Practice Issues: Compilation and Review

Course #6210B/QAS6210B

Course Material
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I. Summary of Important and Recent Issues, Including SSARS No. 19

Objectives:

- Discuss the latest developments affecting compilation and review engagements.
- Explain newly issued SSARS statements and interpretations including SSARS No. 19.
- Describe the impact of fraud on the accountant who performs compilation and review engagements.
- Identify effective design of the management representation letter and engagement letter.

A. INTRODUCTION

This section focuses on new developments affecting compilation and review engagements including SSARS No. 19, along with related interpretations. This section also incorporates some of the matters discussed in the AICPA’s Compilation and Review Alerts, which are non-authoritative practice aids designed to help accountants plan their compilation and review engagements. They clarify certain existing standards and assist accountants in implementing the SSARSs and related interpretations.

Throughout this course, the author uses the terms “CPA,” “accountant” and “member” interchangeably.

B. SSARS NO. 19, COMPILATION AND REVIEW ENGAGEMENTS

In January 2010, the AICPA’s Accounting and Review Services Committee (ARSC) issued SSARS No. 19, Compilation and Review Engagements. SSARS No. 19 makes far-reaching changes to most of the previously issued body of SSARSs. In general, SSARS No. 19 is effective for years ending on or after December 15, 2010.

SSARS No. 19 supersedes SSARS No. 1 (AR section 100), SSARS No. 11 (AR section 50), and SSARS No. 16 (AR section 20), in addition to amending numerous other SSARSs.

Key changes made by SSARS No. 19 include:

1. Permits an accountant to include a description in the compilation report regarding the reason(s) for which his or her independence is impaired.

2. Recodifies the SSARSs into separate sections for compilation and review engagements.

3. Introduces a new term “review evidence” to review engagements.
4. Discusses how to tailor review procedures based on the accountant’s understanding of the client’s industry, knowledge of the client, and awareness of risk.

5. Introduces the concept of materiality to a review engagement.

6. Requires an accountant to document his or her establishment of an understanding with management through a written communication (e.g., engagement letter) regarding the services to be performed.

7. Establishes enhanced documentation requirements for compilation and review engagements.

8. Changes the format of the compilation and review reports.

Although the final SSARS No. 19 standard includes most of the changes proposed within the exposure draft, two particular changes did not make the final document. First, the ARSC’s attempt to replace the concept of limited assurance with a broader moderate assurance was eliminated. Thus, limited assurance is still the threshold for performing a review engagement.

Second, the attempt to allow a review engagement if an accountant also performs a nonattest service (e.g., bookkeeping or write-up services) was not approved in the final SSARS. The ARSC announced that they will address this issue separately.

The following chart summarizes the effects SSARS No. 19 has on existing compilation and review standards.

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<thead>
<tr>
<th><strong>Impact of SSARS No. 19 on Existing SSARS</strong></th>
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<td><strong>CURRENT SSARSs</strong></td>
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<td><strong>Document/Section</strong></td>
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In its November 2010 meeting, the ARSC approved the reissuance of the numerous interpretations previously issued as part of SSARS No. 1. The interpretations of SSARS No. 1, found in AR Section 9100 are now considered interpretations of SSARS No. 19. Many of the interpretations have been renumbered and replaced. Moreover, because SSARS No. 19 is separated into two sections (AR Section 80 for compilation engagements and AR Section 90 for review engagements), interpretations have been issued under each section.
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<td>3</td>
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<td>4</td>
<td>[Discovery of Information After the Date of the Accountant’s Report]</td>
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<td>5</td>
<td>Planning and Supervision</td>
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<td>6</td>
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<th>Old AR 100 Interpretation</th>
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<td>Old AR 100 Interpretation</td>
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Source: AICPA, as modified by author.
There are additional compilation and review interpretations that are retained and found in AR Sections 9200, 9300, 9400, and 9600.

In 2011, the ARSC also approved and issued SSARS No. 20, *Revised Applicability of Statements on Standards for Accounting and Review Services*, which revises paragraph .01 of *AR section 90*, Review of Financial Statements. SSARS No. 20 is a minor change and is reflected in these materials.

**Summary of Changes to SSARSs and Related Interpretations by SSARS No. 19**

As previously noted, SSARS No. 19 supersedes SSARS No. 1 (AR section 100), SSARS No. 11 (AR section 50), and SSARS No. 16 (AR section 20), in addition to amending numerous other SSARSs.

SSARS No. 19 is segregated into three sections:

- **SECTION 1: Framework for Performing and Reporting on Compilation and Review Engagements (AR Section 60)**
- **SECTION 2: Compilation Engagements (AR Section 80)**
- **SECTION 3: Review Engagements (AR Section 90)**

In this first portion of the course, the author summarizes the three sections of SSARS No. 19. Further on in this course, the author addresses many of those issues addressed in SSARS No. 19 but in far greater detail such as going concern, legends, subsequent events, engagement and management representation letters, and more.

**SECTION 1: SSARS No. 19: Framework for Performing and Reporting on Compilation and Review Engagements (AR Section 60)**

1. **Introduction:**

   This section provides a framework and defines and describes the objectives and elements of compilation and review engagements.

2. **Definitions:**

   SSARS No. 19 provides a series of terms that are used throughout the document. The author has scattered those definitions throughout this chapter and placed each one in the appropriate topic area.

   There are a few definitions that need to be reviewed at this juncture of the course:

   **Assurance engagement:** An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria). Audit and review engagements are considered assurance engagements while a compilation engagement is not.
Attest engagement: An engagement that requires independence, as defined in AICPA Professional Standards. Attest engagements include a compilation, review, audit, and agreed-upon procedures engagements.

Interrelation of an assurance engagement with an attest engagement

It is quite common in practice for CPAs to confuse the term “assurance” with “attest” in describing the type of engagement that is performed. Yet, the two terms are not interchangeable.

An attest engagement is any engagement that requires independence and includes compilation, review and audit engagements. A compilation is an attest engagement even though an accountant may perform a compilation engagement if he or she lacks independence. All assurance engagements are attest engagements because the accountant must have independence to provide a level of assurance to the user of the financial statements.

An assurance engagement is any engagement in which the accountant provides some level of assurance to the users of the financial statements. Audit and review engagements are assurance engagements while a compilation engagement is not. An audit provides reasonable assurance and a review provides limited assurance, while a compilation engagement provides no assurance as to whether the financial statements are in accordance with GAAP or another financial reporting framework such as OCBOA.

3. Objectives and Limitations of Compilation Engagements:

A compilation is a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework (GAAP or other). Although a compilation is not an assurance engagement, it is an attest engagement.

A compilation does not provide a basis for obtaining or providing any assurance regarding the financial statements, and differs significantly from a review or an audit of financial statements in several ways that include:

a. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review.

b. A compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit.

4. Objectives and Limitations of Review Engagements:

The objective of a review engagement is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. In a
review engagement, the accountant should accumulate review evidence to obtain a limited level of assurance. Like an audit engagement, a review engagement is an assurance engagement, as well as an attest engagement.

A review differs significantly from an audit of financial statements in several ways:

a. An audit obtains a high level of assurance while a review is designed to obtain only limited assurance:

In an audit, the auditor obtains a high level of assurance (expressed in the auditor’s report as obtaining reasonable assurance) that the financial statements are free of material misstatement. A review is designed to obtain 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 the applicable financial reporting framework. Accordingly, in a review, the accountant does not obtain assurance that he or she will become aware of all significant matters that would be disclosed in an audit.

b. An audit contemplates obtaining audit evidence while a review is limited to obtaining review evidence primarily through inquiry and analytical procedures:

An audit requires obtaining audit evidence through an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit.

Conversely, a review engagement involves obtaining review evidence through primarily the performance of inquiry and analytical procedures.

The following compares the levels of assurance among compilation, review and audit engagements.

<table>
<thead>
<tr>
<th>Levels of Assurance in Types of Engagements</th>
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<tbody>
<tr>
<td>Level of assurance</td>
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<td>% assurance</td>
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<tr>
<td>Compilation</td>
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</table>

The above table illustrates the range of possible interpretations as to responsibility under different engagements. On one end of the spectrum is no assurance, which is what an accountant gives in a compilation engagement. On the other is reasonable assurance which an auditor gives in his or her audit report. Reasonable assurance is defined in
SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* (“Due Professional Care in the Performance of Work”), as a high level of service which most commentators translate into somewhere between 51 to 95 percent depending on how the parties define “high level of assurance.” What is clear is that reasonable assurance is less than an absolute 100 percent guarantee.

With respect to a review engagement, SSARS No. 19 states that the accountant provides “limited assurance” that the financial statements are free from material misstatement. Although SSARS No. 19 does not define the term “limited assurance,” its threshold is less than an audit’s reasonable assurance and greater than a compilation’s no assurance.

5. Professional Requirements:

SSARSs contain professional requirements, together with related guidance, in the form of explanatory material. Accountants performing a compilation or review have a responsibility to consider the entire text of a SSARS in carrying out their work on an engagement and in understanding and applying the professional requirements of the relevant SSARSs.

Not every paragraph of a SSARS carries a professional requirement that the accountant is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in SSARSs.

SSARSs use two categories of professional requirements identified by specific terms to describe the degree of responsibility they impose on accountants, as follows:

- *Unconditional requirements.* The accountant is required to comply with an unconditional requirement in all cases where the circumstances exist to which the unconditional requirement applies. SSARSs use the words “must” or “is required” to indicate an unconditional requirement.

- *Presumptively mandatory requirements.* The accountant also is required to comply with a presumptively mandatory requirement in all cases where the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the accountant may depart from a presumptively mandatory requirement provided that the accountant documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SSARSs use the word “should” to indicate a presumptively mandatory requirement.

**Note:** If a SSARS provides that a procedure or action is one that the accountant “should consider,” the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of a SSARS are to be understood and applied in the context of the explanatory material that provides guidance for their application. The specific terms used to define professional requirements are not intended to apply to interpretative publications issued under the authority of the ARSC because interpretative publications are not SSARSs.
**Example:** A particular SSARS states that an accountant “should consider” performing a certain review procedure.

**Conclusion:** The accountant is presumptively required to consider whether the procedure should be performed. However, the accountant is not presumptively required to actually perform the procedure. Thus, the presumptive requirement only applies to the accountant considering whether he or she should perform the procedure and to the performance of the procedure.

*Explanatory material* is defined as the text within a SSARS (excluding any related appendices or interpretations) that may do the following:

- Provide further explanation and guidance on the professional requirements
- Identify and describe other procedures or actions relating to the activities of the accountant

Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (when not otherwise self-evident); it explains why the accountant might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the accountant to consider in exercising professional judgment in performing the engagement.

Explanatory material that identifies and describes other procedures or actions relating to the activities of the accountant is not intended to impose a professional requirement for the accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the accountant’s attention and understanding; how and whether the accountant carries out such procedures or actions in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words “may”, “might”, and “could” are used to describe these actions and procedures that are considered explanatory material.

6. **Hierarchy of Compilation and Review Standards and Guidance for Compilation and Review Standards:**

SSARS No. 19 outlines the hierarchy of authority for performing compilation and review engagements as follows:

SSARS No. 19 Hierarchy of Authority

<table>
<thead>
<tr>
<th>Tier</th>
<th>Description</th>
<th>Level of authority</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Compilation and Review Standards</td>
<td>Highest</td>
</tr>
<tr>
<td>2</td>
<td>Interpretative Publications</td>
<td>Middle</td>
</tr>
<tr>
<td>3</td>
<td>Other compilation and review publications</td>
<td>Lowest</td>
</tr>
</tbody>
</table>
a. **Compilation and review standards:**

An accountant must perform a compilation or review engagement of a nonissuer in accordance with the SSARSs, except for certain reviews of interim financial information. SSARSs provide a measure of quality and the objectives to be achieved in both a compilation and review engagement.

SSARS No. 19 defines a nonissuer as:

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

- Any entity 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.

In general, a nonissuer is the same as a nonpublic entity; that is, an entity that is not required to comply with the SEC Act of 1934.

Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202), requires an AICPA member who performs compilations or reviews to comply with standards promulgated by the ARSC. The ARSC develops and issues standards in the form of SSARSs through a due process that includes deliberations in meetings open to the public, public exposure of proposed SSARSs, and a formal vote. Finalized SSARSs are codified.

b. **Interpretative publications:**

The accountant should consider interpretative publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretative publication, the accountant should be prepared to explain how he or she complied with the provisions of SSARSs addressed by such guidance.

Interpretative publications consist of the following:

- Compilation and review interpretations of SSARSs
- Appendices to SSARSs
- Compilation and review guidance included in AICPA Audit and Accounting Guides
- AICPA Statements of Position, to the extent that those statements are applicable to compilation and review engagements.
Note: Interpretative publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued under the authority of the ARSC after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with SSARSs.

c. Other compilation and review publications:

Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply SSARSs. An accountant is not expected to be aware of the full body of other compilation and review publications.

Other compilation and review publications include:

- AICPA accounting and review publications not referred to previously
- The AICPA’s annual Compilation and Review Alert
- Compilation and review articles in the Journal of Accountancy and other professional journals
- Compilation and review articles in the AICPA’s The Accountant Letter
- Continuing professional education programs and other instructional materials, textbooks, guide books, compilation and review programs, and checklists
- Other compilation and review publications from state CPA societies, other organizations, and individuals.

Note: If an accountant applies the guidance included in another compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. In determining whether another compilation and review publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying SSARSs and the degree to which the issuer or author is recognized as an authority in compilation and review matters. Other compilation and review publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.

The following chart summarizes the compilation and review hierarchy found in SSARS No. 19.
<table>
<thead>
<tr>
<th>Literature</th>
<th>Issued by</th>
<th>Degree of authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statements on Standards for Accounting and Review Services (SSARSs)</td>
<td>AICPA’s Accounting and Review Services Committee (ARSC) after due process that includes deliberations in meetings open to the public, public exposure, and a formal vote.</td>
<td>Codified and at the highest level of authority for compilation and review engagements.</td>
</tr>
<tr>
<td>Interpretive Publications: Consist of SSARS Interpretations, Appendices, guidance included in AICPA Audit and Accounting Guides, and AICPA Statements of Position</td>
<td>AICPA’s Accounting and Review Services Committee (ARSC) issues an interpretation after all ARSC members comment on whether the interpretation is consistent with the SSARSs.</td>
<td>Recommendations on applications of SSARSs in specific circumstances, including engagements for entities in specialized industries. If an accountant does not apply the guidance in an interpretative publication, the accountant should be prepared to explain how he or she complied with the SSARS provisions addressed by such guidance.</td>
</tr>
</tbody>
</table>
| Other Compilation and Review Publications: Consisting of the AICPA Compilation and Review Alert, articles in the Journal of Accountancy and other journals, CPE programs, textbooks, etc. | Various                                                                   | If an accountant applies the guidance included in another compilation and review publication, he or she should be satisfied that it is both relevant to the circumstances of the engagement, and appropriate. Factors to consider as to whether a publication is appropriate include:  
- Degree to which the publication is recognized as being helpful in understanding and applying the SSARSs  
- Degree to which the issuer or author is recognized as an authority in compilation and review matters. Publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate. |
7. Ethical Principles and Quality Control Standards:

In addition to SSARSs, AICPA members who perform compilation and review engagements are governed by:

a. The AICPA’s Code of Professional Conduct (Code), which expresses the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. The principles of the Code guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The principles call for a commitment to honorable behavior, even at the sacrifice of personal advantage.

b. Statements on Quality Control Standards (SQCSs), which establish standards and provide guidance on a firm’s system of quality control.

The Code establishes the fundamental ethical principles that all AICPA members are required to observe. When performing a compilation or review engagement, the Code requires an accountant to maintain objectivity and integrity and comply with all other applicable provisions.

An accountant has the responsibility to adopt a system of quality control in conducting an accounting practice. Thus, a firm should establish quality control policies and procedures to provide reasonable assurance that personnel comply with SSARSs in compilation and review engagements. The nature and extent of a firm’s quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

SSARSs relate to the conduct of individual compilation and review engagements; SQCSs relate to the conduct of a firm’s accounting practice. Thus, SSARSs and SQCSs are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of an individual engagement and the firm’s accounting practice as a whole. However, deficiencies in, or instances of noncompliance, with a firm’s quality control policies and procedures do not, in and of themselves, indicate that a particular review or compilation engagement was not performed in accordance with SSARSs.

8. Elements of a Compilation or Review Engagement:

SSARS No. 19 addresses the following elements of a compilation and review engagement:

a. A three-party relationship involving management, an accountant, and intended users
b. An applicable financial reporting framework
c. Financial statements or financial information
d. In a review, sufficient appropriate review evidence
e. A written communication or report
9. Three-Party Relationship:

A compilation or review engagement involves three parties:

- Management (or the responsible party)
- An accountant in the practice of public accounting, as defined by the AICPA code
- Intended users of the financial statements or financial information.

**Management (Responsible Party)**

Management must be identified in a compilation or review engagement. In particular, management takes responsibility for:

- The preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- Designing, implementing, and maintaining internal control
- The identification of the applicable financial reporting framework (GAAP, OCBOA, etc.) and the preparation and presentation of the financial statements in accordance with that framework.

