forensic accounting services consist of:

- Litigation services, and
- Investigative services.

Rules for litigation services:

Litigation services consist of accountant services in the capacity as an expert or consultant and involve providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties.

Litigation services are segregated into:

- Expert witness services,
- Litigation consulting services, and
- Other services related to litigation.

Following is a table that summarizes the rules of independence as they relate to the three litigation services noted above.

Impact of Litigation Services on Independence		
Type of litigation service	Impact on independence	Exceptions
<u>Expert witness services:</u> Accountant is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the accountant's expertise, rather than his or her direct knowledge of the disputed facts or events.	Independence <i>is impaired</i> . Expert witness services create the appearance that the accountant is an advocate for and promoting a client's position.	<u>Large group exception:</u> Independence is <i>not impaired</i> if the accountant provides expert witness services for a large group of plaintiffs or defendants that includes one or more attest clients of the firm provided that at the outset of the engagement:

	If the accountant conditionally or unconditionally agrees to provide expert witness testimony for a client, independence would be impaired.	<p>a. The attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim,</p> <p>b. No attest client within the group is designated as a “lead” plaintiff or defendant of the group, and</p> <p>c. No attest client has the sole decision-making power to select or approve the expert witness.</p> <p><u>Fact witness services</u>¹⁸: Answering questions while testifying as a fact witness would not impair independence.</p>
<u>Litigation consulting services</u> : Litigation services where an accountant provides advice about the facts, issues, and strategy of a matter. The consultant does not testify as an expert witness before a trier of fact.	Independence is <u>not impaired</u> provided the accountant complies with the three general requirements under Interpretation 101-3 for providing non-attest services for an attest client.	If the accountant who provides litigation consulting services subsequently agrees to serve as an expert witness, independence <u>would be impaired</u> .
<u>Other litigation services</u> : Consist of those litigation services where an accountant serves as a trier of fact, special master, court-appointed expert, or arbitrator (including serving on an arbitration panel), in a matter involving a client.	Independence <u>is impaired</u> as these services create the appearance that the accountant is not independent.	Independence is <u>not impaired</u> if the accountant serves as a mediator or any similar role in a matter involving a client provided the accountant is not making any decisions on behalf of the parties, but rather is acting as a facilitator by assisting the parties in reaching their own agreement.

¹⁸ A fact witness is one who gives testimony based on his or her direct knowledge of the facts or events in dispute and for his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the accountant’s role is to provide factual testimony to the trier of fact.

Rules for investigative services:

Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Such services do not impair independence provided the accountant complies with the three general requirements under Interpretation 101-3 for an accountant who performs nonattest services for an attest client. Remember, the three general requirements are: 1) The accountant may not perform management functions or make management decisions, 2) The client must take responsibility for the non-attest services being performed, and 3) The understanding must be in writing.

Transition rules for forensic accounting services:

Independence would not be impaired as a result of the more restrictive requirements of the forensic accounting services provisions, provided such services are pursuant to engagements commenced prior to February 28, 2007, and the accountant complied with all applicable independence interpretations and rulings in existence on February 28, 2007.

7. Other Management Functions

Interpretation 101-3 provides other examples of services performed by an accountant which may be deemed management functions. These functions include corporate finance consulting, employee search, and consulting. All of these functions follow the same theme in determining if independence is impaired. If the accountant can authorize transactions, has custody of assets, or supervises employees, he or she is clearly not independent. A few areas are worth noting. If the accountant is asked to interview client personnel, the accountant may not negotiate employee compensation or benefits or actually hire the employee. Instead, the final decision to hire the employee must be made by the client, not the accountant.

All other negotiation services follow a similar track in that an accountant may not negotiate on behalf of the client, suggesting that the accountant may not have authority to consummate the deal. If, instead, the accountant merely negotiates and reports back to the client who makes the ultimate decision, the accountant's independence may still be impaired because the accountant is acting in the capacity of management by meeting with the buyers or sellers in the first place.

Consider the following examples that illustrate these points:

Example 1: Elisa is an outside accountant for a client that she audits. The client is looking to hire a controller for the company and asks Elisa to assist in the process. The client interviews various candidates. After two interviews with a candidate, the client asks Elisa to interview a candidate and give her opinion as to whether the person should be hired and the rate of pay to offer. Elisa also recommends a few individuals to the client for consideration. The client makes the ultimate hiring decision. Is Elisa independent?

Conclusion: Yes. The fact that Elisa interviews candidates and participates in the hiring and compensation discussions does not impair independence. The client makes the ultimate decisions.

Example 2: Because Elisa will be working with the new controller, the client asks Elisa to find a controller for the company. The client gives Elisa an acceptable range of pay and full authority to hire a suitable person.

Conclusion: Elisa is not independent with respect to the client. Elisa has "crossed the line" and is now negotiating compensation and hiring an employee, both of which are management functions in accordance with Interpretation 101-3.

Example 3: An accountant's client is establishing a new operation in another locality. The client has asked the member to recruit and hire for the company a controller and a cost accountant for its new operation.

Conclusion: Independence is impaired because decisions as to employment of personnel are considered a management function. However, an accountant may perform services consisting of recommending a position description and candidate specifications, searching for and initially screening candidates, and recommending qualified candidates to the client. Such consulting assistance would not impair independence provided the client management is responsible for any ultimate hiring decision.

Example 4: Julie is an outside accountant for a client that she audits. The client has decided to sell the business and has asked Julie to negotiate the terms and conditions (including price) with three potential buyers. Once a portion of the terms is negotiated, Julie is to report back to the owners and receive feedback as to how the owners want to proceed. The ultimate decision on a sale and acceptance of the terms and conditions rest with the owners, not Julie. Is Julie independent with respect to the company?

Conclusion: No. Interpretation 101-3 states that negotiating or consummating a transaction on behalf of owners impairs independence. This is the case even though the decision rests with the owners, not the accountant. If instead, Julie assisted in the negotiation in terms of performing analysis and providing financial information to suited buyers, independence would not be impaired.