Management is defined under SSARS No. 19 as:

> “the person(s) with executive responsibility for the conduct of the entity’s operations. Management excludes those individuals that are charged with governance unless they also perform management functions.”

**Note:** A basic assumption underlying the performance of a compilation or review engagement is that the accountant is performing an attest service on subject matter that is the responsibility of the client’s management. Therefore, an accountant is precluded from issuing an unmodified compilation report or a review report on financial statements when management is unwilling to accept responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework or to take responsibility for the design, implementation, and maintenance of internal control.

During the performance of a compilation or review engagement, the accountant may make suggestions about the form or content of the financial statements or prepare them, in whole or in part, based on information that is the representation of management. However, the ultimate responsibility must rest with management.

**Accountant in the Practice of Public Accounting**

If an accountant is not in the practice of public accounting, he or she is precluded from issuing a compilation or review report under the SSARSs.
In performing a compilation or review engagement, an accountant is required to possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable the accountant to compile or review financial statements that are appropriate in form for an entity operating in that industry.

**Note:** An accountant should not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases, this requirement can be satisfied by the accountant using the work of persons from other professional disciplines, referred to as experts. In such cases, the accountant should be satisfied that those persons carrying out aspects of the engagement possess the requisite skills and knowledge, and that the accountant has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.

**Intended Users of the Financial Statements or Financial Information**

In many cases, management and the intended users may be the same. Intended users may be from different entities (for example, a banker or potential investor) or the same entity.

The intended users are the person(s) or class of persons who understand the limitations of the compilation or review engagement and financial statements. The accountant has no responsibility to identify the intended users.

**Note:** In some cases, intended users (such as bankers and regulators) may impose a requirement on or request the client to arrange for additional procedures to be performed for a specific purpose. For example, a banker may request that certain agreed-upon procedures be performed with respect to the entity’s accounts receivable in addition to the financial statements being compiled. An accountant may perform additional services in conjunction with the compilation or review, as long as he or she adheres to professional standards with respect to those additional services.

**10. An Applicable Financial Reporting Framework:**

SSARS No. 19 introduces the concept of the applicable financial reporting framework which includes U.S. GAAP, OCBOA (income tax basis, cash basis, etc), and other frameworks.

A financial reporting framework is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

Examples of financial reporting frameworks include:

- U.S. GAAP (accounting principles generally accepted in the United States of America, as promulgated by the Financial Accounting Standards Board)
- OCBOA (Other comprehensive basis of accounting)
- U.S. Governmental GAAP (principles issued by the Governmental Accounting Standards Board)
• Accounting principles generally accepted in the United States of America, as promulgated by the Federal Accounting Standards Advisory Board
• IFRSs issued by the International Accounting Standards Board.

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

Management and, when applicable, those charged with governance are responsible for the selection of the entity’s applicable financial reporting framework, as well as individual accounting policies when the financial reporting framework contains acceptable alternatives. The financial reporting framework encompasses financial accounting standards established by an authorized or recognized standards setting organization.

11. Financial Statement or Financial Information:

An accountant may be engaged to compile or review a complete set of financial statements or an individual financial statement (for example, balance sheet only). The financial statements may be for an annual period or for a shorter or longer period, depending on management’s needs.

SSARS No. 19 defines financial statements as:

“a structured representation of historical financial information, including related notes, intended to communicate an entity’s economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework.”

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

The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.
12. Evidence:

When performing a compilation engagement, the accountant has no responsibility to obtain any evidence about the accuracy or completeness of the financial statements. As a result, a compilation does not provide a basis for obtaining any level of assurance on the financial statements being compiled.

In connection with the performance of a review engagement, SSARS No. 19 introduces the concept of review evidence.

When performing a review engagement, the accountant should perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining 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 the applicable financial reporting framework.

Review evidence obtained through the performance of analytical procedures and inquiries ordinarily will provide the accountant with a reasonable basis for obtaining limited assurance. In limited cases where analytical procedures and inquiries are not sufficient, SSARS No. 19 requires the accountant perform additional procedures as part of gathering review evidence.

The accountant should apply professional judgment in determining the specific nature, timing, and extent of review procedures. Such procedures should be tailored based on the accountant’s understanding of the industry in which the client operates and the accountant’s knowledge of the entity. The nature, timing, and extent of procedures for gathering review evidence are deliberately limited relative to an audit.

13. Compilation and Review Reports:

If the accountant performs a compilation, a report or written communication is required unless the accountant withdraws from the engagement.

If the accountant is not independent, he or she may issue a compilation report, provided that the accountant complies with the compilation standards which requires the accountant to disclaim independence.

If the accountant performs a review, a written review report is required unless the accountant withdraws from the engagement.

14. Materiality:

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
• Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both.

• Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the accountant in determining whether there are any material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the accountant with such a frame of reference.

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

a. Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence
b. Understand that financial statements are prepared, presented, and reviewed to levels of materiality
c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events
d. Make reasonable economic decisions on the basis of the information in the financial statements.
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 correct:
   a) a compilation is both an assurance and attest engagement
   b) a review is both an assurance and attest engagement
   c) a compilation is an assurance but not an attest engagement
   d) a review is an attest but not an assurance engagement

2. Which one of the following would be performed as part of obtaining review evidence:
   a) assessing fraud risk
   b) confirmations
   c) inquiry
   d) examination of source documents

3. Which of the following words, when used in the SSARSs, requires an accountant to comply with it as an unconditional requirement:
   a) the word “may”
   b) the word “should”
   c) the words “should consider”
   d) the word “must”

4. An accountant is performing a compilation or review engagement. Which of the following would be an example of guidance that has no authoritative status within the hierarchy:
   a) appendices to SSARSs
   b) compilation and review interpretations of SSARSs
   c) AICPA’s annual Compilation and Review Alert
   d) the SSARSs

5. In a compilation or review engagement, which of the following is management responsible for:
   a) testing internal control
   b) preparation of the financial statements
   c) determining the accountant’s procedures to perform
   d) preparing the accountant’s report
6. Which of the following is not required in order for an accountant to perform a compilation engagement under the SSARSs:

   a) independence
   b) being in the practice of public accounting
   c) level of knowledge of the entity’s industry
   d) level of knowledge of the industry accounting principles
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A compilation is an attest engagement but is not an assurance engagement.
   
   **B: Correct.** A review is both an assurance and attest engagement.
   
   C: Incorrect. A compilation is an attest engagement but is not an assurance engagement.
   
   D: Incorrect. A review is both an attest and an assurance engagement.
   
   (See page 12 of the course material.)

2. A: Incorrect. Assessing fraud risk is part of an audit engagement and not part of review evidence.
   
   B: Incorrect. Using confirmations is part of an audit engagement and not part of review evidence.
   
   **C: Correct.** Inquiry is a procedure performed as part of review evidence.
   
   D: Incorrect. Examination of source documents is performed in an audit engagement and not part of review evidence.
   
   (See page 13 of the course material.)

3. A: Incorrect. The word “may” is an example of explanatory material and not an unconditional requirement.
   
   B: Incorrect. The word “should” is a presumptively mandatory requirement, not an unconditional one.
   
   C: Incorrect. The words “should consider” represent a presumptively mandatory requirement as to the procedure or action.
   
   **D: Correct.** The word “must” means the procedure is an unconditional requirement.
   
   (See page 14 of the course material.)
4. A: Incorrect. The Appendices to SSARSs are considered interpretive publications and the accountant should consider such documents to be applicable to the compilation or review engagement.

B: Incorrect. Compilation and review interpretations of SSARSs are interpretative publications that the accountant should consider in performing a compilation or review engagement.

**C: Correct.** The AICPA’s annual *Compilation and Review Alert* is considered other compilation and review publications that have no authoritative status but may help the accountant understand and apply the SSARSs.

D: Incorrect. The SSARSs are authoritative at the highest level of the hierarchy.

(See page 17 of the course material.)

5. A: Incorrect. Management is responsible for designing, implementing and maintaining internal control, but not testing it.

**B: Correct.** Management is responsible for the preparation and fair presentation of the financial statements.

C: Incorrect. The accountant, not management, is responsible for determining the accountant’s procedures to perform.

D: Incorrect. The accountant is responsible for preparing his or her report, not management.

(See page 17 of the course material.)

6. **A: Correct.** An accountant does not have to be independent provided he or she discloses the lack of independence in the compilation report.

B: Incorrect. An accountant must be in the practice of public accounting to perform a compilation engagement.

C: Incorrect. An accountant must have a general level of knowledge of the entity’s industry to perform a compilation engagement.

D: Incorrect. An accountant must have a level of knowledge of the industry accounting principles to perform a compilation engagement.

(See pages 20 to 21 of the course material.)
SECTION 2: SSARS No. 19: Compilation Engagements:

1. Key Changes Found in SSARS No. 19 Related to Compilation Engagements:

Although there are many changes made to the compilation engagement by SSARS No. 19, the key changes are:

- A written understanding (such as an engagement letter) is now required for a compilation engagement.
- An accountant is now permitted to describe the reason(s) for a lack of independence in the compilation report.
- Documentation requirements have been expanded in a compilation engagement to now require that the accountant document any findings or issues that, in the accountant's judgment, are significant.
- The compilation report has been changed to more clearly outline the responsibility of the parties in a compilation engagement.

Most of the requirements for a compilation engagement that were previously found in the SSARSs have been retained in SSARS No. 19.

2. Establishing an Understanding With an Engagement Letter:

SSARS No. 19 makes a change by requiring an accountant to establish an understanding with management regarding the services to be performed for a compilation engagement.

The understanding must be in the form of an engagement letter and should include:

- The objectives of the engagement
- Management’s responsibilities
- Accountant’s responsibilities
- Limitations of the engagement

Details of elements that should be included in the engagement letter include:

**Required elements in an engagement letter:**

- The objective of a compilation is to assist management in presenting financial information in the form of financial statements.
- The accountant utilizes information that is the representation of management (owners) without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.
• Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.

• Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

• Management is responsible to prevent and detect fraud.

• Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

• Management is responsible for making all financial records and related information available to the accountant.

• The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

• 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; testing 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); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the financial statements.

• The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

• The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant's attention during the performance of compilation procedures that fraud or an illegal act may have occurred. The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

• The effect of any independence impairments on the expected form of the accountant's compilation report, if applicable.

Additional matters that may (but are not required to) be discussed include:

• Fees and billings
• Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)

• Conditions under which access to compilation documentation may be granted to others

• Additional services to be provided relating to regulatory requirements

• Indemnification provision for liability if management makes known misrepresentations.

Further on in this course, the author discusses the inclusion of additional matters, such as indemnification clauses, in engagement letters.

**What if compiled financial statements are not expected to be used by a third party and the accountant does not expect to issue a compilation report on the financial statements?**

In an instance in which compiled statements are not expected to be used by a third party and a compilation report is not going to be issued, the accountant should include in the engagement letter an acknowledgement of management’s representation and agreement that the financial statements are not to be used by a third party.

Further, the engagement letter should include the following additional matters:

• Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed

• Substantially all disclosures (and the statement of cash flow, if applicable) required by applicable financial reporting framework may be omitted

• Reference to supplementary information.
Standard Engagement Letter for a Compilation  
(From Exhibit A of SSARS No. 19, as modified by the author)

Mr. John Smith  
President  
Smith Manufacturing, LLC  
100 Main Street  
Nowhere, MA 02110  

Dear Mr. Smith:

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

We will perform the following services:

We will compile, from information you provide, the annual [and interim, if applicable] financial statements of XYZ Company as of December 31, 20XX, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.
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; testing 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); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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 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.

If, during the period covered by the engagement letter, the accountant’s independence is or will be impaired, insert the following:

We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

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.

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of accountant]

Acknowledged:
XYZ Company

President

____________________________________
Date
Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use (From Exhibit A of SSARS No. 19, as modified by the author)

Mr. John Smith  
President  
Smith Manufacturing, LLC  
100 Main Street  
Nowhere, MA 02110

Dear Mr. Smith:

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

We will perform the following services:

We will compile, from information you provide, the [monthly, quarterly, or other frequency] financial statements of XYZ Company for the year 20XX.

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
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; testing 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); or other procedures ordinarily performed in an audit.

Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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 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.

**The financial statements will not be accompanied by a report and are for management’s use only and are not to be used by a third party.**

If, during the period covered by the engagement letter, the accountant’s independence is or will be impaired, insert the following:

*We are not independent with respect to XYZ Company.*

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of accountant]

Acknowledged:
XYZ Company

_______________________
President

_______________________
Date
3. Compilation Performance Requirements:

SSARS No. 19 outlines the performance requirements necessary for a compilation engagement.

In a compilation engagement, the accountant must:

a. **Have an understanding of the industry:** The accountant should possess an understanding of the client’s industry, including the accounting principles and practices generally used in that industry, so that the accountant can compile financial statements that are appropriate in form for an entity operating in that industry.

b. **Have knowledge of the client:** The accountant should have knowledge of the client including:
   - An understanding of the client’s business, including its organization, operating characteristics, and the nature of its assets, liabilities, revenues, and expenses.
   - An understanding of the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. Such an understanding may include matters such as changes in accounting practices and principles, and differences in the client’s business model in comparison with normal industry practices.

   **Note:** An accountant should be aware of unusual accounting policies and procedures that come to his or her attention as a result of his or her knowledge of the industry.

c. **Read the financial statements:** Prior to submitting the financial statements, the accountant should read them and consider whether such financial statements appear to be appropriate in form and free from obvious material errors.

   **Note:** An error is defined as a mistake in the preparation of financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure.

d. **Other procedures:** In a compilation engagement, the accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. If, however, through making inquiries or performing other procedures, the accountant gains knowledge that may suggest that information supplied is incorrect, incomplete, or otherwise unsatisfactory, or that fraud or an illegal act may have occurred, the accountant should request that management consider the effect of such matters on the financial statements and communicate the results of such consideration to the accountant.

   The accountant should also consider the effect of management’s conclusions regarding such matters on the accountant’s compilation report. If the accountant believes the financial statements may be materially misstated, he or she should obtain additional or revised information. If the client refuses to provide such additional or revised information, the accountant should withdraw from the engagement.
4. Documentation in a Compilation Engagement:

SSARS No. 19 expands the documentation requirements for a compilation engagement. The SSARS requires an accountant to prepare documentation in sufficient detail to provide a clear understanding of the work performed.

Accountant documentation should include:

a. An engagement letter documenting the understanding with the client

b. Any findings or issues that, in the accountant’s judgment, are significant (new requirement under SSARS No. 19)

   Example: The results of compilation procedures that indicate that the financial statements could be materially misstated, actions taken to address such findings, the extent to which the accountant had any questions or concerns as a result of the procedures, and how those issues were resolved.

c. Communications (oral or written), to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention, if any.

Note: Prior to the issuance of SSARS No. 19, the documentation requirements for a compilation engagement were limited to documenting a) the understanding with the client as to the type of engagement to be performed, and b) communications to management regarding fraud or illegal acts, if any, that come to the accountant’s attention.

SSARS No. 19 introduces a third requirement which is to document any findings or issues that, in the accountant’s judgment, are significant (item (b) above).

5. Revised Reporting Requirements for Compilation Engagement:

a. Compilation report:

SSARS No. 19 changes the language in the standard compilation report. Most of the elements found in the previous SSARS No. 1 compilation report have been retained in the new compilation report, although these elements are found in different paragraphs within the new report.

The SSARS requires that a compilation report have the following basic elements:

**Title and addressee:**

- *Title.* The compilation report should have a title that clearly indicates that it is the accountant’s compilation report. The accountant may indicate that he or she is independent in the title, if applicable.

  Appropriate titles include:

  “Accountant’s Compilation Report” or “Independent Accountant’s Compilation Report”

- *Addressee.* The accountant’s report should be addressed as appropriate in the circumstances of the engagement.
**Introductory paragraph:**

The introductory paragraph in the accountant’s report should do the following:

- Identify the entity whose financial statements have been compiled
- State that the financial statements have been compiled
- Identify the financial statements that have been compiled
- Specify the date or period covered by the financial statements
- Include a statement that the accountant has not audited or reviewed the financial statements and, accordingly, does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.

**Management’s responsibility for the financial statements and for internal control over financial reporting:**

The report should have a statement that management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

**Accountant’s responsibility:**

The report should have the following statements:

- A statement that the accountant’s responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA.

- A statement that the objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

**Signature of the accountant and date of report:**

The report should have:

- The manual or printed signature of the accounting firm or the accountant, as appropriate, and

- The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant’s report).

**Note:** The report should not describe the procedures that the accountant might have performed as part of the compilation engagement.
### Comparison of Old versus New Standard Compilation Report

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Old Compilation Report</th>
<th>New Compilation Report- SSARS No. 19</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Title</strong></td>
<td>None.</td>
<td>Compilation report should have a title such as “Accountant’s Compilation Report” or “Independent Accountant’s Compilation Report.”</td>
</tr>
<tr>
<td><strong>First Introductory Paragraph</strong></td>
<td>I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.</td>
<td>I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.</td>
</tr>
<tr>
<td><strong>Second Management’s responsibility</strong></td>
<td>None</td>
<td>Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.</td>
</tr>
<tr>
<td><strong>Third Accountant’s responsibility and conclusion</strong></td>
<td>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.</td>
<td>My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.</td>
</tr>
<tr>
<td><strong>Separate paragraph if accountant’s independence is impaired</strong></td>
<td>I am (we are) not independent with respect to XYZ Company. [The accountant is not permitted to disclose the reason(s) for the independence impairment]</td>
<td><img src="https://via.placeholder.com/150" alt="Text" /> I am (we are) not independent with respect to XYZ Company. <img src="https://via.placeholder.com/150" alt="Text" /> [The accountant is permitted (but not required) to disclose the reason(s) for the independence impairment]</td>
</tr>
</tbody>
</table>
Illustrative Standard Compilation Report
US GAAP

Accountant’s Compilation Report

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)
Illustrative Standard Compilation Report
Income Tax Basis

Accountant’s Compilation Report

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

I (we) have compiled the accompanying statement of assets and liabilities- income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

b. Reporting on financial statements that omit substantially all disclosures:

SSARS No. 19 retains the previous reporting requirement when substantially all disclosures are omitted. The omission can apply to both disclosures and the statement of cash flows.

The accountant may compile financial statements that omit substantially all the disclosures required by an applicable financial reporting framework, including those disclosures that might appear in the body of the financial statements.
The accountant may compile such financial statements provided that the omission of such disclosures is not, to his or her knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements.

Such a report should include the following elements in a paragraph after the paragraph that describes the accountant’s responsibility:

- A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework (or ordinarily included in the financial statements if the financial statements are prepared in accordance with an OCBOA)

- A statement that if the omitted disclosures (and statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows (or equivalent for presentations other than accounting principles generally accepted in the United States of America)

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

When the entity wishes to include disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled as follows:

“Selected Information—Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example, “Accounting Principles Generally Accepted in the United States of America”) Are Not Included.”
Illustrative Standard Compilation Report
Management Elects to Omit Substantially All Disclosures and the Statement of Cash Flows Required by U.S. GAAP

Accountant’s Compilation Report

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)
Illustrative Standard Compilation Report
Management Elects to Omit Substantially All Disclosures Ordinarily Included in Income Tax Basis of Accounting

Accountant’s Compilation Report

Board of Directors
XYZ Company

I (we) have compiled the accompanying statement of assets and liabilities- income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared in accordance with 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 assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

c. Reporting when an accountant is not independent:

One of the most significant changes made by SSARS No. 19 is the way in which an accountant may report when he or she is not independent. Previously, an accountant was required to disclose when he or she was not independent with respect to a client, but was precluded from disclosing the reason why the accountant lacked independence.
SSARS No. 19 makes a change by allowing an accountant to disclose the reason why he or she is not independent with respect to a client which is the subject of the compilation report.

- When the accountant is issuing a report with respect to a compilation of financial statements for an entity, and with respect to which the accountant is not independent, the accountant’s report should be modified by indicating his or her lack of independence in the final paragraph of the compilation report.

An example:

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

- The accountant is permitted (but not required) to disclose a description about the reason(s) that his or her independence is impaired.

Examples included in SSARS No. 19, as modified, follow:

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

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

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

**Note:** If an accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.
Board of Directors
XYZ Company

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Last paragraph:
I am (we are) not independent with respect to XYZ Company.

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

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

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

James J. Fox & Company, CPA
[Date] (date of completion of compilation engagement)
AICPA Q&A: Lack of Independence

In January 2010, the AICPA issued a Q&A entitled Significant Change to Compilation Reporting Requirements When Independence Is Impaired, to address some of the issues surrounding the lack of independence in a compilation engagement.

Following are excerpts from that Q&A:

Question—When may I start describing the reasons for lack of independence in my compilation report?

Answer—You may use the provision in paragraph 2.21 with respect to any compilation report that you issue after December 30, 2009 (the official issuance date of SSARS No. 19).

Question—May I disclose the reasons for the lack of independence only for December 2009 compilations and subsequent periods, or may I use it for earlier compilations (for example, November 2009 compilations)?

Answer—You may disclose the reasons for a lack of independence in a November (or earlier) compilation report as long as your report is released (or reissued) after the official issuance of SSARS No. 19, which is December 30, 2009.

Question—What constitutes “official issuance,” and how will I know that date?

Answer—Official issuance is the date on which a standard is first made public and, therefore, available for use. A standard is first made available electronically through the AICPA’s subscription services. Even if you do not subscribe to an electronic subscription, you can still use this provision once the standard is issued. After the standard is issued, the AICPA’s Audit and Attest Standards Team will send a blast e-mail to members about the issuance date. Notification also will be made public through many other AICPA publication processes.

Question—May I use the new standard compilation report illustrated in SSARS No. 19 after the standard is issued?

Answer—No. The effective date of SSARS No. 19 is for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Early implementation of the new standard is not permitted, except for the one paragraph permitting disclosure of the reasons for a lack of independence in the compilation report. Therefore, you cannot use the new standard compilation report until SSARS No. 19 becomes effective.

Question—Does SSARS No. 19 require me to state the reasons why I am not independent with respect to a compilation client?

Answer—No. SSARS No. 19 permits, but does not require, the accountant to disclose the reasons. You may simply state that you are not independent with respect to the client without disclosing the reasons.
**Question**—May I disclose the reasons for the lack of independence in one period and then not disclose the reasons in a subsequent period for the same client?

**Answer**—Yes. Each period for which a compilation report is issued for a client is treated as a separate compilation. For example, you may decide to disclose the reasons in a compilation report on financial statements for the period ended March 31, 2010, and then decide to not disclose the reasons in a compilation report on financial statements for the period ended June 30, 2010, or vice versa.

**Question**—Are there factors that I should consider before deciding to disclose the reason(s) for the impairment?

**Answer**—An accountant should exercise his or her professional judgment in making that decision. That judgment might include consideration of such factors as the number of reasons for independence impairment or the ability of the user of the compiled financial statements to understand the nature of the impairments.

Paragraph 2.21 of SSARS No. 19 states in part, “If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.” Therefore, if the accountant’s independence is impaired for three reasons (for example, ownership, nonattest services, and family relationships), the accountant may decide that describing all three would make the report too lengthy or too confusing. Consequently, the accountant might decide to stay with the extant language and merely say that he or she is not independent. On the other hand, an accountant who is providing a nonattest service that impairs independence may feel that this information would be beneficial for users to know. Therefore, that accountant may decide to disclose the reason.

**Question**—Are there any limitations on what the report may say?

**Answer**—No. The ARSC did not prescribe any requirements except that if an election is made to describe, then all the reasons for the impairment must be described. That means that an accountant could, if he or she chooses, write a paragraph three pages long to describe the reasons for the impairment. Although that length certainly isn’t expected, the ARSC anticipates and expects that some accountants will go into far greater detail than will others.

**Question**—Assuming an accountant is not independent for two reasons (for example, a family relationship and ownership), does each reason need to be in a separate paragraph?

**Answer**—No. An accountant may combine the reasons into a single paragraph. For example, assuming the accountant held an ownership interest in the client and the accountant’s spouse was the CFO of the company, a description paragraph may be drafted, such as the following:

I am not independent with respect to XYZ Company as of and for the year ended December 31, 2010, because I am a minority shareholder in XYZ Company and my spouse is an officer of XYZ Company.
**Question**—Assuming an accountant’s independence is impaired because the accountant maintains a number of controls for the client, does each area of internal control need to be listed by the accountant, or may the accountant merely say that his or her independence is impaired because he or she maintained internal controls?

**Answer**—The provision is flexible and allows an accountant to provide as much detail as he or she feels appropriate in the circumstances. Therefore, the accountant may either state the areas of internal control maintained by the accountant or provide a general description of the reason or give no reason at all and merely say that he or she is not independent. In making this decision, the accountant should make sure that his or her description is not misleading. For example, if the accountant is maintaining only small aspects of internal control over financial reporting, the accountant would not want to describe the reason by saying that he or she is maintaining all controls for the client. Such a statement would be misleading and inaccurate.

**Question**—May this provision be used for review reports….?

**Answer**—No. ….. Paragraph 3.2 of SSARS No. 19 states that the accountant is precluded from performing a review engagement if the accountant’s independence is impaired for any reason.

**Observation:** Although SSARS No. 19 permits an accountant to disclose the reason for the lack of independence, there is a question as to whether the accountant should make that disclosure and whether such disclosure would be meaningful to the user of the financial statements. If, for example, the reason for lack of independence is that the accountant is a related party to the client, that information may be useful. However, if the lack of independence is due to the fact that the client has not paid two years’ of accounting bills, that fact may not be meaningful to the user and may send the wrong message.

d. Reporting when compiled financial statements are not expected to be used by a third party:

When an accountant submits compiled financial statements to his or her client that are not expected to be used by a third party, the accountant is not required to issue a compilation report.

Instead, the accountant should follow the following rules:

- The accountant should include a reference on each page of the financial statements restricting their use, such as:

  - Restricted for Management’s Use Only, or
  - Solely for the Information and Use by the Management of XYZ Corporation and not intended to be and should not be used by any other party
• If the accountant becomes aware that the financial statements have been distributed to third parties, the accountant should discuss the situation with the client and determine the appropriate course of action, including requesting that the client have the financial statements returned.

• If, after the accountant requests that the statements be returned, the client does not comply with that request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third party use, preferably in consultation with his or her attorney.

Observation: Management-use only financial statements are essentially a compilation engagement without a compilation report being issued. All of the performance requirements for a compilation engagement under SSARS No. 19 must be adhered to.

e. Emphasis of a matter:

An accountant may, but is not required to, emphasize in his or her report, a matter that is disclosed in the financial statements. The matter should be presented in a separate paragraph of the accountant's report.

1) Emphasis paragraphs are optional at the sole discretion of the accountant.

2) Examples of matters that the accountant may wish to emphasize include the following:

- Uncertainties
- That the entity is a component of a larger business enterprise
- That the entity has had significant transactions with related parties
- Unusually important subsequent events
- Accounting matters, exclusive of those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.

Typically, more routine transactions such as purchases of assets in the normal course of business are not matters that would be included in an emphasis of a matter paragraph even though an accountant may choose not to do so.

Is an accountant permitted to include an emphasis of a matter paragraph in a compilation report that omits substantially all disclosures?

An emphasis of matter paragraph should not be used in lieu of management disclosures. Therefore, the accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless that matter is also disclosed in the financial statements.
f. Departures from the Applicable Financial Reporting Framework:

An accountant who is engaged to compile financial statements may become aware of a departure from the *applicable financial reporting framework* (including inadequate disclosure) that is material to the financial statements.

*Applicable financial reporting framework.* The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. For example, U.S. GAAP or the income tax basis of accounting would be examples of applicable financial reporting framework.

- If an accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if the effects have been determined by management or are known due to the accountant’s procedures.

- The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

- If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, the accountant should withdraw from the engagement, provide no further services with respect to those financial statements, and possibly consult with the accountant’s legal counsel.
Example

Illustrative Standard Compilation Report
U.S. GAAP Departure

Accountant’s Compilation Report

Board of Directors
XYZ Company

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. During our compilation, I (we) did become aware of a departure (certain departures) from accounting principles generally accepted in the United States of America that is (are) described in the following paragraph.

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders’ equity would have been decreased by $500,000.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)

g. Restricted use versus general use compilation report:

Accountant’s compilation reports are separated into two categories, general \((unrestricted)\) use and restricted use, as follows:
**General (unrestricted) use:**

Applies to accountant’s reports that are not restricted to specified parties. Reports on financial statements that are prepared in conformity with an applicable financial reporting framework ordinarily are general (unrestricted) use.

An accountant is not precluded from restricting the use of any report even if the report would otherwise be general use.

**Restricted use:**

Restricted use reports are those reports intended only for one or more specified third parties. The restriction may be the result of numerous circumstances that include:

- The purpose of the report, and
- The potential risk that the report might be misunderstood when taken out of the context in which it was intended to be used.

1) When a report is issued on subject matter or a presentation based on a measurement or disclosure criteria contained in a contractual agreement or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the use of the report because:

- The basis, assumptions, or purpose of the presentations (contained in such an agreement or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions.
- The subject matter, or presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

2) If an accountant issues a single combined report covering both subject matter that requires a restriction on use to specified parties, and subject matter that ordinarily does not require a restriction (e.g., general use), the use of the single combined report should be restricted to the specified parties.

3) If, as required by law or regulation, a separate restricted use report is included in a document that also contains a general use report, the inclusion of a separate restricted use report in the document does not affect the intended use of either report. The restricted use report remains restricted for use, and the general use report continues to get unrestricted.

4) Subsequent to the completion of an engagement that has a restricted use report, the accountant may be asked to add other parties as specified parties. If this is the case, an accountant is permitted to add other parties provided the accountant:

a) Considers several factors that include:
   - Identity of the other parties
   - Their knowledge of the basis of the measurement or disclosure criteria
   - The intended use of the report.
b) Obtains *affirmative acknowledgment*, preferably in writing, from the other parties as to their understanding of the nature of the engagement, and the measurement or disclosure criteria used in the engagement and related report.

**Note:** If the other parties are added after the accountant issues his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, the acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

5) **Report language- restricted use:**

The accountant’s report that is restricted should contain a separate paragraph at the end of the report that includes the following information:

- A statement indicating that the report is intended solely for the information and use of the specified parties.

- An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

**How does an accountant guarantee that restricted use reports are not distributed by the client to parties beyond the specified parties?**

SSARS No. 19 states that in connection with a restricted use report, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to nonspecified parties. The accountant is not precluded from reaching an understanding with the client that the intended use of the report will be restricted and from obtaining the client’s agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

The SSARS also states that the accountant is not responsible for controlling a client’s distribution of restricted use reports. A restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

**h. Other reporting requirements- compilation engagement:**

**Legend:** Each page of the financial statements compiled by the accountant should include a reference, such as:

- “See accountant’s compilation report” or
- “See independent accountant’s compilation report”
**OCBOA financial statements:** Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include:

- A description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from generally accepted accounting principles (GAAP). The effects of the differences need not be quantified.

- Informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

6. **Entity’s Ability to Continue as a Going Concern:**

   During the performance of a compilation engagement, an accountant may obtain information that indicates that an uncertainty may exist about an entity’s ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements).

   In such circumstances, the accountant should take the following steps:

   a. Request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for disclosure.

   b. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions, including the adequacy of the related disclosures, if applicable.

   c. If the accountant determines that management’s conclusions are unreasonable or the disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is not adequate, the accountant should follow the guidance of a departure from an applicable financial reporting framework.

   d. The accountant may emphasize an uncertainty about an entity’s ability to continue as a going concern, provided that the uncertainty is also disclosed in the financial statements.

7. **Subsequent Events:**

   A subsequent event may have a material effect on compiled financial statements and may come to the attention of the accountant in one of two ways:

   a. During the performance of compilation procedures, or

   b. Subsequent to the date of the accountant’s compilation report but prior to the release of the report.\(^1\)

\(^1\) If an accountant compiles financial statements with no report, the submission date of the compiled financial statements is the equivalent of the accountant’s compilation report date.
Regardless of the way in which the accountant discovers the subsequent event, the accountant should request that management consider the possible effects on the financial statements, including whether there is adequacy of disclosure.

If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or notes, the accountant should treat the transaction as a departure from GAAP, or other applicable financial reporting framework.

In addition, an accountant may wish to include an explanatory paragraph of a subsequent event in the report as an emphasis of a matter. The accountant may add an additional paragraph as long as the matter is also disclosed in the financial statements.

**8. Subsequent Discovery of Facts Existing at the Date of the Compilation Report:**

Subsequent to the date of the report on the compiled financial statements, the accountant may become aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

SSARS No. 19 provides the following guidance in connection with such a situation:

a. **General rule:** The general rule is that after the date of the accountant’s compilation report, the accountant has no obligation to perform other compilation procedures with respect to the financial statements, unless new information comes to his or her attention.

b. **Exception to the general rule:** The exception is when the accountant becomes aware of information that relates to financial statements previously reported on by him or her but that was not known to the accountant at the date of the report (and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the compilation). In such a case, the accountant:

   - Should undertake to determine whether the information is reliable and whether the facts existed at the date of the report.

   - Should discuss the matter with the client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary.

   - May choose to discuss the matter with those other than management including those parties charged with governance.

   - Should consider the time elapsed since the financial statements were issued.

   - May wish to consult with his or her legal counsel.
c. The accountant should obtain additional or revised information if the nature and effect of the matter are such that:

- The accountant’s report or the financial statements would have been affected if the information had been known to the accountant at the accountant’s compilation report date and had not been reflected in the financial statements, and
- The accountant believes that persons are currently using or are likely to use the financial statements and those persons would attach importance to the information.

d. When the accountant has concluded that action should be taken to prevent further use of the accountant’s report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements.

When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances. The accountant should take whatever steps he or she considers necessary to satisfy himself or herself that the client has made the necessary disclosures, under the following guidance:

1) If the effect of the subsequently discovered information on the accountant’s report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant’s report.

- The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant’s report.

Note: In general, only the most recently issued compiled financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

2) When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements, pursuant to subparagraph (1).