Observation: An accountant should be careful not to impair his or her independence in situations involving the sale or purchase of a business. If the firm is hired to negotiate the terms and conditions of a sale or purchase, this activity may be deemed to impair independence even though the client makes the ultimate decision. This can be a trap in the first year of an acquisition where the firm may be precluded from auditing or reviewing the entity's financial statements. Instead, the firm should limit its negotiating to acting as an advisor as well as providing information and analysis on the transaction. The difference between negotiating and acting as an advisor is a subtle one. The author believes that if a negotiation is done solely by the accountant without the assistance of the client, the accountant is not acting as an advisor. Instead, he or she is acting as part of management and independence is impaired. Conversely, when the client is negotiating the transaction and the accountant only assists in the negotiating, the accountant's role is one of being an advisor and independence is not impaired.

How do consulting services fit into the Interpretation?

The AICPA's Division of Management Consulting Services has issued a Statement on Standards for Consulting Services (SSCS) that sets the definitions and standards for consulting services engagements. The term consulting supersedes the term management consulting services.

The Standard states that:

“The performance of Consulting Services for an attest client does not, in and of itself, impair independence. However, members and their firms performing attest services for a client should comply with applicable independence standards, rules and regulations issued by AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.”

What this means is that the performance of a consulting engagement for a client does not, by definition, impair independence. The accountant should look at the other independence rules to determine whether he or she is independent. The concern is that in performing the consulting engagement, the accountant may inadvertently act in the capacity of management. In such circumstances, the accountant should follow the general rules found in Interpretation 101-3. That is, make sure he or she does not authorize transactions, supervise employees, make decisions on behalf of the client, etc. Specifically, the role of advisor and analyzer is not considered a management function.

8. Acting as a Trustee

It is quite common for a CPA to be asked to serve as a trustee for a client or as an executor of a client's estate. The client is alive and well and the trust does not become activated until the client dies. An example may be a trust that will hold the common stock of a company that the member presently audits or reviews, but again, not until the owner dies. There may also be an irrevocable insurance trust that owns an insurance policy that will be used to fund estate taxes. Or, the CPA will be an executor or co-executor of the owner's estate. How do these situations affect independence? Is the fact that the CPA will become a trustee or executor impair his or her independence now?

Interpretation 101-1 states that independence is impaired if the CPA:

Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the enterprise during the period of a professional engagement or at the time of expressing an opinion.

The Ethics Board has issued several rulings that deal with this issue on point. The fact that a CPA has been named as an executor or trustee in a client's will does not affect his or her independence now. The key is whether the CPA was independent during the year being audited or reviewed and the period up to the date the report is issued. The fundamental problem lies in the risk that a client may die in the middle of a year, and immediately the CPA is named as executor or trustee. At that point, independence is impaired and the CPA and his or her firm are precluded from performing the engagement. Let's look at a few examples that illustrate these important points:

Example 1: A CPA is the sole trustee of a trust that holds all of the voting stock of Company C. As the trustee, the CPA is actively involved in all management functions.

Conclusion: The CPA is not independent with respect to Company C because he is acting as a trustee of a trust that holds the company's stock.

Example 2: A CPA is a named trustee of a trust that **will hold** 100% of the common stock of Company B upon the death of Harry, the 100% shareholder. Presently, the trust has no assets and Harry, not the CPA, provides all of the management of Company B. The CPA reviews the financial statements of Company B for the year ended December 31, 20X1 and issues his review report on March 1, 20X2. Harry is alive and kicking for the entire period.

Conclusion: The CPA is independent provided he is not a trustee during the period January 1, 20X1 through March 1, 20X2. The fact that the CPA will become a trustee upon a certain event occurring (e.g., death of Harry) is not an issue in this case. Because the CPA was not a trustee during the period of the financial statements, the engagement period or at the date that the review report was issued, independence is not impaired.

Example 3: Same facts as Example 2, except that Harry dies on October 1, 20X1 and the CPA is named as the trustee of the trust that now holds 100% of the common stock of Company B.

Conclusion: Too bad for the CPA. Effective October 1, 20X1, he is not independent with respect to Company B and therefore, taints the entire financial statement period. Thus, he is precluded from issuing a review report for the year ended December 31, 20X1. He could issue a compilation report and include a disclaimer for lack of independence.

Example 4: Same facts as Example 3, except that the CPA is one of four trustees and the trust only owns 10% of the common stock of the company.

Conclusion: The CPA is still not independent because the trust has a direct financial interest in Company B. Interpretation 101-1 provides a materiality threshold only for indirect financial interests, not direct interests. The fact that the CPA is a trustee means that he is deemed part of management, which impairs independence.

Example 5: Bill is the co-trustee of an insurance trust set up for a client who is deceased. The son of the deceased client is now the 100% shareholder of Company X, which is an audit client of Bill and one of the beneficiaries of the insurance trust.

Conclusion: The fact that Bill is a trustee of an insurance trust does not impair his independence with respect to Company X. The insurance trust has no direct or indirect investment in the common stock of Company X. The fact that the son happens to be both a beneficiary of the trust and a 100% shareholder of Company X has no effect on Bill's independence with respect to X.

Example 6: Same facts as Example 5, except that Bill is a co-trustee of the insurance trust. The trust has no direct or indirect investment in the common stock of Company X. The other trustee is the son of the deceased client who is also the 100% shareholder of Company X, an audit client.

Conclusion: Oddly enough, independence is not impaired. The trust does not have a direct or indirect financial interest in Company X. Further, the fact that the son is both the co-trustee and 100% shareholder of Company X has no bearing on Bill's independence with respect to Company X.

Observation: The author included example 6 to illustrate a common scenario in practice. It is typical for a CPA to be named as a co-trustee with a family member. The client trusts (no pun intended) the CPA but not enough to control the family affairs outright. The key point to remember is that the trust must have a direct or material indirect investment in the client in order to impair independence with respect to the client. The mere fact that there is commonality of control between the trust and the client with the same family member in both roles, is not important. We are not dealing with rules of attribution and related party issues as customarily used in tax law and accounting. The ethics rules are separate and distinct from other areas that may deal with attribution differently. There is further discussion made in this chapter about attribution with respect to spouses and close relatives in Interpretation 101-9.

9. Member of Social Club

Question: A member belongs to a social club (e.g., country club, tennis club) in which membership requirements involve the acquisition of a pro rata share of equity or debt securities. Is the member's independence impaired with respect to the club?

Response: Probably not. As long as membership in a club is essentially a social matter, independence is not impaired because such equity or debt ownership is not considered a direct financial interest within the meaning of Interpretation 101. However, the member should not serve on the club's governing board or take part in management. To do so would impair the member's independence.