3) When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In such a situation, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of:

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2 Technical Practice Aid (TIS 9150) The Accountant’s Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report (April 2010), references the fact that the term “applicable” applies to a situation in which financial statements have been issued to third parties. In such case, the revised report should be issued and include a reason for the financial statement revision as well as an explanation in the notes to financial statements.
• The client notifying persons who are known to be using or who are likely to use the financial statements that the statements should not be used; that revised financial statements will be issued; and, when applicable, that the accountant’s report will be issued as soon as practicable.

e. If the client refuses to make the disclosures, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as outlined subsequently to prevent further use of the financial statements and, if applicable, the accountant’s report.

Note: The steps that can appropriately be taken will depend upon the degree of certainty of the accountant’s knowledge that persons exist who are currently using or who will use the financial statements and, if applicable, the accountant’s report and who would attach importance to the information and the accountant’s ability as a practical matter to communicate with them. Unless the accountant’s attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

1) Notify the client that the accountant’s report must no longer be associated with the financial statements.

2) Notify the regulatory agencies having jurisdiction over the client that the accountant’s report should no longer be used.

3) Notify each person known to the accountant to be using the financial statements, that the financial statements and the accountant’s report should no longer be used.

Note: In most situations, it will not be practicable for the accountant to give appropriate individual notification to all persons. For example, it may be difficult to notify all stakeholders whose identities ordinarily are unknown to the accountant.

Instead, notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

f. Details on required disclosure: The content of any disclosure of information subsequently discovered to persons other than the accountant’s client should follow these guidelines:

1) The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

2) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose of the disclosure.
**Note:** The disclosure should not include any comments concerning the conduct or motives of any person. If the client has not cooperated, the accountant’s disclosure need not detail the specific information but can merely indicate that the client has not cooperated with the accountant’s attempt to substantiate information that has come to the accountant’s attention and that, if the information is true, the accountant believes that the compilation report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant’s compilation report should not be used.

9. **Supplementary Information:**

When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the following rules should be applied:

a. The accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to such information.

b. When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should refer to the other data, or the accountant can issue a separate report on the other data.

c. If a separate report is issued, the report should state that the other data accompanying the financial statements are presented only for the purposes of additional analysis and that the information has been compiled from information that is the representation of management, without audit or review, and that the accountant does not express an opinion or provide any assurance on such data.

10. **Communicating to Management and Others:**

If an accountant obtains evidence or other information during his or her performance of compilation procedures, that fraud or an illegal act may have occurred, that matter should be brought to the attention of the appropriate level of management using the following rules:

a. The accountant is not required to report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

b. When such fraud or an illegal act involves senior management, the accountant should report the matter (either orally or in writing) to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance.

1) Any communication that is done orally should be documented by the accountant.

c. When such fraud or an illegal act involves an owner of the business, the accountant should consider resigning from the engagement.
**Note:** There may be instances where there are potential conflicts between the accountant’s ethical and legal obligations for confidentiality of client matters. In such circumstances, the accountant may wish to consult with legal counsel before discussing matters involving fraud or illegal acts with parties outside the client.

d. An accountant should consult with his or her legal counsel whenever any evidence or information comes to his or her attention during a compilation engagement that fraud or an illegal act may have occurred, unless an illegal act is clearly inconsequential.

e. The accountant is not required to disclose any evidence or information about a fraud or illegal act to parties other than client’s senior management (or those changed with governance).

However, in the following instances, a duty may exist for the accountant to disclose to parties outside of the entity:

- To comply with certain legal and regulatory requirements
- To a successor accountant when the successor decides to communicate with the predecessor accountant regarding acceptance of the engagement to compile or review the financial statements of a nonissuer
- In response to a subpoena.

11. **Change in an Engagement from an Audit or Review to a Compilation:**

There may be instances in which an accountant, who has been engaged to audit or review financial statements, before the completion of the audit or review, is asked to change the engagement to a compilation.

a. There may be numerous reasons for the change in the engagement, whether imposed by the client or by circumstances, as follows:

- There may be a change in circumstances affecting the entity’s requirement for an audit or a review,
- There could be a misunderstanding as to the nature of the type of engagement, or
- There might be a restriction on the scope of an audit or review.

**Note:** A change in circumstances that affects the entity’s requirement for an audit or review or a misunderstanding concerning the nature of an audit, review, or compilation would ordinarily be considered a reasonable basis for requesting a change in the engagement.

Before an accountant agrees to change the engagement to a compilation, the accountant should consider all of the following issues:

- The reason given for the client’s request and its implications of a restriction on the scope of the audit or review, whether imposed by the client or by circumstances
• The additional audit or review effort required to complete the audit or review

• The estimated additional cost to complete the audit or review.

b. If the audit or review procedures are substantially complete, or the cost to complete such procedures is relatively insignificant, the accountant should consider whether it is appropriate to accept a change in the engagement to a compilation.

Note: The accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. When an accountant has been engaged to audit an entity’s financial statements, the accountant typically would be precluded from issuing a compilation report if:

• The accountant has been prohibited by the client from corresponding with the entity’s legal counsel, or

• The client does not provide the accountant with a signed representation letter.

c. If the accountant concludes that reasonable justification exists to change the engagement to a compilation, and if the accountant complies with the standards for a compilation engagement, the accountant should issue a compilation report.

The report should not reference:

1) The original engagement (audit or review), or

2) Any audit or review procedures that may have been performed.

Observation: If an accountant does change from an audit or review engagement to a compilation engagement, implicit in that change is that the accountant will comply with the standards required to perform a compilation engagement.
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. Under SSARS No. 19, in connection with a compilation engagement, communication of an understanding of the engagement must be done:

   a) orally or in writing at the option of the accountant
   b) in writing with an engagement letter
   c) orally if properly documented in the working papers
   d) in writing but not through a signed engagement letter

2. If an accountant is performing a compilation engagement, he or she must perform which of the following procedures:

   a) analytical procedures
   b) inquiry
   c) confirmation
   d) understand the client’s business

3. Which one of the following is an expansion of the documentation requirements for a compilation engagement under SSARS No. 19. Documenting:

   a) the understanding with the client
   b) communications to the appropriate level of management regarding fraud or illegal acts
   c) findings or issues that are significant
   d) analytical procedures performed

4. Which of the following is a new element required for a compilation report under SSARS No. 19:

   a) state that the financial statements have been compiled
   b) specify the date or period covered by the financial statements
   c) have a report title
   d) state that the accountant’s responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA
5. Assume an accountant issues a compilation report covering comparative financial statements for the years ended December 31, 20X1 and 20X2, and the accountant lacks independence in both fiscal years. Which of the following is correct:

a) the accountant is required to disclose the reason(s) for the lack of independence in both years
b) the accountant may decide to disclose the reason(s) for lack of independence in one year and not disclose the reasons in the other year
c) the accountant is not allowed to disclose the reason(s) for the lack of independence in either year
d) the accountant is permitted to disclose the reason(s) for the lack of independence and if so, must disclose those reasons in both years or not at all

6. How should an accountant report, when compiled financial statements are not expected to be used by a third party:

a) the accountant should issue a standard compilation report
b) the accountant should include a reference on each page of the financial statements restricting their use
c) the accountant should place a restriction in the engagement letter with no modification required in the report or financial statements
d) a modified compilation report is required with a paragraph that stipulates the limitation for third party use

7. Which of the following is not an example of a matter an accountant may wish to emphasize in a compilation or review report:

a) uncertainties
b) unusually important subsequent events
c) significant transactions with related parties
d) purchases of fixed assets in the normal course of business

8. Which of the following would be a reason why an accountant may wish to restrict the use of a compilation report:

a) the accountant wishes to limit his or her risk that misstatements may exist and be uncovered by third parties
b) the client wishes to keep information confidential
c) there is a potential risk that the report might be misunderstood
d) the client wants a lower cost compilation and has only one third party

9. Facts: An accountant becomes aware of information that relates to financial statements previously reported on, but that was not known at the date of the report. What should the accountant do:

a) ignore it as it is not the responsibility of the accountant once the financial statements are issued
b) insist that the client revise the financial statements to reflect the information
c) consider the time elapsed since the financial statements were issued
d) contact all known third parties and demand that the financial statements be retrieved
10. An accountant is asked to change an engagement from a review to a compilation before the accountant completes the review engagement. If the accountant agrees to change the engagement to a compilation, which of the following actions is appropriate:

a) the compilation report should reference the original review engagement
b) the compilation report should identify the review procedures that were performed prior to converting to a compilation engagement
c) the accountant should perform the compilation engagement only if the cost to complete the original review engagement is insignificant
d) the accountant must comply with the standards for a compilation engagement
SOLUTIONS AND SUGGESTED RESPONSES

1. **A:** Incorrect. Oral communication is not an option under SSARS No. 19.

   **B:** Correct. SSARS No. 19 requires the use of an engagement letter.

   C: Incorrect. The communication must be in writing.

   D: Incorrect. An engagement letter signed by the client must be used.

   (See page 29 of the course material.)

2. **A:** Incorrect. Analytical procedures are performed in a review engagement, not a compilation engagement.

   **B:** Incorrect. Inquiry is performed in a review engagement, not a compilation engagement.

   C: Incorrect. Confirmation is not required in a compilation engagement, but is typically a procedure for an audit.

   **D:** Correct. An accountant must understand the client’s business in performing a compilation engagement. That understanding includes understanding its organization, operating characteristics, and the nature of its assets, liabilities, revenues and expenses.

   (See page 36 of the course material.)

3. **A:** Incorrect. Documenting the understanding with the client had previously existed and is not a new documentation requirement.

   **B:** Incorrect. Communications to the appropriate level of management regarding fraud or illegal acts was required prior to SSARS No. 19.

   **C:** Correct. Documenting findings or issues that are significant is a new requirement under SSARS No. 19.

   D: Incorrect. Analytical procedures are not a requirement for compilation engagements and certainly do not have to be documented.

   (See page 37 of the course material.)
4. A: Incorrect. There has always been a requirement to state that the financial statements have been compiled.

B: Incorrect. Prior to SSARS No. 19, the compilation report had to specify the date or period covered by the financial statements.

C: Correct. SSARS No. 19 requires that the compilation report have a title which was not a requirement previously.

D: Incorrect. Previously, the report stated that the accountant’s responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA.

(See page 39 of the course material.)

5. A: Incorrect. The accountant is permitted, but not required to the reason(s) for the lack of independence in either or both years.

B: Correct. The accountant may decide to disclose the reason(s) for lack of independence in one year and not disclose the reasons in the other year. Disclosure in both years is not required.

C: Incorrect. SSARS No. 19 allows the accountant to disclose the reason(s) for the lack of independence in either year or both years.

D: Incorrect. The accountant is permitted to disclose the reason(s) for the lack of independence but is not required to disclose it in both years or not at all. Each year stands on its own.

(See pages 47 to 48 of the course material.)

6. A: Incorrect. A compilation report is not required.

B: Correct. The accountant should include a reference on each page of the financial statements restricting their use such as “Restricted for Management’s Use Only.”

C: Incorrect. Although the engagement letter should identify the third party limitation, there is a modification required to the financial statements with a reference on each page restricting the use of the financial statements.

D: Incorrect. A compilation report is not required in this situation.

(See page 49 of the course material.)
7. A: Incorrect. An uncertainty is a matter than could give rise to an emphasis of a matter due to its importance to the reader.

B: Incorrect. Unusually important subsequent events could be emphasized because, by definition, they are important to the reader of the financial statements.

C: Incorrect. Significant transactions with related parties are listed by the author as an important item that might want to be emphasized.

D: Correct. Purchases of fixed assets in the normal course of business may not be significant enough to warrant an emphasis of a matter in a report.

(See page 50 of the course material.)

8. A: Incorrect. There is nothing found in the SSARSs that provides that the accountant may use a restricted use report to limit his or her risk that misstatements may exist and be uncovered by third parties.

B: Incorrect. Having a goal of keeping information confidential is not a reason for issuing a restricted use report.

C: Correct. One reason for issuing a restricted use report is the potential risk that the report might be misunderstood particularly when the subject matter is narrow and understood by a few individuals.

D: Incorrect. Because an accountant must perform the same amount of work for a restricted use versus a general use report, cost savings is not a factor to consider.

(See page 53 of the course material.)

9. A: Incorrect. The accountant cannot ignore the information, even if the financial statements are issued.

B: Incorrect. The accountant should undertake to determine whether the information is reliable and whether the facts existed at the date of the report. Then, the accountant should discuss the matter with the client and request cooperation in whatever investigation may be necessary. Nothing requires the accountant to insist on revising the financial statements.

C: Correct. In making an appropriate determination as to what to do, the accountant should consider the time that has elapsed since the financial statements were issued. The longer the time, the less important the additional information becomes.

D: Incorrect. Only as a last resort would the accountant contact the third parties directly, and only after other actions were taken.

(See page 56 of the course material.)
10. A: Incorrect. The compilation report should not reference the original review engagement.

B: Incorrect. The compilation report should not identify the review procedures that were performed prior to converting to a compilation engagement.

C: Incorrect. The accountant should not perform the compilation if the cost to complete the original review engagement is insignificant.

D: Correct. To perform the compilation engagement, the accountant must comply with the standards for a compilation engagement.

(See page 61 of the course material.)
SECTION 3: SSARS No. 19: Review Engagements:

Like compilation engagements, SSARS No. 19 makes several changes to the existing codification related to review engagements.

1. Key Changes to a Review Engagement Found in SSARS No. 19:

Although there are many changes made to the review engagement by SSARS No. 19, the key changes are:

a. A written understanding (such as an engagement letter) is now required for a review engagement.

b. SSARS introduces the concept of “review evidence” to a review engagement.

c. Documentation requirements have been expanded to now require that the accountant document 1) management’s responses to inquiries regarding significant fluctuations in information from expected amounts, and 2) significant matters covered in the accountant’s inquiry procedures and responses thereto.

d. The review report has been changed to more clearly outline the responsibility of the parties.

Most of the requirements for a review engagement that were previously found in the SSARSs have been retained in SSARS No. 19.

2. General Rules for Performing a Review Engagement:

Although a review engagement is found in the SSARSs, auditing literature provides guidance for a review of interim financial information. More specifically, an accountant who is auditing an entity’s financial statements is permitted to review interim financial information under SAS No. 116, Interim Financial Information (and not the SSARSs) if all of the following exist:

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

b. The accountant either: 1) has been engaged to audit the entity’s current year financial statements, or 2) audited the entity’s latest annual financial statements and, in situations where it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review.

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

If all three of the above-noted elements do not exist, the review must be performed under the SSARSs and not under SAS No. 116.
An accountant is precluded from performing a review engagement if the accountant’s independence is impaired for any reason.

**Observation:** In the exposure draft to SSARS No. 19, the ARC had a proposed provision that would have allowed an accountant to perform a review engagement if his or her independence was impaired because the accountant performed nonattest services such as bookkeeping or write-up work.

3. Establishing an Understanding:

The accountant is required to establish an understanding with management regarding the services to be performed for a review engagement and must document that understanding through a written communication (engagement letter) with management.

An engagement letter with management and, if applicable, those charged with governance should include the following matters:

**Required matters:**

- The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.

- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

- Management is responsible to prevent and detect fraud.

- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

- Management is responsible for making all financial records and related information available to the accountant.

- Management will provide the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

- The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

- A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management.
A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion regarding the financial statements as a whole.

The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant’s attention during the performance of review procedures that fraud or an illegal act may have occurred. The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

**Other matters the accountant may wish to include in the letter:**

- Fees and billings
- Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)
- Conditions under which access to review documentation may be granted to others
- Additional services to be provided relating to regulatory requirements

**Other matters that should be addressed if applicable:**

- Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed
- Reference to supplementary information
Board of Directors  
XYZ Company

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

We will perform the following services:

We will review the financial statements of XYZ Company as of December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

f. Providing us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A review includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining
sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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.

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

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

__________________________________
[Signature of accountant]

Acknowledged:
XYZ Company

_______________________    _____________
President                   Date

4. Performance Requirements- Review Engagement:

In performing a review engagement, an accountant is required to perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining 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 the applicable financial reporting framework (e.g., GAAP, OCBOA, etc).

Review evidence is a new term introduced by SSARS No. 19 and is defined as "information used by the accountant to provide a reasonable basis for the obtaining of limited assurance."

In obtaining review evidence, an accountant must perform the following procedures:
Performance procedures:

a. Understanding of the industry in which the client operates
b. Obtain knowledge of the entity
c. Understand risk

Review procedures:

a. Analytical procedures
b. Inquiries and other review procedures

**Understanding the industry:**

The accountant is required to possess an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry, sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed.

**Note:** The accountant is not precluded from accepting an engagement for a client in an industry in which the entity operates and for which the accountant has no previous experience. However, the accountant is required to obtain the necessary level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

**Knowledge of the client:**

The accountant is required to obtain knowledge about the client sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed. Such knowledge includes:

- An understanding of the client’s business
- An understanding of the accounting principles and practices used by the client

In obtaining an understanding of the client’s business, the accountant should have a general understanding of the client’s organization; its operating characteristics; and the nature of its assets, liabilities, revenues, and expenses. The accountant’s understanding of an entity’s business is ordinarily obtained through experience with the entity or its industry and inquiry of the entity’s personnel.

The accountant should understand the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant may obtain an understanding of the accounting policies and procedures used by management through inquiry, the review of client prepared documents, or experience with the client.

In obtaining this understanding of the client’s accounting policies and practices, the accountant should be alert to unusual accounting policies and procedures that come to the accountant’s attention as a result of his or her knowledge of the industry.
**Understand risk:**

One of the performance requirements for a review engagement is that an accountant must focus his or her analytical procedures and inquiries in those areas in which risk of material misstatement is highest.

For example, if through inquiry an accountant discovers that the company does not maintain perpetual inventory records, the accountant may wish to focus analytical procedures to a greater degree in the inventory area.

Although an accountant should be aware of risk in performing procedures, the accountant is not required to perform risk assessment procedures like those that would be required in an audit.

**Observation:** In the exposure draft of SSARS No. 19, the document includes a description of the concept of review risk. In the final document, SSARS No. 19 makes reference to overall risk but does not mention the specific term “review risk.”

**Review procedures:**

Based on the accountant’s performance procedures to gather review evidence (understanding of the industry, knowledge of the entity, and understanding review risk), the accountant is required to perform review procedures. In performing review procedures, the accountant should design and perform analytical procedures and inquiries and other review procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

**Note:** Review evidence obtained through the performance of analytical procedures and inquiry will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, the accountant should perform additional procedures if the accountant determines such procedures to be necessary to obtain limited assurance that the financial statements are not materially misstated.

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

b. The results of the accountant’s analytical procedures and inquiries may modify the accountant’s risk awareness. For example, the response to an inquiry that cash has not been reconciled for several months may revise the accountant’s awareness of risks relative to the cash account.

**Analytical procedures:**

The accountant is required to understand financial and nonfinancial relationships in evaluating the results of analytical procedures. Generally such an understanding requires the accountant to have knowledge of the client and the industry in which the client operates.
An understanding of the purposes of analytical procedures and the limitations of those procedures also is important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the accountant.

1. Analytical procedures involve comparisons of expectations developed by the accountant to recorded amounts or ratios developed from recorded amounts.

2. The accountant is required to develop such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant’s understanding of the industry in which the client operates and knowledge of the client.

Examples of sources of information for developing expectations include:

a. Financial information for comparable prior period(s), giving consideration to known changes

b. Anticipated results (for example, budgets or forecasts, including extrapolations from interim or annual data)

c. Relationships among elements of financial information within the period

d. Information regarding the industry in which the client operates (for example, gross margin information)

e. Relationships of financial information with relevant nonfinancial information (for example, payroll costs to number of employees).

3. Analytical procedures may be performed at the financial statement level or at the detailed account level. The nature, timing, and extent of the analytical procedures are a matter of professional judgment.

4. If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the accountant should investigate these differences by inquiring of management and performing other procedures as necessary in the circumstances.

Note: Review evidence relevant to management’s responses may be obtained by evaluating those responses, taking into account the accountant’s understanding of the entity and its environment, along with other review evidence obtained during the course of the review. Although the accountant is not required to corroborate management’s responses with other evidence, the accountant may need to perform other procedures when, for example, management is unable to provide an explanation, or the explanation, together with review evidence obtained relevant to management’s response, is not considered adequate.

Inquiries and other review procedures:

The accountant is required to perform inquiries and other review procedures in obtaining review evidence. Such procedures include:
a. Inquire of members of management who have responsibility for financial and accounting matters concerning the following:

- Whether the financial statements have been prepared in conformity with the applicable financial reporting framework
- The entity’s accounting principles and practices and the methods followed in applying them and the entity’s procedures for recording, classifying, and summarizing transactions and accumulating information for disclosure in the financial statements
- Unusual or complex situations that may have an effect on the financial statements
- Significant transactions occurring or recognized near the end of the reporting period
- The status of uncorrected misstatements identified during the previous engagement
- Questions that have arisen in the course of applying the review procedures
- Events subsequent to the date of the financial statements that could have a material effect on the financial statements
- Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements (for example, communications received from employees, former employees, or others)
- Significant journal entries and other adjustments
- Communications from regulatory agencies

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

b. Inquire concerning actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements

c. Read the financial statements to consider, on the basis of information coming to the accountant’s attention, whether the financial statements appear to conform to the applicable financial reporting framework

d. Obtain reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees.
**Note:** The accountant ordinarily is not required to corroborate management’s responses with other evidence; however, the accountant should consider the reasonableness and consistency of management’s responses in light of the results of other review procedures and the accountant’s knowledge of the client’s business and the industry in which it operates.

5. Incorrect, Incomplete, or Otherwise Unsatisfactory Information:

If, during the performance of review procedures, the accountant becomes aware that information is incorrect, incomplete, or otherwise unsatisfactory, the accountant should request that management consider the effect of these matters on the financial statements. After such consideration, management should communicate the results to the accountant.

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

If the statements are materially misstated, the accountant should treat the misstatement as a departure from the applicable financial reporting framework.

6. Management Representations:

The accountant is required to obtain written representations from management for all financial statements and periods covered by the accountant’s review report.

a. If comparative financial statements are reported on, the representations should address all periods reported on, including the previous years.

b. If current management was not present during all periods covered by the accountant’s review report, the accountant should obtain written representations from current management for all such periods.

**Note:** If management was not present for a previous period, one way to deal with the issue is to include language “to the best of my knowledge and belief” in with the representations covering the previous period.

c. The accountant should request that management provide written representation for the following matters:

- Management’s acknowledgment of its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
• Management’s belief that the financial statements are fairly presented in accordance with the applicable financial reporting framework

• Management’s acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements

• Management’s acknowledgement of its responsibility to prevent and detect fraud

• Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others

• Management’s full and truthful response to all inquiries

• Completeness of information

• Information concerning subsequent events
Review Engagement
Management Representation Letter
(Exhibit B of SSARS No. 19)

[Date]3

To [the Accountant]

We are providing this letter in connection with your review of the [identification of financial statements] of [name of entity] as of [dates (for example, December 31, 20X1, and December 31, 20X2)] and for the [periods of review (for example, for the years then ended)] for the purpose of obtaining 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 [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]. We confirm that we are responsible for the fair presentation of the financial statements in accordance with [the applicable financial reporting framework] and the selection and application of the accounting policies.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, (as of [the date of the accountant’s review report]) the following representations made to you during your review:

1. The financial statements referred to previously are fairly presented in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].
2. We have made the following available to you:
   a. financial records and related data.
   b. minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. No material transactions exist that have not been properly recorded in the accounting records underlying the financial statements.
4. We acknowledge our responsibility for the preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].
5. We acknowledge our responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

3 The date should be the date the client presents and signs the representation letter. The letter should not be presented and signed prior to the date of the accountant’s review report.
6. We acknowledge our responsibility to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.
8. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
9. No material losses exist (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
10. None of the following exist:
    a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies.4
    c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.
11. The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.
12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
13. The following have been properly recorded or disclosed in the financial statements:
    a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the FASB ASC 275, Risks and Uncertainties. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

4 If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:“We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.”
14. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company’s accounts (if applicable).

15. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.5

16. We have responded fully and truthfully to all inquiries made to us by you during your review.

[Name of Owner or Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title, when applicable]

Note: Management’s representations within the representation letter should be made as of the date of the accountant’s review report. The accountant does not have to have physical receipt of the management representation letter as of the date of the accountant’s review report, provided that management has acknowledged that they will sign the representation letter without modification and it is received prior to the release of the report.

The representation letter should be addressed to the accountant and should be signed by those members of management whom the accountant believes are responsible for and knowledgeable about (directly or through others in the organization) the matters covered in the representation letter. Typically, the chief executive officer and chief financial officer or others with equivalent positions in the entity, should sign the representation letter.

d. Updated representation letter:

In certain circumstances, the accountant should consider the need to obtain an updated representation letter. Examples of such circumstances include:

- There is a significant period of time between obtaining a representation letter and issuing the review report.

5 If the accountant dual dates the report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.
• A material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original representation letter.

• A predecessor accountant is requested to reissue the report for a prior period and those financial statements are to be presented on a comparative basis with reviewed statements of a subsequent period.

The updating management representation letter should state the following:

• Whether any information has come to management’s attention that would cause management to believe that any of the previous representations should be modified, and

• Whether any events have occurred subsequent to the balance sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.
Review Engagement
Updated Management Representation Letter

[Date] 6

To [Accountant]

In connection with your review(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods of review] for the purpose of obtaining 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 [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)], you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the accountant or date of previous representation letter] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

________________________________
[Name of Owner or Chief Executive Officer and Title]

________________________________
[Name of Chief Financial Officer and Title, when applicable]

Note: In the Updated Management Representation Letter noted above, management need not repeat all of the representations made in the original representation letter.

If matters exist that should be disclosed to the accountant, they may be indicated by listing them following the representation. For example, if an event subsequent to the date of the accountant’s review report is disclosed in the financial statements, the final paragraph could be modified as follows: “To the best of our knowledge and belief, except as discussed in note X to the financial statements, no events have occurred…”

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6 The accountant has two methods available for dating the report when a subsequent event requiring disclosure occurs after the completion of the review, but before issuance of the report on the related financial statements. The accountant may use dual dating (for example, “February 16, 20XX, except for note Y, as to which the date is March 1, 20XX,”) or may date the report as of the later date.
7. Documentation Required in a Review Engagement:

Documentation prepared by an accountant in a review engagement should be sufficient to:

a. Provides the principal support for the representation in the accountant’s review report that the accountant performed the review in accordance with SSARSs

b. Provides the principal support for the conclusion that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework

Specific documentation should include:

- The engagement letter documenting the understanding with the client.

- The analytical procedures performed, including:
  - The expectations, when the expectations are not otherwise readily determinable from the documentation of the work performed, and the factors considered in the development of the expectations
  - Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts
  - Management’s responses to the accountant’s inquiries regarding fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount

- Any additional review procedures performed in response to significant unexpected differences arising from analytical procedures and the results of such additional procedures.

- The significant matters covered in the accountant’s inquiry procedures and the responses thereto. The accountant may document the matters covered by the accountant’s inquiry procedures and the responses thereto through a memorandum, checklist, or other means.

- Any findings or issues that, in the accountant’s judgment, are significant (for example, the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached). Significant unusual matters that the accountant considered during the performance of the review procedures, including their disposition.

- Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention.

- The representation letter.
Note: The accountant is not prevented from supporting the review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement files (e.g., compilation or nonattest services) or quality control files (e.g., consultation files) and, in limited situations, oral explanations. Oral explanations on their own do not represent sufficient support for the work the accountant performed or conclusions the accountant reached but may be used by the accountant to clarify or explain information contained in the documentation.

8. Reporting on a Review of Financial Statements:

Report content:

Financial statements reviewed by an accountant should be accompanied by a written report, the basic elements of which should include:

a. Title. The accountant’s review report should have a title that clearly indicates that it is the accountant’s review report and includes the word independent. An appropriate title would be:

“Independent Accountant’s Review Report”

Unlike a compilation report, SSARS No. 19 requires that the word “independent” be included in the title of the review report while that word is optional for a compilation report.

b. Addressee. The accountant’s report should be addressed as required by the circumstances of the engagement.

c. Introductory paragraph. The introductory paragraph in the accountant’s report should:

- Identify the entity whose financial statements have been reviewed
- State that the financial statements have been reviewed
- Identify the financial statements that have been reviewed
- Specify the date or period covered by the financial statements
- Include a statement that a review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners)
- Include a statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole, and that, accordingly, the accountant does not express such an opinion.

d. Management’s responsibility for the financial statements. A statement that management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
e. **Accountant’s responsibility.** A statement that the accountant’s responsibility is to conduct the review in accordance with SSARSs issued by the AICPA.

- A statement that those standards require the accountant to perform the procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.

- A statement that the accountant believes that the results of his or her procedures provide a reasonable basis for his or her report.

f. **Results of engagement.** A statement that, based on his or her review, the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report.

g. **Signature of the accountant.** The manual or printed signature of the accounting firm or the accountant, as appropriate.

h. **Date of the accountant’s report.** The date of the review report (the accountant’s review report should not be dated earlier than the date on which the accountant has accumulated review evidence sufficient to provide a reasonable basis for concluding that the accountant has obtained 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 the applicable financial reporting framework).

**Emphasis of a matter:**

An accountant may, but is not required to, emphasize in his or her report, a matter that is disclosed in the financial statements. The matter should be presented in a separate paragraph of the accountant’s review report.

a. Emphasis paragraphs are optional at the sole discretion of the accountant.

b. Examples of matters that the accountant may wish to emphasize include the following:

- Uncertainties
- That the entity is a component of a larger business enterprise
- That the entity has had significant transactions with related parties
- Unusually important subsequent events
- Accounting matters, exclusive of those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.
<table>
<thead>
<tr>
<th>Paragraph or Title</th>
<th>Previous Review Report</th>
<th>New Review- SSARS No. 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title</td>
<td>None.</td>
<td>Must have a title and include the word “independent”, such as “Independent Accountant’s Review Report.”</td>
</tr>
<tr>
<td>First Introductory paragraph</td>
<td>We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings and cash flows for the year then ended, 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 XYZ Company.</td>
<td>I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.</td>
</tr>
<tr>
<td>Second Management’s responsibility</td>
<td>None.</td>
<td>Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.</td>
</tr>
<tr>
<td>Third Accountant’s responsibility</td>
<td>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.</td>
<td>My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provide a reasonable basis for our report.</td>
</tr>
<tr>
<td>Fourth Results of the engagement</td>
<td>Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.</td>
<td>Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.</td>
</tr>
</tbody>
</table>
**Review report on OCBOA financial statements:**

Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include the following:

a. A description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from GAAP. The effects of the differences need not be quantified.

b. Informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

**Legend on financial statements:**

Each page of the financial statements reviewed by the accountant should include a reference, such as:


**Departures from the Applicable Financial Reporting Framework:**

An accountant who is engaged to review financial statements may become aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements.

a. If an accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if the effects have been determined by management or are known due to the accountant’s procedures.

b. The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

c. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, the accountant should withdraw from the engagement, provide no further services with respect to those financial statements, and possibly consult with the accountant’s legal counsel.
What if the accountant is unable to perform the necessary inquiry and/or analytical procedures needed for a review engagement?

When the accountant is unable to perform the inquiry and analytical procedures he or she considers necessary to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework or the client does not provide the accountant with a representation letter, the review will be incomplete. A review that is incomplete does not provide an adequate basis for issuing a review report.

Is an accountant permitted to issue a review report on one financial statement?

Yes. The accountant may be asked to issue a review report on one financial statement, such as a balance sheet, and not on other related financial statements, such as the statements of income, retained earnings, and cash flows. The accountant may do so if the scope of his or her inquiry and analytical procedures has not been restricted.
Independent Accountant’s Review Report

[Appropriate Salutation]

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

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provide a reasonable basis for our report.

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

[Signature of accounting firm or accountant, as appropriate]
[Date]
Review Engagement
Standard Review Report
Income Tax Basis of Accounting
From Exhibit D of SSARS No. 19

Independent Accountant’s Review Report

[Appropriate Salutation]

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

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis for accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provides a reasonable basis for our report.

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

[Signature of accounting firm or accountant, as appropriate]

[Date]
Review Engagement
Illustrative Standard Review Report

GAAP Departure
From Exhibit D of SSARS No. 19

Independent Accountant’s Review Report

[Appropriate Salutation]

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

Management (owners) is (are) responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provide a reasonable basis for our report.

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

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed (me) us that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined. Or

As disclosed in Note X to the financial statements, the company has adopted [description of newly adopted method], whereas it previously used [description of previous method]. Although the [description of newly adopted method] is in conformity with accounting principles as generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by Financial Accounting Standards Board Accounting Standards Codification 250, Accounting Changes and Error Corrections.

[Signature of accounting firm or accountant, as appropriate]
[Date]
Restricted use versus general use review report:

Accountant’s review reports are separated into two categories, general (unrestricted) use and restricted use, as follows:

**General (unrestricted) use:**

Applies to accountant’s reports that are not restricted to specified parties. Reports on financial statements that are prepared in conformity with an applicable financial reporting framework ordinarily are general (unrestricted) use.

An accountant is not precluded from restricting the use of any report even if the report would otherwise be general use.

**Restricted use:**

Restricted use reports are those reports intended only for one or more specified third parties. The restriction may be the result of numerous circumstances that include:

- The purpose of the report, and
- The potential risk that the report might be misunderstood when taken out of the context in which it was intended to be used.

a. When a report is issued on subject matter or a presentation based on a measurement or disclosure criteria contained in a contractual agreement or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the use of the report because:

- The basis, assumptions, or purpose of the presentations (contained in such an agreement or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions.
- The subject matter, or presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

b. If an accountant issues a single combined report covering both subject matter that requires a restriction on use to specified parties, and subject matter that ordinarily does not require a restriction (e.g., general use), the use of the single combined report should be restricted to the specified parties.

c. If, as required by law or regulation, a separate restricted use report is included in a document that also contains a general use report, the inclusion of a separate restricted use report in the document does not affect the intended use of either report. The restricted use report remains restricted for use, and the general use report continues to be unrestricted.

d. Subsequent to the completion of an engagement that has a restricted use report, the accountant may be asked to add other parties as specified parties. If this is the case, an accountant is permitted to add other parties provided the accountant:
1) Considers several factors that include:

- Identity of the other parties
- Their knowledge of the basis of the measurement or disclosure criteria
- The intended use of the report.