10. Unpaid Fees

Question: A member's client has not paid fees for previously rendered professional services. Is independence impaired with respect to the client for the current year?

Response: Independence is impaired if, when the report on the client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report. The rule does not apply if unpaid fees are due from a client in bankruptcy.

Observation: The author believes that this one-year rule should be changed to reflect a materiality threshold. There may be circumstances in which a client owes a de minimis amount of fees incurred more than one year from the date of the report. Yet, regardless of the amount outstanding, independence is impaired. In the present economic climate, unpaid fees may not be a chronic problem among accounting firms. However, memories can be short. During the last recession in the early 1990s, firms were barraged with unpaid fees from good clients that encountered short-term cash flow problems. The result is the firms were placed in a very difficult position of having impaired independence with a large percentage of clients. This situation will occur again during the next economic downturn. The solution is not an easy one. A purist may suggest that a CPA give up an audit or review engagement for a long-term client who is unable to fully pay the prior year's audit or review fees before issuance of the audit or review report. However, there are a few possible options for the CPA to comply with the independence ruling and still keep the client.

1. Option one is for the CPA to delay issuance of the report until the bill is paid. That is, the field work and all other work related to the engagement could be completed but the report could be held by the CPA until the bill is paid. Of course, this may require cooperation with the third party (e.g., bank, etc.) who may insist on receiving the report on a timely basis.
2. Another option is to drop the engagement level to the issuance of a compilation report with a disclaimer for lack of independence.
3. As a last resort, the CPA could forgive a portion or all of the unpaid fees and, perhaps, make up the difference in later engagements. If the CPA does forgive a portion or all of the unpaid fees, he or she should not make an agreement to recover the fees in a later engagement. Such an arrangement could be construed to be the equivalent of a defacto loan which may still impair independence.

11. Leasing Property to or from a Client

Question: A member or his/her firm leases property to or from a client. Is independence impaired with respect to the client?

Response: It depends whether the lease qualifies as an operating lease or a capitalized lease based on FASB No. 13 (ASC 840) criteria.

Independence is not impaired if:

- The lease qualifies as an operating lease,
- The terms and conditions of the lease are arm's length, and
- Payments are being made in accordance with the lease terms.

Independence is impaired if the lease meets the criteria of a capitalized lease as defined in FASB No. 13, paragraph 6 because the lease would be considered a loan to or from the client. The exception is where the lease qualifies for certain grandfathering rules found in Interpretations 101-1.A.4 and 101-1.A.5.

Observation: Under the above ruling, a member could rent office space from a client and still audit or review the client provided the lease terms and conditions were arm's length and payments were made in accordance with the payment terms. Typically the lease of real property will not qualify as a capitalized lease because the lease term is less than 75% of the remaining useful life of the building and the lease does not satisfy the other three criteria for capitalizing a lease found in FASB No. 13.

Member Performs Services for Common Interest Realty Association

Question: A member or his/her firm is associated with, or a member of, a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Is the member or his/her firm's independence impaired with respect to the CIRA?

Response: Yes. However, there is an exception whereby independence is not considered impaired if all of the following conditions are met:

- The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- The member or his/her firm's annual assessment is not material to either the CPA or his/her firm or the CIRA's operating budgeted assessments.
- The liquidation of the CIRA or the sale of common assets would not result in a distribution to the CPA or his/her firm.
- Creditors of the CIRA would not have recourse to the CPA or CPA's firm if the CIRA became insolvent.
- The CPA or his/her firm does not act or appear to act in any capacity equivalent to a member of management or employee for the CIRA, including membership on the board of directors or committees (excluding advisory committees as defined in Ethics Ruling No. 72.)

If the CPA or his/her firm has a relationship with a real estate developer or management company that is associated with the CIRA, see Interpretation 102-2 for guidance.

P. International Compilation and Review Standards

The Compilation and Review Alert makes reference to the fact that there is confusion about where the international compilation and review standards apply in lieu of the U.S. standards.

In 1994, the International Auditing Practices Committee of the International Federation of CPAs issued two standards as follows:

- *Engagements to Compile Financial Information and*
- *Engagements to Review Financial Statements*

These standards are published in the AICPA Professional Standards in Volume 2, AU sections 8910 and 8930, respectively, and provide CPAs with guidance on the professional responsibilities and the form and content of reports issued for international compilation and review engagements. The issue at hand is how the international standards interrelate with the U.S. standards found in the SSARs. In general, these international standards do not override the U.S. SSARs.

The international standards apply to CPAs who practice in the United States or abroad and are engaged to either compile or review financial statements for use solely outside the United States. In instances where financial statements are compiled or reviewed for use both inside and outside the United States, the CPA should follow the SSARs, not the international standards.

Example: A CPA located in Texas is hired to review financial statements of a U.S. company that has a Mexican owner. The statements will be issued both within the United States and in Mexico.

Conclusion: The engagement and the related review report should be issued in accordance with the SSARs given the fact that the statements will be issued within the United States. If, instead, the statements will be issued solely to third parties in Mexico, the international standards should be followed, not the SSARs. For information on the International compilation and review standards, call the International Auditing Practices Committee of the International Federation of CPAs at 212-286-9344.

Q. Responsibility to Third Parties: The Privity Standard

Lawsuits initiated by clients against the accountant may take a different form than those from third parties, such as banks, investors, etc. Most frequently, the client sues for breach of contract using the notion that the accountant failed to render the agreed-upon services in the manner contracted in the engagement letter. Generally, an accountant may be sued under any one of the following **five causes of action**:

Breach of contract: The accountant failed to perform the agreed-upon services in the manner contracted in the engagement letter (or verbally, if no engagement letter was signed.)

Negligence: The accountant failed to meet professional accounting standards.

Negligent misrepresentation: The accountant provided erroneous information to the client through failure to exercise due care.

Fraud: The accountant knowingly or recklessly made a material false statement of fact or omitted a material fact.

Breach of fiduciary duty: The accountant failed to uphold the responsibility associated with professionalism and accountability. Examples include unauthorized disclosure of confidential client information.

Any one or all of the above five causes of action can be brought by a client against an accountant. However, what about damages claimed by third parties such as a bank, investor or bonding company? Since they usually are not a party to the contract (e.g., engagement letter), what causes of action can they bring?