2) Obtains **affirmative acknowledgment**, preferably in writing, from the other parties as to their understanding of the nature of the engagement, and the measurement or disclosure criteria used in the engagement and related report.

**Note:** If the other parties are added after the accountant issues his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, the acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

\[\text{e. Report language- restricted use:}\]

The accountant’s report that is restricted should contain a separate paragraph at the end of the report that includes the following information:

- A statement indicating that the report is intended solely for the information and use of the specified parties.

- An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

**How does an accountant guarantee that restricted use reports are not distributed by the client to parties beyond the specified parties?**

SSARS No. 19 states that in connection with a restricted use report, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to non-specified parties. The accountant is not precluded from reaching an understanding with the client that the intended use of the report will be restricted and from obtaining the client’s agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

The SSARS also states that the accountant is not responsible for controlling a client’s distribution of restricted use reports. A restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.
9. Entity’s Ability to Continue as a Going Concern:

During the performance of a review engagement, an accountant may obtain information that indicates that an uncertainty may exist about an entity’s ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements).

In such circumstances, the accountant should take the following steps:

a. Request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for disclosure.

b. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions, including the adequacy of the related disclosures, if applicable.

c. If the accountant determines that management’s conclusions are unreasonable or the disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is not adequate, the accountant should follow the guidance of a departure from an applicable financial reporting framework.

d. The accountant may emphasize an uncertainty about an entity’s ability to continue as a going concern, provided that the uncertainty is also disclosed in the financial statements.

10. Subsequent Events:

A subsequent event may have a material effect on reviewed financial statements and may come to the attention of the accountant in one of two ways:

a. During the performance of review procedures, or

b. Subsequent to the date of the accountant’s review report but prior to the release of the report.

Regardless of way in which the accountant discovers the subsequent event, the accountant should request that management consider the possible effects on the financial statements, including whether there is adequacy of disclosure.

If the accountant determines that the subsequent event is not adequately accounting for in the financial statements or notes, the accountant should treat the transaction as a departure from GAAP, or other applicable financial reporting framework.

In addition, an accountant may wish to include an explanatory paragraph of a subsequent event in the report as an emphasis of a matter. The accountant may add an additional paragraph as long as the matter is also disclosed in the financial statements.

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Footnote 7 was deleted.
11. Subsequent Discovery of Facts Existing at the Date of the Review Report:

Subsequent to the date of the report on the reviewed financial statements, the accountant may becomes aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

SSARS No. 19 provides the following guidance in connection with such a situation:

a. **General rule**: The general rule is that after the date of the accountant’s review report, the accountant has no obligation to perform other review procedures with respect to the financial statements, unless new information comes to his or her attention.

b. **Exception to the general rule**: The exception is when the accountant becomes aware of information that relates to financial statements previously reported on by him or her but that was not known to the accountant at the date of the report (and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the review engagement). In such a case, the accountant:

   - Should undertake to determine whether the information is reliable and whether the facts existed at the date of the report.
   - Should discuss the matter with the client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary.
   - May choose to discuss the matter with those other than management including those parties charged with governance.
   - Should consider the time elapsed since the financial statements were issued.
   - May wish to consult with his or her legal counsel.

c. The accountant should obtain additional or revised information if the nature and effect of the matter are such that:

   - The accountant’s report or the financial statements *would have been affected* if the information had been known to the accountant at the accountant’s review report date and had not been reflected in the financial statements, and
   - The accountant believes that persons are currently using or are likely to use the financial statements and those persons would attach importance to the information.
d. When the accountant has concluded that action should be taken to prevent further use of the accountant’s report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements.

When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances. The accountant should take whatever steps he or she considers necessary to satisfy himself or herself that the client has made the necessary disclosures, under the following guidance:

1) If the effect of the subsequently discovered information on the accountant’s report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant’s report.

• The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant’s report.

**Note:** In general, only the most recently issued reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

2) When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements, pursuant to subparagraph (1).

3) When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In such a situation, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of:

• The client notifying persons who are known to be using or who are likely to use the financial statements that the statements should not be used; that revised financial statements will be issued; and, when applicable, that the accountant’s report will be issued as soon as practicable.

e. If the client refuses to make the disclosures, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as outlined subsequently to prevent further use of the financial statements and, if applicable, the accountant’s report.

**Note:** The steps that can appropriately be taken will depend upon the degree of certainty of the accountant’s knowledge that persons exist who are currently using or who will use the financial statements and, if applicable, the accountant’s report and who would attach importance to the information and the accountant’s ability as a
practical matter to communicate with them. Unless the accountant’s attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

1) Notify the client that the accountant’s report must no longer be associated with the financial statements.

2) Notify the regulatory agencies having jurisdiction over the client that the accountant’s report should no longer be used.

3) Notify each person known to the accountant to be using the financial statements that the financial statements and the accountant’s report should no longer be used.

**Note:** In most situations, it will not be practicable for the accountant to give appropriate individual notification to all persons. For example, it may be difficult to notify all stakeholders whose identities ordinarily are unknown to the accountant.

Instead, notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

**f. Details on required disclosure:** The content of any disclosure of information subsequently discovered to persons other than the accountant’s client should follow these guidelines:

1) The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

2) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose of the disclosure.

**Note:** The disclosure should not include any comments concerning the conduct or motives of any person. If the client has not cooperated, the accountant’s disclosure need not detail the specific information but can merely indicate that the client has not cooperated with the accountant’s attempt to substantiate information that has come to the accountant’s attention and that, if the information is true, the accountant believes that the review report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant’s review report should not be used.

**12. Supplementary Information- Review Engagement:**

When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to such information.
When the accountant has reviewed the basic financial statements, an explanation should be included in the review report or in a separate report on the other data. The report should state that the review has been made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework and that either:

a. The other data accompanying the financial statements are presented only for purposes of additional analysis and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or

b. The other data accompanying the financial statements are presented only for purposes of additional analysis and have not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or provide any assurance on such data.

13. Communicating to Management and Others:

If an accountant obtains evidence or other information during his or her performance of review procedures, that fraud or an illegal act may have occurred, that matter should be brought to the attention of the appropriate level of management using the following rules:

a. The accountant is not required to report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

b. When such fraud or an illegal act involves senior management, the accountant should report the matter (either orally or in writing) to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance.

1) Any communication that is done orally should be documented by the accountant.

c. When such fraud or an illegal act involves an owner of the business, the accountant should consider resigning from the engagement.

**Note:** There may be instances where there are potential conflicts between the accountant’s ethical and legal obligations for confidentiality of client matters. In such circumstances, the accountant may wish to consult with legal counsel before discussing matters involving fraud or illegal acts with parties outside the client.

d. An accountant should consult with his or her legal counsel whenever any evidence or information comes to his or her attention during a review engagement that fraud or an illegal act may have occurred, unless an illegal act is clearly inconsequential.
e. The accountant is not required to disclose any evidence or information about a fraud or illegal act to parties other than client’s senior management (or those changed with governance).

However, in the following instances, a duty may exist for the accountant to disclose to parties outside of the entity:

- To comply with certain legal and regulatory requirements
- To a successor accountant when the successor decides to communicate with the predecessor accountant regarding acceptance of the engagement to compile or review the financial statements of a nonissuer
- In response to a subpoena.

14. Change in an Engagement from an Audit to a Review:

There may be instances in which an accountant, who has been engaged to audit financial statements, before the completion of the audit, is asked to change the engagement to a review.

a. There may be numerous reasons for the change in the engagement, whether imposed by the client or by circumstances, as follows:

- There may be a change in circumstances affecting the entity’s requirement for an audit,
- There could be a misunderstanding as to the nature of the type of engagement, or
- There might be a restriction on the scope of an audit.

Note: A change in circumstances that affects the entity’s requirement for an audit, or a misunderstanding concerning the nature of an audit would ordinarily be considered a reasonable basis for requesting a change in the engagement.

Before an accountant agrees to change the engagement to a review, the accountant should consider all of the following issues:

- The reason given for the client’s request and its implications of a restriction on the scope of the audit, whether imposed by the client or by circumstances
- The additional audit effort required to complete the audit
- The estimated additional cost to complete the audit.

b. If the audit procedures are substantially complete, or the cost to complete such procedures is relatively insignificant, the accountant should consider whether it is appropriate to accept a change in the engagement to a review.
Note: The accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. When an accountant has been engaged to review an entity’s financial statements the accountant typically would be precluded from issuing a review report if:

- The accountant has been prohibited by the client from corresponding with the entity’s legal counsel, or
- The client does not provide the accountant with a signed representation letter.

c. If the accountant concludes that reasonable justification exists to change the engagement to a review, and if the accountant complies with the standards for a review engagement, the accountant should issue a review report.

The report should not reference:

1) The original audit engagement, or
2) Any audit procedures that may have been performed.

15. Effective Date and Implementation:

SSARS No. 19 is effective for compilation and review engagements for periods ending on or after December 15, 2010. Early application is permitted with respect to the lack of independence disclosure provision for compilation engagements.

a. Transition for lack of independence provision for compilation engagements:

Early application of SSARS No. 19 is not permitted except with respect to the lack of independence provision related to compilation engagements.
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. In performing a review engagement, an accountant is not required to perform which of the following procedures:
   a) understand the industry in which the client operates
   b) have knowledge of the entity
   c) perform analytical procedures
   d) perform a fraud risk assessment

2. In performing analytical procedures, an accountant should compare ____________ to ________________.
   a) budgeted amounts, prior period amounts
   b) expected amounts, recorded amounts
   c) budgeted amounts, computed amounts
   d) estimated amounts, budgeted amounts

3. In obtaining a management representation letter for a review engagement for comparative financial statements, the representations should address:
   a) only the current period
   b) both periods
   c) the current period with limited representations for the prior period
   d) either the current period or both periods at the option of the accountant

4. Which of the following would be an example of circumstances in which an accountant may wish to obtain an updated representation letter in a review engagement:
   a) there is a short period of time between obtaining a representation letter and issuing the review report
   b) a predecessor account is requested to reissue the report for a prior period
   c) management changes after the review engagement is completed
   d) a material subsequent event occurs after the report is released
5. In performing a review engagement, which of the following is correct as it relates to oral inquiries received from management:
   a) oral explanations do represent sufficient support for the work the accountant performed
   b) oral explanations, if received from upper management, carry sufficient weight for the accountant to rely on them as sufficient support for the work the accountant performed
   c) oral explanations do not represent sufficient support for the work the accountant performed or conclusions reached but may be used to clarify or explain information
   d) oral explanations carry no value unless accompanied by written documentation to carry any weight

6. Which of the following would be an appropriate title for an accountant’s review report:
   a) Accountant’s Review Report
   b) Review Report
   c) Independent Accountant’s Review Report
   d) Accountant’s Report

7. One important change to the content of the accountant’s review report is:
   a) the revised report now states that the financial statements are the representation of management
   b) the revised report removes the limited assurance language
   c) the revised report includes management’s responsibility for the preparation of the financial statements
   d) the revised report removes a title

8. If there is a restricted use report, what action might the accountant perform to guarantee that the report is not distributed by the client to parties beyond the specified parties:
   a) consider communicating with all of the specified parties
   b) consider informing the client about the restricted distribution
   c) audit the distribution list to ensure that there is no unauthorized distribution
   d) make sure there is sufficient language in the report noting the restriction

9. An accountant is permitted to emphasize an uncertainty about an entity’s ability to continue as a going concern in the review report provided:
   a) certain codified language is included in the report
   b) the uncertainty is also disclosed in the notes to financial statements
   c) the uncertainty expires within one year of the balance sheet date
   d) a review report is issued and not a compilation report
10. With respect to subsequent events, the general rule is that after the date of the accountant’s review report, the accountant:

a) must perform review procedures up to the date on which the report is released
b) has no obligation to perform other procedures unless new information comes to his or her attention
c) must perform review procedures after the report is released if additional information comes to the accountant’s attention
d) has no obligation to perform other procedures

11. Which of the following acts is an accountant not required to report:

a) fraud that is inconsequential
b) illegal acts that are inconsequential
b) illegal acts that are consequential
d) fraud that is consequential
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. An accountant is required to obtain an understanding of the industry in which the client operates.

B: Incorrect. An accountant is required to have knowledge of the entity in performing a review engagement.

C: Incorrect. An accountant must perform analytical procedures in a review engagement.

D: Correct. An accountant is not required to perform a fraud risk assessment in a review engagement. That procedure is required in an audit.

(See pages 74 to 75 of the course material.)

2. A: Incorrect. Comparing budgeted amounts to prior period amounts is generally not part of the analytical procedures.

B: Correct. The accountant should compare expected amounts with recorded amounts.

C: Incorrect. Comparing budgeted amounts to computed amounts does not assist the accountant in dealing with the current year recorded amounts.

D: Incorrect. Comparing estimated amounts with budgeted amounts does not address the current recorded amounts.

(See page 76 of the course material.)

3. A: Incorrect. The representations should cover both periods and not only the current period.

B: Correct. The accountant is required to obtain written representations from management for all financial statements and periods covered by the accountant’s review report.

C: Incorrect. There is no provision dealing with limited representations. Both periods have the same amount of representations.

D: Incorrect. The accountant does not have the choice between either the current period or both periods. If the report covers two periods, the representations should cover those same two periods.

(See page 78 of the course material.)
4. A: Incorrect. An example would be where there is a significant period of time between obtaining a representation letter and issuing the review report.

B: Correct. An updated representation letter may be needed where a predecessor account is requested to reissue the report for a prior period and the financial statements are to be presented on a comparative basis with reviewed statements of a subsequent period.

C: Incorrect. The fact that management changes after the review engagement is completed is not a situation in which an updated letter would be needed.

D: Incorrect. A material subsequent event that occurs after the completion of inquiry and analytical procedures, but before the report is released, might warrant an updated letter.

(See page 83 of the course material.)

5. A: Incorrect. SSARS No. 19 states that oral explanations do not, by themselves, represent sufficient support for the work the accountant performed.

B: Incorrect. The fact that oral explanations are received from upper management has no impact on the weight of the information.

C: Correct. Oral explanations, on their own, do not represent sufficient support for the work the accountant performed or conclusions reached but may be used to clarify or explain information.

D: Incorrect. Oral explanations do carry some value in that they can be used to help the accountant clarify and explain information that is contained in the documentation.

(See page 86 of the course material.)

6. A: Incorrect. The title must have the word independent in it.

B: Incorrect. The report must not only indicate that it is the accountant’s report but also have the word “independent.”

C: Correct. The term “Independent Accountant’s Review Report” is the appropriate title that references the word “accountant” and “independent.”

D: Incorrect. The report must reference that it is a review report and must have the word “independent.”

(See page 86 of the course material.)

B: Incorrect. There is no change in the limited assurance language.

C: Correct. The revised report now includes language about management’s responsibility for the preparation and fair presentation of the financial statements.

D: Incorrect. The revised report now includes a title.

(See page 88 of the course material.)

8. A: Incorrect. The goal of finding unauthorized parties is not achieved by communicating with all of the specified parties.

B: Correct. Although there is no guaranteed way to restrict use, the accountant should consider informing the client about the restricted distribution.

C: Incorrect. The accountant is not responsible for controlling a client’s distribution of restricted use reports and has no requirement to audit the distribution.

D: Incorrect. Simply making sure there is sufficient language in the report noting the restriction is not going to ensure that the report is not distributed. All this action will do is let the parties know that it is restricted.

(See page 95 of the course material.)

9. A: Incorrect. SSARS No. 19 does not require certain codified language to be included in the report.

B: Correct. In order to emphasize an uncertainty in a review report, SSARS No. 19 requires that there also be a disclosure in the notes to financial statements.

C: Incorrect. SSARS No. 19 does not have a one-year provision with respect to the ability to emphasize an uncertainty.

D: Incorrect. The rules do not differentiate between a review and compilation report as long as the uncertainty is also disclosed in the notes.

(See page 96 of the course material.)
10. A: Incorrect. There is no obligation to perform review procedures up to the date on which the report is released.

**B: Correct.** The accountant has no obligation to perform other procedures after the date of the accountant’s review report, unless new information comes to his or her attention.

C: Incorrect. Once the report is released, the accountant has no obligation to perform review procedures.

D: Incorrect. There is no obligation to perform other procedures unless new information comes to the accountant’s attention.

(See page 97 of the course material.)

11. A: Incorrect. All fraud must be reported by the accountant even if it is inconsequential.

**B: Correct.** The accountant is not required to report illegal acts that are inconsequential.

C: Incorrect. Illegal acts that are consequential must be reported.

D: Incorrect. All fraud must be reported.

(See page 100 of the course material.)
C. CONTROLLERSHIP ISSUES: WHAT’S GOING ON IN PRACTICE?

For years, accountants have performed write-up services for clients in addition to performing a compilation, review or even an audit engagement. More recently, those services have expanded to part-time controllership engagements. Because bookkeeping and controllership functions, by themselves, do not necessarily entail issuing a report, many accountants take it for granted that such engagements are risk-free. Yet, recent statistics obtained from major insurance carriers reach a different conclusion:

1. Malpractice cases against accountants in write-up services have risen dramatically in recent years.
   a. Undetected fraud is the number one charge against accountants in write-up engagements with the focus on cash and accounts receivable.
   b. Accountants in part-time controllership cases are being held to a higher standard than acting as an internal accountant.