For years, the answer has been found in the so-called **privity standard**, developed after a 1931 court case, *Ultramares Corp v. Touche, Niven & Co* (New York, 1931).

The privity (contract) standard states:

Accountants' liability is limited to those third parties with whom the accountant has a contractual relationship.

Under a strict interpretation of this standard, the accountant is exempt from responsibility to third parties ***unless the accountant has a contract with the third party***. And, usually, the third party is not a party to the contract (engagement letter), giving the accountant a shield against third party lawsuits.

Unfortunately for accountants, since the inception of the privity standard in 1931, case law and most state statutes have watered down the privity standard to the extent that it now only applies in a few states such as Pennsylvania and Virginia.

The result is that, depending on the state of jurisdiction, responsibility to third parties can be categorized into **four different levels** as follows:

1. Privity (discussed above)
2. Near-privity
3. Restatement approach
4. Foreseeability approach

Near-privity: Under the near-privity (near-contract) standard, a third-party that does not have a contractual relationship with the accountant can still bring suit against an accountant for negligence if **all three** of the following conditions apply:

1. The accountant is aware that his or her financial report is to be used for a particular purpose,
2. A specific, **known third party**, intends to rely on the financial report, and
3. The accountant's conduct clearly demonstrates that the accountant is aware the third party will rely on the financial report.

Note: The near-privity standard is based on the case of *Credit Alliance Corporation v. Arthur Andersen & Co.* (1985) in which an auditor was sued by a lender in connection with a client that filed bankruptcy. Under the near-privity standard, the accountant must know who the third party is and the fact that the specific third party will rely on the accountant's report. The task of documenting that an accountant was aware of the third party's reliance on the report has not been clearly decided by the courts since the Credit Alliance case. For example, is a telephone call initiated by a third party to an accountant adequate to confirm that the accountant knew the third party and that the party would rely on his or her report? It is not clear. What is clear is that knowing that some *unidentified third party* will receive the report is usually not enough. The identity of the third party must be known for the near-privity defense to be challenged by a third-party.

Observation: With the issuance of SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services- 2005*, accountants are permitted to restrict the use of compiled or reviewed financial statements. This change provides an excellent opportunity for accountants in states that have near-privity third-party defenses to limit third-party liability. For example, in his or her compilation or review report, an accountant in New York State (currently a near-privity state) could restrict the use of the compiled or reviewed financial statements to a known named third party such as a particular bank. In doing so, the accountant restricts his or her liability to that named third party.

Restatement approach: In those states that follow the restatement approach, accountants are responsible to third parties who fall into **either one** of two categories:

1. Third parties the accountant **expressly knows** will be provided with the financial report, and
2. Third parties who are members of a **limited class of persons** to whom the accountant knows the financial report will be given.

Note: The restatement approach requires that the accountant know the class of third party (e.g., bankers, insurance companies, etc.), but not necessarily the name of the party. This is different from the requirement of the near-privity defense where the third party must be identified.

Example 1: Fred, an accountant reviews a client's financial statements and issues a review report. Fred gives the client several copies of the financial statements **without knowing** specifically to whom the statements will be provided. The client gives a copy of the statements to a vendor who grants credit to the client. Subsequently, the client's business fails and the vendor sues Fred for negligence. The state of jurisdiction follows the restatement approach for responsibility to third parties.

Conclusion: Fred is not liable to the vendor because he did not have notice that the financial statements would be given to the creditor or to a class of third parties (e.g. vendors).

Example 2: Same facts as Example 1, except that during the review engagement, the client informs Fred that the statements will be issued to the vendor, names the vendor, and states that the vendor will be using the statements to grant credit to the client.

Conclusion: Under the restatement approach, Fred would be responsible to the vendor because he expressly knew the financial statements would be given to the vendor.

Example 3: Same facts as Example 2, except that during the review engagement, the client informs Fred that the statements will be issued to one or more vendors without disclosing names.

Conclusion: Under the restatement approach, Fred would be responsible to any vendor to whom the statements were given because Fred was aware the statements would be given to a **particular class of third parties (vendors)**.

Note: In the above series of examples, if the state of jurisdiction followed the near-privity standard, Fred would have been liable to the third party only in Example 2, where Fred was informed that a known, third party would rely on the report for a particular purpose, to issue credit.

Foreseeability approach: The accountant is liable to **any "reasonably foreseeable"** third-party recipient of the accountant's financial report provided the third party relies on the report for its proper business purpose. Further, the accountant is not required to know the specific third party or how the report will be used.

Example: An insurance company obtains a copy of a client's financial statements used to issue an employee fraud policy. Subsequently, employee fraud was found and a claim was made against the policy. The insurance company sues the accountant, claiming that the accountant did not disclose certain known information that would have resulted in rejection of the application. The state of jurisdiction follows the foreseeability approach to third-party liability.

Conclusion: Assuming there is negligence, the accountant is liable to the insurance company under the foreseeability approach. It was **"reasonably foreseeable"** for the insurance company to be the recipient of the accountant's financial report. This is the case even though the accountant did not know about the insurance company or the purpose for which the insurance company would use the report.

Observation: The foreseeability approach is a very dangerous standard for accountants. The good news is that only a few states follow the foreseeability approach to third party liability.

R. Public Perception of Accountants in Jury Trials

A Gallup Poll concluded that the image of the accounting profession has improved back to its pre-Enron level.

Specifically, 45 percent of those polled had a positive image of the accounting profession as compared with only 31 percent right after Enron surfaced in 2002, and a pre-Enron high of 47 percent.

Regardless of how the public perceives the accounting profession as a whole, a recent study suggests that there continues to be a significant disconnect between the perceived responsibility accountants have to their clients and third parties, and their actual responsibilities.

Camico Mutual Insurance Co. has published a report entitled, Public Perceptions in a "Post Enron" World, based on a survey of the American Public. The purpose of the survey was to investigate potential juror attitudes towards accountants and whether those attitudes have been negatively affected by the recent corporate scandals, including Enron. The survey was performed by Dynamics Incorporated, a trial consulting firm, and was based on surveys of random respondents from the general public in Atlanta, Los Angeles, Miami, New Orleans, New York, and Seattle.

General conclusions reached from the survey include:

In the post-Enron environment:

1. 78% of those surveyed believe the things they hear in the news about corporate wrongdoing.
2. 61% of respondents believe that accountants are responsible for making sure their clients stay honest.
3. 42% of respondents state that they blame external accountants for the legal and/or ethical problems facing Corporate America today.
4. Only 13% of respondents believe that accountants have become more ethical in the past five years.
5. 62% of respondents think that a professional accounting firm would look the other way if a client violated the law in order to maintain its relationship with the client.
6. 71% of respondents believe that if an accountant is hired by a company to review financial statements, but not retained to do an audit, they would expect the accountant to uncover fraud.

7. 67% believe a professional accounting firm that does not catch a company's fraud should pay a severe penalty.

Although the survey is based on the public's perception of auditors, the conclusions reached apply to all accountants including those engaged in compilation and review engagements. Simply put, there continues to be evidence that the public does not differentiate between the accountant's responsibility related to an audit, review and compilation engagement.

Following are excerpts from the survey:

How closely, if at all, have you followed the news about corporate scandals or wrongdoing?

Very closely	35%
Follow it, but not closely	28%
Sometimes follow it	24%
Rarely follow it	7%
Did not follow it at all	6%

Have you ever felt that you were misled about the financial health of a company?

Yes	37%
No	63%

Which type of crime poses a greater threat to society, street crime or white collar crime?

Street crime	49%
White collar crime	51%

Do you tend to believe the things you hear in the news about corporate wrongdoing?

	Pre <u>Enron</u>	Post <u>Enron</u>
Yes	46%	78%
No	54%	22%

Who, if anyone, do you blame for the legal and/or ethical problems facing Corporate America today?

CEO	70%
Corporate senior executives	68%
CFO	62%
Inside lawyers	58%
Board of directors	55%
Inside accountants	53%
External accountants	42%
External lawyers	40%
External consultants	34%

Do you think accountants have become less ethical, more ethical, or stayed the same in the past five years?

Less ethical	38%
More ethical	13%
Stayed the same	49%

Over the last few years, has your opinion of accounting firms that audit corporations changed?

Yes	52%
No	48%

I do not trust accountants:

Strongly agree	8%
Somewhat agree	13%
Neutral	22%
Somewhat disagree	24%
Strongly disagree	33%

Do you think that a professional accounting firm would look the other way if a client violated the law in order to maintain its relationship with the client?

Yes	62%
No	38%

Compared to accountants who work for large national accounting firms, do you think that accountants in small firms are less honest, more honest or about the same in terms of honesty?

About the same	55%
More honest	39%
Less honest	6%

A company is ultimately responsible for its financial statements, not the accountant who audits the company.

Strongly agree	59%
Somewhat agree	20%
Neutral	9%
Somewhat disagree	6%
Strongly disagree	6%

Accountants should know laws that relate to financial matters:

Strongly agree	22%
Somewhat agree	67%
Neutral	7%
Somewhat disagree	4%
Strongly disagree	0%

Accountants are responsible for making sure that companies stay honest:

	Pre <u>Enron</u>	Post <u>Enron</u>
Agree	34%	61%
Neither	25%	10%
Disagree	39%	29%

If an accountant is hired by a company to review financial statements, but not retained to do an audit, would you expect the accountant to uncover fraud?

	Pre <u>Enron</u>	Post <u>Enron</u>
Yes	40%	71%
No	60%	29%

Quality of work of small firms (when compared with the work of large firms):

	Pre <u>Enron</u>	Post <u>Enron</u>
Higher	16%	36%
Same	46%	55%
Lower	38%	9%

An auditor who works closely with a company's financial statements should easily detect any fraud:

Strongly agree	45%
Somewhat agree	29%
Neutral	10%
Somewhat disagree	12%
Strongly disagree	4%

A professional accounting firm that does not catch a company's fraud should pay a severe penalty:

Strongly agree	42%
Somewhat agree	25%
Neutral	12%
Somewhat disagree	12%
Strongly disagree	9%

While some accountants have done bad things, the entire accounting profession should not be condemned:

Strongly agree	65%
Somewhat agree	20%
Neutral	5%
Somewhat disagree	4%
Strongly disagree	6%

Source: Camico Mutual Insurance Company

S. Ethics Interpretations

501-1: Response to requests by clients and former clients for records:

What responsibility does an accountant have to return records to a client who has not paid his or her bill?

Revised Ethics Ruling 501-1 gives guidance on this matter.

Terminology:

Client provided records are accounting and other records belonging to the client that were provided to the member by or on behalf of the client.

Client records prepared by the member (accountant) are accounting or other records (such as tax returns, general ledgers, subsidiary journals, and supporting schedules such as detailed employee payroll records and depreciation schedules) that the accountant was engaged to prepare for the client.

Supporting records are information not reflected in the client's books and records that are otherwise not available to the client with the result that the client's financial information is incomplete. Examples include supporting records that include adjusting, closing, combining, or consolidating journal entries (including supporting computations for such entries) that are produced by the accountant during an engagement, such as an audit or review.

Member's (accountant's) working papers include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member.

Ruling:

1. When a client or former client makes a request for client-provided records, client records prepared by the member, or supporting records, that are in the custody or control of the member or the member's firm that have not previously been provided to the client, the member should respond to the client's request as follows:¹⁹
 - a. Client provided records in the member's custody or control should be returned to the client.
 - b. Client records prepared by the member should be provided to the client, except that client records prepared by the member may be withheld if the preparation of such records is not complete or there are fees due the member for the engagement to prepare those records.

¹⁹ The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.

- c. Supporting records relating to the completed and issued work product should be provided to the client, except that such supporting records may be withheld if there are fees due to the member for the specific work product.
 - d. Member's working papers are the member's property and need not be provided to the client under provisions of this Interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.
- 2. Once the member has complied with these requirements, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such copies.
- 3. Charging for copies: In connection with any request for client-provided records, client records prepared by a member, or supporting records, the member may:
 - a. Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client.
 - b. Provide the requested records in any format usable by the client.²⁰
 - c. Make and retain copies of any records returned or provided to the client.
- 4. When a member is required to return or provide records to the client, the member should comply with the client's request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that state statutes may grant the member a lien on certain records, his or her custody or control does not relieve the member of his or her obligation to comply with this Interpretation. In addition, the member should comply with any state laws and regulations that impose obligations that are greater than the provisions of this Interpretation.