2. Accountants may have a lack of independence depending on the degree of services provided.

In order to mitigate some of the risks associated with these engagements, the following are a few suggestions.

   a. Make sure you obtain an engagement letter for both write-up services and part-time controllership engagements.

   b. Make sure your malpractice insurance covers controllership since the service could be construed as an employer-employee relationship rather than a professional-client relationship.

   c. Watch out for independence issues if you plan to issue a report.

   d. Part-time controllers should consider whether they need to issue a report and the impact of their position on the ability to do so.

The following section discusses the present developments with the controllership issue.

**Issue:** An accountant in public practice is permitted to issue a compilation report even if he or she is not independent provided the report identifies the fact that he or she is not independent.

Yet, many CPAs provide part- or full-time controllership services including:

- Maintaining the accounting books and records,
- Preparing financial statements, and
- Performing certain management functions for their clients, such as hiring employees, authorizing purchases, investing idle cash, signing checks, or serving as an officer or director of a company.
Ethics Interpretation 101-3 (as revised) provides that if an accountant performs certain activities, he or she has impaired his or her independence.

The list of activities consists of the following. Does the accountant:

- Have the authority to, or authorize, execute or consummate a transaction, or otherwise exercise authority on behalf of a client (for example, negotiate a transaction)?
- Prepare source documents or originate data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)?
- Have custody of client assets?
- 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 the accountant does any of the above activities on behalf of a client, he or she is not independent.

For years, there was confusion as to the extent to which CPAs could avoid issuing compilation reports on financial statements. On one side of the issue, there were CPAs in public accounting who also provided management services (as listed above) for their clients. Some CPAs in this situation argued that because they were both engaged in public accounting and performing management services, they could choose to issue financial statements in the capacity as a member of management, not public accounting. Thus, they argued that requirements to issue a compilation report under the SSARSs did not apply. The result was that the compilation report was replaced with the issuance of a transmittal letter sent to the third party along with the financial statements.

On the other side of the issue, there were CPAs in industry who were issuing financial statements for their employers. Instead of issuing the financial statements with a transmittal letter, they issued them with a compilation report noting a lack of independence in the report.

Thus, CPAs in public accounting who performed management services bypassed the requirements of the SSARSs (compilation report), and CPAs in industry issued compilation reports for their employer companies.

There simply was no authority to deal with the crossover among CPAs in industry and public accounting. For CPAs in industry who issued a compilation report for their employer, nothing in the SSARSs precluded them from doing so provided they noted the lack of independence.

For CPAs in public accounting who issued merely a transmittal letter in the capacity as a member of management, AICPA Ethics Ruling No. 10 gave some guidance for an accountant in industry who was also a stockholder, partner, director, officer or employee of an entity for which he or she prepared financial statements to be transmitted to a third party.
If the member (accountant) submits financial statements in his or her capacity as a stockholder, partner, director, officer or employee to a third party, the member (CPA) should clearly communicate, preferably in writing, the relationship of the member to the entity and should not imply that the member is independent of the entity.....

The Ethics Ruling essentially indicated that an accountant could issue financial statements in his or her capacity as a member of management provided he or she indicated his or her relationship to the entity; that is, indicated an employment title or the fact that the accountant was a “part-time controller.”

Thus, existing authority appeared to authorize the crossover of activities by CPAs in industry and public accounting. Yet, many observers took the position that, although not stated in the SSARSs, a compilation report was supposed to be issued by an accountant in public accounting, not industry. And, use of a transmittal letter and the avoidance of the issuance of a compilation report should be set aside for CPAs who were truly part of management, exclusive of CPAs that provided part-time controllership work.

SSARS Interpretation No. 8, Applicability of Statements on Standards for Accounting and Review Services When Performing Controllership or Other Management Services

Finally, the ARSC offered some authoritative guidance as to the reporting responsibilities for accountants offering controllership services as well as those in industry seeking to issue compilation reports for their companies.

Question: If an accountant is in the practice of public accounting and provides an entity with controllership or other management services that entail the submission of financial statements, is the accountant required to follow the requirements of AR section 80 (SSARS No. 19)?

Interpretation: If the accountant is in the practice of public accounting as defined by the AICPA Code of Conduct and is not a stockholder, partner, director, officer, or employee of the entity, the accountant is required to follow the performance and communication requirements of AR section 80 (SSARS No. 19), including any requirement to disclose a lack of independence.

If the accountant is in the practice of public accounting and is also a stockholder, partner, director, officer, or employee of the entity, the accountant may either (1) comply with the requirements of AR section 80 (SSARS No. 19), or (2) communicate, preferably in writing, the accountant’s relationship to the entity (for example, stockholder, partner, director, officer, or employee).

The following is an example of the type of communication that may be used by the accountant:

*The accompanying balance sheet of Company X as of December 31, 20XX, and the related statements of income and cash flows for the year then ended have been prepared by (name of accountant), CPA. I have prepared such financial statements in my capacity (describe capacity, for example, as director) of Company X.*
If an accountant is not in the practice of public accounting, the issuance of a report under SSARS would be inappropriate; however, the previously mentioned communication may be used.

The following chart summarizes the requirements of Interpretation No. 8:

**Facts:** An accountant performs management or controllership services for a client:

<table>
<thead>
<tr>
<th>Description</th>
<th>Acceptable action</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPA in public accounting and does not provide management or controllership services. However, he or she is not independent for other reasons (client relationship, unpaid fees, etc.).</td>
<td>Must issue a compilation report with a separate paragraph indicating lack of independence per AR Section 80 of SSARS No. 19.(^8)</td>
</tr>
<tr>
<td>CPA is in the practice of public accounting and performs management or controllership services. He or she <em>is not</em> a stockholder, partner, director, officer, or employee of the entity.</td>
<td>Required to follow AR Section 80 of SSARS No. 19 (compilation report) and disclose lack of independence in report.</td>
</tr>
<tr>
<td>CPA is in the practice of public accounting and performs management or controllership services. He or she is a stockholder, partner, director, officer, or employee of the entity.</td>
<td>CPA has a choice. May either (1) comply with the requirements of AR Section 80 of SSARS No. 19 , or (2) communicate, preferably in writing, the accountant’s relationship to the entity (for example, stockholder, partner, director, officer, or employee).</td>
</tr>
<tr>
<td>CPA is not in the practice of public accounting and provides management or controllership services to a company.</td>
<td>CPA is not allowed to issue a compilation report under AR Section 80 of SSARS No. 19.</td>
</tr>
</tbody>
</table>

**Example 1:** An accountant is in public practice and is the brother of his client, clearly lacking independence. He/she is not a stockholder, partner, director, or employee of the company.

**Conclusion:** Under existing rules found in AR Section 80 of SSARS No. 19, the accountant may issue a compilation report provided the report states that he or she is not independent.

**Example 2:** An accountant is in public accounting. He performs part-time controllership services for a client. The accountant is not a stockholder, partner, director, officer or employee of the entity. In fact, the accountant receives a Form 1099 for his services. The entity needs to issue financial statements to the bank.

**Conclusion:** Under Interpretation No. 8, an accountant in public accounting who is not a stockholder, partner, director, officer or employee of an entity, must comply with SSARS No. 19. Thus, the accountant’s only option is to issue a compilation report. Sending financial statements with a transmittal letter in the capacity as a part-time controller is not permitted.

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\(^8\) SSARS No. 19 permits an accountant to disclose the reason(s) for the lack of independence.
**Example 3:** Same facts as Example 2 except the accountant is also a director of the company.

**Conclusion:** Under Interpretation No. 8, an accountant in public accounting who is also a stockholder, partner, director, officer or employee of an entity, has a choice of reporting. Option 1 is to comply with AR Section 80 of SSARS No. 19 by issuing a compilation report, noting lack of independence. Option 2 is to issue financial statements in the capacity as a director of the company and communicate that his relationship with the company – that is, issue a transmittal letter indicating that he is a director of the company. The Interpretation recommends, but does not require, that the communication be in writing.

**Example 4:** An accountant is a CFO for a company and wishes to issue a compilation report on the company. She is not in public accounting.

**Conclusion:** Interpretation No. 8 states that where an accountant is not in public accounting, the issuance of a report under AR Section 80 of SSARS No. 19 (e.g., compilation report) is not appropriate. Thus, the CFO’s only option is to issue financial statements in the capacity as an officer of the company.

**Definitions:**

The AICPA Code of Ethics defines the practice of public accounting as follows:

“The practice of public accounting consists of the performance for a client, by a member or a member’s firm, while holding out as CPAs, of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by the designated Council, [such as Statements of Financial Accounting Standards, Auditing Standards, Accounting and Review Services, Consulting Services, Governmental Accounting Standards, Attestation Engagements].”

**What is the definition of “employee?”**

The interpretation references that an accountant in public practice that is also a stockholder, partner, director, officer or employee, has the choice between issuing a compilation report under AR Section 80 of SSARS No. 19, or giving financial statements to a third party with a communication (such as a transmittal letter).

The Interpretation does not define the term “employee.”

For example, is an accountant who receives a Form 1099 for working as a part-time controller one day per week deemed to be an employee? The author believes that the definition of an employee is not based on the definition found in the Internal Revenue Code but rather one that is based on the substance of the relationship and the degree to which the accountant is engaged in management and controllership services. Thus, an accountant who works four days a week as a part-time controller and receives a Form 1099 for her services still might be considered an employee due to the breadth of her services.
What is the form of communication made to a third party by an accountant who is in industry, and not public accounting?

Interpretation No. 8 gives some recommended language that can be used when an accountant in industry is either permitted or required to issue a communication to accompany financial statements.

Further, Ethics Rulings 65 and 10 give guidance in situations in which an accountant wishes to issue financial statements with a transmittal letter to a third party.

Ethics Ruling 65 on independence, integrity and objectivity states:

*If the member uses the accountant designation in a manner to imply that he or she is independent of the employer, the member would be knowingly misrepresenting facts in violation of Rule 102. Therefore, it is advisable that in any transmittal within which the member uses his or her CPA designation, he or she clearly indicate the employment title. In addition, if the member states affirmatively in any transmittal that a financial statement is presented in conformity with generally accepted accounting principles, the member is subject to Rule 203.*

Ethics Ruling 10 further states:

*If the member (CPA) submits financial statements in his or her capacity as a stockholder, partner, director, officer or employee to a third party, the member (CPA) should clearly communicate, preferably in writing, the relationship of the member to the entity and should not imply that the member is independent of the entity.

In addition, if the communication states affirmatively that the financial statements are presented in conformity with generally accepted accounting principles, the member is subject to Rule 203 of the Code of Professional Conduct.

*If the member prepares financial statements as a member in public practice and/or submits them using the member’s public practitioner’s letterhead or other identification, the member should comply with applicable standards including the requirement to disclose a lack of independence.*

If an accountant in industry wishes to issue a communication (transmittal letter) to accompany financial statements to be given to a third party, the following rules apply:

1. The communication must be on the entity’s letterhead.

2. The accountant can use his or her CPA designation provided he or she notes his or her title related to the entity (stockholder, partner, director, employee).

3. If the accountant does mention in his or her letter that the financial statements are presented in conformity with GAAP, the accountant is subject to Ethics Rule 203 which states that he or she shall not knowingly state that statements are in conformity with GAAP when they are not.
## Sample Transmittal Letter - Non-Authoritative

**ACME Manufacturing Co.**  
**Robert Reilly, CPA**  
**Chief Financial Officer**

Mr. William No, President  
NoLoan Bank and Trust  
54 Everywhere Way  
Nowhere, USA  

March 16, 20X2

Dear Mr. No:

Attached you will find the financial statements of ACME Manufacturing Co. for the month ended February 28, 20X1.

The accompanying balance sheet of ACME Manufacturing as of February 28, 20X1, and the related statements of income and cash flows for the year then ended have been prepared by Robert Reilly, CPA. I have prepared such financial statements in my capacity as Chief Financial Officer of the company.

*These financial statements have been prepared in accordance with generally accepted accounting principles.* (optional)

Very truly yours,

Robert Reilly, CPA  
Chief Financial Officer  
ACME Manufacturing Co.
ACME Manufacturing Co.
Balance Sheet
February 28, 20X1

**ASSETS**

**Current assets:**
- Cash: $xx
- Accounts receivable: xx
- Inventories: xx
  - Total current assets: xx

**Property and equipment:**
- Cost: xx
- Less accumulated depreciation: xx
  - Total property and equipment: xx
  - $xx

**LIABILITIES AND STOCKHOLDERS’ EQUITY**

**Current liabilities:**
- Accounts payable: $xx
- Accrued expenses and taxes: xx
- Short-term notes payable: xx
  - Total current liabilities: xx

**Long-term debt:**
- xx

**Stockholders’ equity:**
- Common stock: xx
- Retained earnings: xx
  - Total stockholders’ equity: xx
  - $xx

*Internally Generated Financial Statements*
ACME Manufacturing Co.
Income Statement
For the Month Ended February 28, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$xx</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>xx</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>xx</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>xx</td>
</tr>
<tr>
<td>Net operating income</td>
<td>xx</td>
</tr>
<tr>
<td>Income taxes</td>
<td>xx</td>
</tr>
<tr>
<td>Net income</td>
<td>$xx</td>
</tr>
</tbody>
</table>

Internally Generated Financial Statements

**Observation:** The author wishes to make the following observations about the above financial statements.

First, notice that the above transmittal letter is placed on the Company’s letterhead and references Robert Reilly’s employment title.

Second, there is a reference to GAAP in the transmittal letter. This is not a requirement under any of the authoritative literature. However, if the accountant does mention in his or her letter that the financial statements are presented in conformity with GAAP, the accountant is subject to Ethics Rule 203 which states that he or she shall not knowingly state that statements are in conformity with GAAP when they are not. The author recommends that any transmittal letter is silent on the GAAP or OCBOA format to provide maximum financial reporting flexibility.

Third, it may be advisable to stamp each statement "Internally Generated Financial Statements" to ensure that the third party fully understands that these statements were generated internally and not with the assistance of an outside CPA. If the above internally generated financial statement format is followed, it would not be appropriate to apply any SSARS No. 19 requirements such as a "See Accountant’s Compilation Report" legend. The author recommends that an accountant who is also a stockholder, partner, director, officer or employee consider the risk associated with issuing financial statements with a transmittal letter. Logically, the author believes that if a transmittal letter is issued, the accountant should be protected under the entity veil as being a stockholder, partner, director, officer, or employee of that entity. However, the accountant might wish to consult with legal counsel as to legal liability. For example,
could a third party who knows that an accountant is in public accounting as well as being a director, attempt to sue the accountant in his capacity as a member of public accounting, rather than as a director? The accountant should review his or her malpractice insurance policy and/or consult with legal counsel to consider whether such services are covered under the policy and place the accountant at personal risk with respect to the financial statement issued with a transmittal letter.

Hierarchy: Accountants in Public Accounting Serving also as Stockholders, Partners, Directors, Officers, or Employees

Are you in public accounting?  
No  
  Issue transmittal letter with financial statements (compilation report not permitted)

Yes  
  Are you independent?  
  Yes  
  Issue a compilation report  
  No  
  Are you a stockholder, partner, director, officer, or employee?  
  No  
  Issue a compilation report with an independence exception  
  Yes  
  Stockholder, partner, officer, director, or employee who is also in public accounting has a choice between issuing a compilation report or transmittal letter  
  Choice  
  Issue a transmittal letter with financial statements (not permitted to issue a compilation report)
D. DISTRIBUTING DRAFT FINANCIAL STATEMENTS

In some situations, the accountant may submit a preliminary “draft” set of financial statements for the client’s perusal before the compilation or review engagement is complete.

Interpretation No. 5 of AR Section 80, and Interpretation No. 4 of AR Section 90 of SSARS No. 19, Submitting Draft Financial Statements, state that an accountant may submit draft statements to a client:

1. When information needed to complete a compilation or review of the financial statements will not be available until a later date, or
2. To provide a client with the opportunity to read and analyze the financial statements before their final issuance.

The accountant may issue draft statements as long as:

1. The statements are marked with the words such as “Draft,” “Draft-Subject to Change,” “Preliminary Draft,” or similar language, and
2. The accountant intends to submit the final financial statements with an appropriate compilation or review report when the information needed to complete the engagement becomes available.

What if the client indicates that he or she plans to submit draft financial statements to a third party such as a bank before issuance of the final statements?

The accountant should inform the client that the best course of action is to wait until the engagement is complete and final statements are issued. However, the accountant is not responsible for and cannot control the distribution of draft financial statements that he or she has submitted to the client.

A previously issued Compilation and Review Alert referenced a case involving draft statements in an audit engagement involving a third party’s reliance on draft financial statements. In this case (ESCA Corp. v. KPMG Peat Marwick, Wash App, June 9, 1997), the court found for the plaintiff, a bank who had relied on the financial statements to increase a line of credit. However, the case brings to the forefront that firms should be cautious when issuing draft financial statements. In this particular case, two factors assisted the firm in at least minimizing damages:

1) Clear labeling of every page of the draft financial statements with words:
   “Preliminary Draft, For Discussion Purposes Only”
2) Limited distribution of the report to selected members of the client’s staff.
E. CONSIDERATION OF FRAUD IN A COMPILATION AND REVIEW ENGAGEMENT

In an audit of financial statements, an auditor must perform functions in planning his or her audit to address fraud and illegal acts. SAS No. 99, Consideration of Fraud in a Financial Statement Audit, and SAS No. 54, Illegal Acts by Clients, are the governing authority for audit engagements and require an auditor to:

- Document an understanding of an entity’s environment, including internal control, in order to identify the risk of material misstatement, and
- Assess and document fraud risk.