Observation: The revised Ethics Ruling 501-1 gives accountants leverage in dealing with clients that have not paid their bills. More specifically, an accountant can withhold most client or accountant-prepared records until the bill is paid in full. Of course, many state licensing boards may not take the AICPA's accountant-friendly approach outlined in 501-1, and instead may require the accountant to give the client all applicable records and sue the client for collection of the unpaid bill.

²⁰ The member is not required to convert records that are not in electronic format. However, if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client's request should be honored.

Requests for Records Pursuant to Interpretation 501-1:

Question: Individuals associated with a client entity who are currently on opposing sides in an internal dispute have each issued separate requests calling for a member to supply them with records pursuant to Interpretation 501-1. Does the member have to comply with all such requests?

Answer: In providing professional services to individuals, partnerships, or corporations, a member will usually deal with an individual who has been designated or held out as the client's representative. Such a representative might include, for example, a general partner or a majority shareholder. A member who has provided the records to the individual designated or held out as the client's representative has no obligation to provide such records to other individuals associated with the client.

Ethics FAQ Changes – FIN 48

As a result of the issuance of FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes (ASC 740)*, in connection with uncertainties related to tax positions, a question has arisen as to whether an accountant impairs his or her independence if he or she assists a client in applying FIN 48.

Background: FIN 48 requires a company to recognize the tax benefit of a tax position only if it is more likely than not that the position and benefit will be sustained upon audit. In many instances, the determination of whether a tax position satisfies the more likely than not criterion is made with the assistance of an accountant or auditor. If an accountant or auditor does, in fact, assist a client in implementing and applying FIN 48, has that accountant or auditor impaired his or her independence by making management decisions?

In response to this issue, the AICPA Professional Ethics Division added the FIN 48 issue to its non-authoritative listing of Bookkeeping FAQs that appears on the AICPA website.

Question: Would assisting a client in applying FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, such as identifying potential uncertain tax positions, advising the client whether those tax positions meet the more-likely-than-not (MLTN) threshold, and calculating the related unrecognized tax benefits impair independence?

Answer: The provision of such services would not impair independence provided the client can make an informed judgment on the results of the member's services and the other requirements of Interpretation 101-3 are met. In meeting the requirements of Interpretation 101-3, the member may assist the client in understanding why the tax positions do or do not meet the MLTN threshold and the basis for any unrecognized tax benefit so that the client can accept responsibility for the amounts reported and disclosed in the financial statements.

Note: Assisting a client in applying FIN 48 is the performance of a non-attest service covered by Interpretation 101-3. The Interpretation requires an accountant to take certain actions to avoid impairing independence.

Those actions are:

1. The accountant may not perform management functions or make management decisions as they relate to the tax return or tax positions taken.
2. The client must agree to perform certain functions in connection with the nonattest tax services such as:
 - a. Make all management decisions and perform all management functions,
 - b. *Designate an individual who possesses the skill, knowledge, and/or experience*, preferably someone within senior management, to oversee the nonattest tax services,
 - c. Evaluate the adequacy and results of the nonattest tax services performed,
 - d. Accept responsibility for the results of the nonattest tax services, and
 - e. Establish and maintain internal controls, including monitoring ongoing activities.
3. *Written establishment and documentation with client.* The member should establish and *document in writing* his or her understanding with the client with respect to:
 - Objectives of the nonattest tax engagement
 - Nonattest tax services to be performed
 - Client's acceptance of its responsibilities
 - Member's responsibilities
 - Any limitations of the engagement

The written establishment (requirement 3 above) and documentation which is typically presented in the engagement letter, should have reference to tax positions.

T. Determining Whether Financial Statements Have Been Prepared by the Accountant (Technical Practice Aid (TIS Section 9150)) (Issued December 2008):

Inquiry: AR section 100, Compilation and Review of Financial Statements states that the accountant should not submit unaudited financial statements of a nonissuer to his or her client or third parties unless, as a minimum, he or she complies with the provisions of AR section 100 applicable to a compilation engagement.

Submission of financial statements is defined in section 100 as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. If an accountant's work effort results in or contributes to the existence of financial statements, what should an accountant consider in determining whether he or she prepared those financial statements?

Reply: Due to computer technology, it is often unclear whether existing financial statements have been "prepared" by an accountant or by management. In considering whether an accountant is deemed to have prepared financial statements, an accountant needs to apply professional judgment to all the facts and circumstances some of which may include the following:

1. The process used to create the financial statements: If an accountant takes a client's trial balance and puts the accounts into a format that would represent a financial statement, then an accountant has probably prepared the financial statements. The less an accountant has to do with creating the statements, the less likely an accountant would be deemed to have prepared the statements.
2. Whether the client engaged the accountant to prepare financial statements or reasonably expected that as part of the professional services engagement the accountant would prepare the financial statements: An accountant may determine that he or she prepared financial statements even when not so engaged if, as part of an accounting or bookkeeping services engagement, in the accountant's professional judgment, the client reasonably expected that the existing financial statements were prepared as a product of that engagement.
3. The extent of work effort that an accountant contributed to the existence of the financial statements: If an accountant is intricately involved in adjusting the general ledger and other accounts that are, in turn, presented in a financial statement format, the more likely an accountant may be viewed as preparing the financial statements. On the other hand, if an accountant is not very involved in the accounting process, the less likely that he or she would be considered to have prepared financial statements.
4. Where the underlying accounting information resides: If all the accounting data resides on the accountant's computer, it is more likely that the accountant is deemed to have prepared the financial statements. However, based on the facts and circumstances of the situation, an accountant may conclude that he or she prepared financial statements through the use of accounting or bookkeeping software utilized by the client.

Factors such as who printed the financial statements or the location at which an accountant's services were performed (e.g., at the client's location or the accountant's office) are generally not factors in determining whether the accountant has prepared financial statements.

The above factors are not all-inclusive and are not meant to be used as a program or checklist for determining whether the accountant has prepared financial statements. Other factors may be considered in an accountant exercising his or her professional judgment.

REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following is true regarding a CPA's independence:
 - a) a CPA can issue an audit report even if he or she is not independent
 - b) a CPA cannot issue a compilation report without being independent
 - c) the CPA can issue a review report even if he or she lacks of independence
 - d) a CPA who performs certain nonattest services violates his or her independence
2. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client regarding all of the following except:
 - a) objectives of the nonattest engagement
 - b) client's acceptance of its responsibilities
 - c) member's responsibilities
 - d) cost of the services
3. Which of the following is not true regarding the documentation requirement for nonattest services:
 - a) where a member only provides nonattest services to a client, the requirements are not effective until the client becomes an attest client
 - b) the rules for documentation do not dictate the form of the written documentation
 - c) the failure to prepare the required documentation would impair independence under any circumstances
 - d) if a client engages a member to perform tax services, the understanding could be documented in the member's billing or correspondence files
4. The key factor in determining whether the performance of bookkeeping services impairs the accountant's independence is:
 - a) the cost of the services
 - b) whether the accountant makes management decisions or performs management functions in performing those services
 - c) the amount of time involved in performing the services
 - d) the accountant's experience level in performing the services

5. Which of the following is true regarding the performance of nonattest services as part of a compilation engagement:
- a) the written documentation requirement of Interpretation 101-3 does not apply to compilation engagements that do not disclaim independence
 - b) the same issues apply to a compilation engagement as they do an audit or review
 - c) if the accountant prepares any source documents, he or she does not have to disclaim independence in the compilation report
 - d) the accountant is required to document the client's understanding of their responsibilities in a compilation engagement letter
6. With regards to tax compliance services, the accountant should:
- a) make all management decisions and perform all management functions
 - b) evaluate the adequacy and results of the nonattest tax services
 - c) document in writing the objectives of the nonattest tax engagement
 - d) accept responsibility for the results of the nonattest tax services
7. For tax services, which of the following is not one of skills, knowledge or experience a client should possess to be considered competent under the Interpretation:
- a) the client should understand the tax law
 - b) the client should understand the company's tax position
 - c) the client should have a general understanding of how the amounts in the tax return were determined
 - d) the client should make all decisions regarding significant tax positions taken in the return
8. Which of the following impairs an accountant's independence related to payroll services:
- a) authorizing or approving payment of payroll taxes
 - b) processing the client's payroll from client-approved payroll time records
 - c) transmitting client-approved and reviewed payroll tax returns
 - d) all of the above
9. Which of the following valuations would generally not impair independence:
- a) business combinations
 - b) appraisals of assets or liabilities
 - c) ESOPs
 - d) pension or postemployment benefit liabilities
10. Which of the following would impair an accountant's independence with respect to litigation services:
- a) answering questions while testifying as a fact witness
 - b) serving as a mediator by assisting the parties in reaching their own agreement
 - c) after providing litigation consulting services, agreeing to serve as an expert witness
 - d) providing expert witness services for a large group under any circumstances

11. Which of the following services can an accountant perform for a client without impairing independence with regard to hiring personnel:
- a) interview the candidate
 - b) negotiate the candidate's employee compensation or benefits
 - c) actually hire the employee
 - d) all of the above
12. Which of the following is true regarding the international standards related to compilation and review engagements:
- a) the international standards only apply to CPAs who practice outside the United States
 - b) the international standards should be followed for compilations used both inside and outside the United States
 - c) the international standards should be followed when a review of financial statements is performed solely for use outside the United States
 - d) all of the above
13. Under which of the following is the accountant exempt from responsibility to third parties unless the accountant has a contract with the third party:
- a) privity standard
 - b) near-privity
 - c) restatement approach
 - d) foreseeability approach
14. According to the revised ethics ruling 501-1, which of the following must be returned to a client, even if there are unpaid fees:
- a) client provided records
 - b) client records prepared by the member
 - c) supporting records relating to the completed and issued work product
 - d) member's working papers
15. Under the AICPA technical practice aid, which of the following may support a conclusion that the accountant prepared the financial statements:
- a) accountant puts the client's trial balance into a general ledger format in order of account number
 - b) the client reasonably expected that the existing financial statements were prepared as a product of that engagement.
 - c) accountant is not very involved in the accounting process
 - d) accountant prints out the financial statements but did not create them

SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The general rule is that a CPA who is not independent is precluded from issuing an audit report on the financial statements.

B: Incorrect. A CPA may issue a compilation report if he or she is not independent, provided he or she disclaims independence with the compilation report.

C: Incorrect. The CPA is not permitted to issue a review report if he or she is not independent.

D: Correct. When a CPA performs certain services, his or her independence may be impaired for that client, particularly when the CPA has decision making authority.

(See page 94 of the course material.)

2. A: Incorrect. This is one of the items that should be included in the written document.

B: Incorrect. This is one of the items that should be included in the written document.

C: Incorrect. This is one of the items that should be included in the written document.

D: Correct. This is not one of the items that should be included in the written document.

(See page 97 of the course material.)

3. A: Incorrect. The documentation requirement does not become effective until the client becomes an attest client.

B: Incorrect. The method of documentation is not as important as the content of the documentation.

C: Correct. The Interpretation states the failure to prepare the required documentation would not impair independence provided the member did establish an understanding with the client.

D: Incorrect. If a client engages a member to perform tax services, the understanding could be documented in a tax organizer, in a memo contained in the tax working papers, or in the member's billing or correspondence files.

(See pages 102 to 103 of the course material.)

4. A: Incorrect. The cost of services is not the key factor.

B: Correct. The client must make the management decisions, not the accountant.

C: Incorrect. The time spent performing the services is not the key factor.

D: Incorrect. The level of experience of the accountant is not the key factor.

(See page 112 of the course material.)

5. A: Incorrect. The written documentation requirement applies to compilation engagements that do not disclaim independence.

B: Correct. The same issues regarding independence apply to a compilation engagement as they do an audit or a review, meaning that independence would be impaired by making management decisions or performing management functions in performing the bookkeeping service.

C: Incorrect. Preparing source documents is one of the tasks if performed by the accountant that they would have to disclaim independence in the compilation report.

D: Incorrect. Interpretation No. 101-3 does not require the accountant to document the client's understanding in writing in a compilation engagement letter.

(See page 116 of the course material.)

6. A: Incorrect. The accountant may not perform management functions or make management decisions as they relate to the tax return or other tax compliance services.

B: Incorrect. The client, not the accountant, should evaluate the adequacy and results of the nonattest tax services.

C: Correct. The accountant should establish and document in writing his or her understanding with the client with respect to the objectives of the nonattest tax engagement, the nonattest tax services to be performed, the client's acceptance of its responsibilities, the member's responsibilities, and any limitations of the engagement.

D: Incorrect. The client, not the accountant, should accept responsibility for the results of the nonattest tax services.

(See page 129 of the course material.)

7. **A: Correct.** The client does not need to understand the tax law.

B: Incorrect. The client should understand the company's tax situation.

C: Incorrect. The client should have a general understanding of how the amounts on the return were determined.

D: Incorrect. The client must make all decisions regarding significant tax positions.

(See page 129 of the course material.)

8. **A: Correct.** Authorizing and approving payment of payroll and payroll taxes is considered performing a management function, and therefore impairs the accountant's independence.

B: Incorrect. Processing client payroll and generating unsigned checks would not impair the accountant's independence if the client approved the payroll time records and the client signs the checks.

C: Incorrect. If the payroll tax returns and the tax payments are approved by the client, the accountant can transmit them to the proper agencies.

D: Incorrect. Not all of the items listed would impair the accountant's independence.

(See page 132 of the course material.)

9. A: Incorrect. An accountant generally cannot perform valuations on business combinations because they require a significant degree of subjectivity.

B: Incorrect. An accountant generally cannot perform appraisals of assets and liabilities because they require a significant degree of subjectivity.

C: Incorrect. An accountant generally cannot perform valuations on ESOPs because they require a significant degree of subjectivity.

D: Correct. One valuation service that typically does not impair independence is an actuarial valuation of a client's pension or postemployment benefit liabilities since it typically produces reasonably consistent results and does not require a significant degree of subjectivity.

(See page 141 of the course material.)

10. A: Incorrect. As a fact witness, the accountant's role is to provide factual testimony to the trier of fact. Answering questions in such a capacity would not impair independence.

B: Incorrect. If the accountant is not making any decisions on behalf of the parties, but instead is acting as a facilitator by assisting the parties in reaching their own agreement, he or she can serve as a mediator without impairing independence.

C: Correct. If an accountant provides litigation consulting services and complies with the three general requirements under Interpretation 101-3 for providing nonattest services for an attest client, then independence would not be impaired. If the accountant provides litigation consulting services, and subsequently agrees to serve as an expert witness, independence is impaired.

D: Incorrect. An accountant would not impair independence if: the attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim; no attest client within the group is designated as the "lead"; and no attest client has the sole decision-making power to select or approve the expert witness.

(See pages 146 to 147 of the course material.)

11. **A: Correct.** The accountant cannot act in the capacity of management, but interviewing a candidate to provide feedback to management (who makes the final decision) would not be acting in the capacity of management.

B: Incorrect. Negotiating compensation or benefits would clearly be acting in the capacity of management, and would therefore impair independence.

C: Incorrect. Making the final hiring decision would be acting in the capacity of management, and would therefore impair independence.

D: Incorrect. Since some of the options listed would impair independence, all of the above cannot be the correct answer.

(See page 148 of the course material.)

12. A: Incorrect. Among other guidelines, the international standards apply to CPAs who practice in the United States or abroad.

B: Incorrect. For compilations performed for use both inside and outside the United States, the CPA should follow SSARSS, not the international standards.

C: Correct. For a review engagement performed for use solely outside the United States, the international standards should be followed.

D: Incorrect. Since not all of the statements are true, all of the above cannot be the correct answer.

(See page 154 of the course material.)

13. **A: Correct.** The privity (contract) standard states the “Accountant’s liability is limited to those third parties with whom the accountant has a contractual relationship.”

B: Incorrect. The near-privity standard allows a third party who does not have a contractual relationship to sue the accountant if three conditions are met.

C: Incorrect. Under the restatement approach, the accountant cannot be held liable to a third party unless the accountant expressly knows the third parties will be provided with the financial report, or the third parties are members of a limited class of persons to whom the accountant knows the financial report will be given.

D: Incorrect. Under the foreseeability approach, the accountant is liable to any “reasonably foreseeable” third-party recipient of the accountant’s financial report provided the third party relies on the report for its proper business purpose. The accountant is not required to know the third party.

(See page 155 of the course material.)

14. **A: Correct.** Client provided records in the member’s custody or control should be returned to the client.

B: Incorrect. These records should be provided to the client, except when the preparation of these records is not complete or there are fees due the member for the engagement to prepare those records.

C: Incorrect. These records should be provided to the client except if fees are due to the member for the specific work product.

D: Incorrect. These records are the member’s property and need to be provided to the client under any provisions of this revised ruling.

(See page 162 of the course material.)

15. A: Incorrect. The fact that the accountant put the trial balance in a format by account number (and not necessarily in a financial statement format) does not indicate that he or she prepared the financial statements.

B: Correct. One factor that may support that the accountant prepared the financial statements is that the client reasonably expected that the existing financial statements were prepared as part of the accountant’s engagement.

C: Incorrect. The fact that the accountant is not very involved in the accounting process does not support that he or she prepared the financial statements.

D: Incorrect. Printing out the financial statements has no bearing on who prepares them.

(See page 166 of the course material.)

GLOSSARY

Attest engagement – An engagement that requires independence, as defined in AICPA *Professional Standards*.

Engagement letter – An engagement letter spells out the type and extent of the services to be provided, any limitations of these services agreed to, the timing and deadlines for performance, as well as possibly describe what is expected of you, the client.

Fraud – An intentional act that results in a misstatement in compiled or reviewed financial statements.

Illegal act – A violation of laws or governmental regulations, excluding fraud.

Nonissuer – All entities except for those defined in Section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c], the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that are required to file reports under Section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Prescribed form – Is a standard preprinted (financial statement) form designed or adopted by the body to which it is to be submitted, such as a bank financial statement.

Privity standard – Accountant's liability is limited to those third parties with whom the accountant has a contractual relationship.

Representation letter – A letter that acknowledges management's responsibility for fair presentation in the financial statements, that management believes the statements are presented in conformity with GAAP or OCBOA, and management's acknowledgment of full and truthful responses to all inquiries, completeness of information, and that the CPA has been made aware of any subsequent events that could affect measurements or disclosures in the financial statements.

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