Many accountants are not sure as to their responsibility for fraud and illegal acts in connection with a compilation or review engagement.

The SSARSs do not require the accountant to understand internal control nor assess fraud risk in conducting a compilation or review engagement.

However, SSARS No. 19 does require that an accountant adhere to certain performance requirements in a compilation or review engagement as follows:

1. **Establish an understanding with the client, in writing:** The accountant must include language in his or her engagement letter that states that the accountant will inform the appropriate level of management of any evidence or information that comes to the accountant’s attention during the performance of compilation and review procedures that fraud or an illegal act may have occurred.

   **Note:** One of the key changes found in SSARS No. 19 is that with respect to either a compilation or review engagement, the accountant must document the understanding of the engagement in writing, which means that an engagement letter must be obtained. Prior to the issuance of SSARS No. 19, an accountant had to document an understanding, but such an understanding did not have to be in writing.

   Sample language found in SSARS No. 19’s engagement letter follows:

   “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 (compilation) 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. **Make an inquiry about fraud:** With respect to a review engagement, SSARS No. 19 provides the inquiries that an accountant must make related to fraud. Specifically, SSARS No. 19 requires that an accountant:

   “make an inquiry as to management’s knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, such as communications received from employees, former employees, or others.”
3. Include a representation in the management representation letter related to fraud:

Sample representations consist of the following:

“We acknowledge our responsibility to prevent and detect fraud.”

“We have no knowledge of any fraud or suspected fraud affecting the Company involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.”

4. Report any fraud or illegal acts: The accountant must report to the appropriate level of management, any evidence or information that comes to his or her attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.

a. The accountant must report any fraud even if the matter is considered inconsequential.

b. The accountant is not required to report matters involving illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such items to be communicated. Further, the accountant is not required to communicate suspected illegal acts.

c. Definitions used:

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.

d. If there is an indication that fraud may exist or an illegal act may have occurred involving senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the manager, owner, or board of directors. The communication may be written or oral, provided oral communication is documented.

e. When the suspected fraud or illegal act involves an owner of the business, the accountant should consider resigning from the engagement and should consider consulting with his or her legal counsel and insurance provider whenever fraud or an illegal act is suspected (unless such illegal act is clearly inconsequential).

f. The disclosure of any evidence or information that comes to the accountant’s attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred to parties other than the client’s senior management (or board of directors) usually is not part of the accountant’s responsibility and would not be subjected to the accountant’s ethical or legal obligations of confidentiality.

Exception: Following are circumstances whereby the accountant may have a duty to disclose to parties outside the entity:
• To comply with certain legal and regulatory requirements.

• To a successor CPA when the successor decides to communicate with the predecessor accountant under SSARS No. 4, regarding acceptance of an engagement.

• In response to a subpoena.

5. **Consider the reporting and disclosure impact of fraud or illegal act:** If, during the performance of a compilation or review engagement, any evidence or information comes to the accountant's attention regarding fraud or an illegal act that may have occurred, the accountant should:

   a) Request that management consider the effect of the matter on the financial statements.

   b) Consider the effect of the matter on his or her review report.

   c) If the accountant believes the financial statements are materially misstated,

      • **Compilation engagement:** Obtain additional or revised information.

      • **Review engagement:** Perform additional inquiry and analytical procedures necessary to achieve limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP.

**Protecting Against Fraud – Compilation and Review:**

The statistics are chilling. Accounting firms are being sued for employee fraud and defalcation throughout the gamut of engagements. That's right: audits, reviews, compilations and even write-up engagements. Most of the problems stem from the client's lack of understanding as to what CPAs and auditors really do. The majority of clients and third parties still think auditors and CPAs are guarantors. And the scope of a compilation or review engagement is considered on a parity with that of an audit. This fact has been documented in numerous jury decisions against CPA firms in which juries have consistently held firms responsible at the level of an audit, even though a compilation engagement was performed. Complexity of accounting and auditing promulgations adds to this problem when juries and judges cannot understand the differences in scope among the different types of engagements.

As it relates to fraud, as previously noted in this section, an accountant is not responsible for considering fraud in a compilation or review engagement. In fact, management, not the accountant, is responsible for the prevention of fraud. However, SSARS No. 19 does require the accountant to inform management of any material errors, fraud, or illegal acts that come to the accountant's attention, regardless of whether a compilation or review engagement is performed.
An accountant is not required to report illegal acts that are clearly inconsequential. Further, if the fraud or illegal act involves an owner of the business, the accountant should consider resigning from the engagement.

SSARS No. 19 requires that an accountant inquire as to whether any frauds have occurred. This does not mean that the accountant must search for fraud. It only means that if fraud is discovered, it should be communicated. Further, in litigation involving juries, it is typically difficult to make a jury understand the different degrees of responsibilities in a compilation, review or audit engagement. Therefore, regardless of the engagement, the accountant should approach the engagement with professional skepticism.

The accountants responsibility to investigate questionable information was established in the 1136 Tenants’ Corp case. In this case, the courts held the accountant liable to its client, a cooperative apartment corporation, for negligence for failing to detect fraud. The plaintiff was awarded damages in the amount of $234,000 (including interest) and the accountants fee was just $600.

The lesson is clear. Just because you are conducting a compilation or review engagement, don’t think you are exempt from responsibility to detect fraud. If something doesn’t seem right, it probably isn’t and should be further investigated regardless of the level of responsibility.

The fraud issue has come to a head as a result of the issuance of SAS No. 99, Consideration of Fraud in a Financial Statement Audit. Effective in 2003, SAS No. 99 expanded the audit procedures in considering fraud risk in planning their audits. Although auditors are not responsible for finding fraud, historically juries have held auditors to a much higher standard than the one required by auditing standards.

Although the requirement to consider fraud had been around for some time in SAS No. 82, the issuance of SAS No. 99 significantly expanded the procedures that an auditor must apply in considering fraud risk. Commentators believe that SAS No. 99 has given plaintiffs’ attorneys greater ammunition in scrutinizing an auditors failure to find fraud. This, in turn, could be used to attack firms in compilation, review and even write-up services engagements in which plaintiffs’ counsel can attempt to link these lower level services in with the fraud requirements of an audit.

CPAs must take certain precautions in any engagement to help mitigate the risk that a client will sue the accountant if a fraud or employee defalcation occurs and is not detected. These precautions must be taken across the board in compilation, review, audit and write-up engagements.

Note: Further on in this manual the author discusses the latest results of a survey of prospective jurors.
Recommendations:

The author has three recommendations that should be considered in minimizing the accountant's exposure to fraud risk in compilation, review and write-up engagements.

Recommendation 1: Make sure the engagement letter is up-to-date for internal control and fraud language!

Many clients still do not fully understand the difference between a compilation, review and audit engagement. Consequently, if there is an undetected fraud within a compilation or review engagement, the client may blame the accountant for failing to communicate internal control weaknesses or detect the fraud, regardless of what the accountant's actual responsibility is. One way to guard against such a situation is to ensure that the engagement letter is up-to-date with language that clarifies the accountant’s responsibility.

An effectively drafted engagement letter is usually one of the accountant’s best defenses against a client who sues. The accountant may find a letter helpful to clarify and document the understanding regarding the accountant’s responsibility regarding fraud and internal control weaknesses.

Although SAS No. 99 relates to audits, it is important that the accountant update his or her engagement letters for both compilation and review engagements to incorporate reference to fraud and internal control.

Language that should be included in an engagement letter for both a compilation and review is illustrated in SSARS No. 19. Sample engagement letters are discussed further in this manual.

We will (description of services provided).

A compilation (review) does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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.
Recommendation 2: Make sure the client is fully aware of his or her responsibility to prevent and detect fraud.

An effective way to avoid misunderstandings is to educate the client as to the importance of internal control and the prevention of fraud. The accountant is then in a position to work with the client in a separate consulting engagement to improve the client’s internal control.

Review the client profile most susceptible to fraud:

- Small-business owners
- Doctors
- Owners who have weak internal controls and who fail to take even the simplest precautions

Recommendation 3: Send out a standard internal control/fraud letter to all clients for all engagements.

Many insurance companies strongly recommend that CPAs assist clients with ensuring that basic internal control and defalcation procedures are in place even though the accountant is performing a compilation (or write-up) or review engagement. By doing so, it is difficult for a client to later accuse the accounting firm of not informing the client about weaknesses in internal control that lead to fraud. Remember, even though a review or compilation engagement is being performed, CPAs are held accountable for defalcations. One of the best ways to protect the firm (and the client) is to provide the client with a standard internal control/fraud letter. This letter is useful for small businesses where there tends to be minimal separation of duties and where the client can play an active role in internal control. Consider the following sample letter that can be customized to the client’s needs for compilation and review engagements.
Sample Internal Control/Fraud Letter to Clients
Compilation or Review Engagement Clients

Dear Client:

Each year many business owners discover that their assets are not as well protected as they thought when they become victims of employee theft. This is particularly true in small-business environments where a single employee manages all the finances. Often there are no “checks and balances” to verify that transactions are accurate. Most employee thefts are perpetrated by highly trusted employees in key positions, involving substantial sums of money.

When proper, consistent procedures are not in place, employees can learn to manipulate the accounting system to their benefit. Whether they take money from the company or their mistakes are undiscovered, the end result can greatly impact your company’s management discussions, financial reports, and tax filings.

Unfortunately, once your financial records have been altered, discovering problems is extremely difficult. Most standard accounting practices are not designed to uncover internal problems such as embezzlement.

Depending on your CPA to protect against acts of one employee is a dependence that is false comfort. A review (compilation) engagement is not designed nor intended to uncover or search for defalcations. In conducting a review (compilation), the accountant does not gather evidence that may be necessary to uncover a defalcation. Also, the accountant concentrates on large transactions and major accounts that, if in error, could have a material effect on the company’s financial statements. For this reason, an employee who tampers with a number of small accounts over an extended period will usually escape detection.

Many people holding key financial positions may have gained an understanding of the review (compilation) process and its inherent limitations. Therefore, they are in a position to access the company’s assets by methods not subject to detection. The odds are that you will probably never experience a major defalcation. Yet, statistics are high that at least one of our clients will be victimized every few years.

Therefore, the best way to safeguard your company's assets is to recognize and improve weaknesses in your internal procedures. Defalcations are more likely to be discovered when there is an appropriate separation of duties between asset handling and recording functions. It is also critical that you exercise managerial oversight.

The following business practices can help you minimize potential internal control problems:

1. **Related duties should be assigned to different people:** Certain accounting functions are designed to cross-reference each other for accuracy: writing/signing checks, ordering/paying/receiving materials, handling cash/recording cash, etc. These procedures can reveal inconsistencies in your records in a timely manner.
2. **Reconcile and scrutinize your bank statements every month:** A bank statement can tell you a lot about your business if you review the information in a timely manner. Actions you should do on a monthly basis include the following:
   - Receive the unopened bank statement directly and open it up personally.
   - Scan the front and back of all canceled checks.
   - Question the purpose of all transfers.
   - Compare payroll checks with employee records, and ask questions.

3. **Signing checks:**
   - Never sign a check without inspecting original supporting documentation including the invoice, shipping documents and the purchase order.
   - Cancel all supporting documentation after signing a check.
   - Never sign a check that is not completely filled in.
   - Verify the names of your vendors.

4. **Protection of valuables:**
   - Keep blank checks and the signature stamp secure.
   - Deposit all cash and checks daily.
   - Get fidelity bond insurance for all accounting and key employees.
   - Backup all computer files on a regular basis and store the backup at a secure, remote location.
   - Periodically, change computer system passwords.

5. **Watch out for changes in employee behavior:**
   - Always verify employee references before hiring.
   - Be aware of substance abuse, changes in lifestyle, living beyond means, possessiveness of work.

These are some of the internal controls that can help you reveal many discrepancies. Our firm can help you develop and implement any of these important internal controls. If you have any questions, we would be happy to assist you any way we can.

Very truly yours,

James J. Fox & Company, CPA
The following checklist can be used in a client interview or can be mailed to a client as an accompaniment to the internal control/defalcation letter.

<table>
<thead>
<tr>
<th>Client Internal Control/Defalcation Checklist</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <strong>Segregation of Duties:</strong></td>
</tr>
<tr>
<td>Is the person who handles cash also responsible for recording cash?</td>
</tr>
<tr>
<td>Does the person who pays or orders inventory also receive materials?</td>
</tr>
<tr>
<td>Are two or fewer people responsible for the accounting function?</td>
</tr>
<tr>
<td>Is only one person responsible for reviewing financial statements each month?</td>
</tr>
<tr>
<td>Is your review of financial journals sporadic?</td>
</tr>
<tr>
<td>2. <strong>Bank Reconciliations:</strong></td>
</tr>
<tr>
<td>Do you reconcile the bank statement on a timely basis, at least once a month?</td>
</tr>
<tr>
<td>Do you review any adjustments and verify reconciling items?</td>
</tr>
<tr>
<td>Are reconciliations performed by one person and reviewed by another?</td>
</tr>
<tr>
<td>Is the person who writes checks restricted from signature authority?</td>
</tr>
<tr>
<td>Do you review canceled checks and endorsements on a monthly basis?</td>
</tr>
<tr>
<td>Do you compare payroll checks with your current employee records?</td>
</tr>
<tr>
<td>Do you question funds transferred between bank accounts?</td>
</tr>
<tr>
<td>Do you track the number of credit card bills you sign each month?</td>
</tr>
<tr>
<td>3. <strong>Supporting Documentation:</strong></td>
</tr>
<tr>
<td>Do you ever sign blank checks?</td>
</tr>
<tr>
<td>Do you ever sign checks without original supporting documentation?</td>
</tr>
<tr>
<td>Have funds ever been transferred between accounts without review or verification?</td>
</tr>
<tr>
<td>Do you ever sign checks for new business vendors without knowing or verifying their name and association with your company?</td>
</tr>
</tbody>
</table>
4. **Employees:** [Know your employees and be aware of changes in their behavior.]
   Are any employees extremely possessive of their work records and reluctant to share their tasks?
   
   Are any employees apprehensive about taking a vacation and time off, and are also the first one in the office and the last one out?
   
   Have you noticed a substantial change in the lifestyle of any employees?
   
   Do any of your employees have a possible substance abuse problem?
   
   Are any of your employees living beyond their means?
   
   Have you ever hired an employee without checking references?
   
   Do you permit accounting personnel to work longer than a year without taking a vacation?
   
   Do you have any accounting staff who has not been bonded?

5. **Safeguard Assets:**
   
   Are blank checks and signature stamps locked up?
   
   Do you restrictively endorse all checks?
   
   Do you deposit all cash and checks daily?
   
   Do you maintain a list of office furniture, equipment, and vehicles?
   
   Do you back up all computer files on a regular basis and store the backup in a remote location?
   
   Do you have password restrictions for your systems?
   
   Do you maintain adequate insurance coverage on all assets including business interruption insurance?

**Observation:** The author has used the above letter and checklist very effectively with clients to assist them in tightening up their internal controls. These documents can be mailed to all compilation and review clients as a standard document for all compilation and review engagements. However, the author believes that a mass mailing approach may not be the most effective and prudent way to use these documents and may result in some clients being confused and uncertain as to the accountant's ulterior motive of sending the document in the first place. Instead, the author recommends that the letter and checklist be reviewed and discussed with selected high-risk clients in the engagement exit meeting. You may find that the client looks at your fraud advice as sound, value-added information. You should also review this letter with your malpractice insurance company to ensure that they are in agreement with its use.

**How do the requirements for considering fraud differ in a compilation, review and audit engagement?**

The following comparison was published in the *Compilation and Review Alert*, as modified by the Author.
<table>
<thead>
<tr>
<th>Requirement</th>
<th>Compilation</th>
<th>Review</th>
<th>Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insert language in the engagement letter about fraud and illegal acts</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Engagement cannot be relied upon to disclose errors, fraud or illegal acts. Accountant will report fraud (unless clearly inconsequential) and illegal acts to the appropriate level of management.</td>
<td>Engagement cannot be relied upon to disclose errors, fraud or illegal acts. Accountant will report fraud (unless clearly inconsequential) and illegal acts to the appropriate level of management.</td>
<td>GAAS requires an auditor to obtain reasonable assurance as to whether the financial statements are free from material misstatement, by error or fraud. Audit is not designed to detect immaterial errors and fraud.</td>
</tr>
<tr>
<td>Required to gather information about fraud</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Yes, including having a brainstorming session to consider ways in which fraud might be committed.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Identify fraud risks</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Evaluate internal control including risks of material misstatement due to fraud</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Respond to the assessment of fraud risk</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Communicate information about fraud</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Document the consideration about fraud</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Further research when information is incomplete or inaccurate</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Perform additional services related to management’s override of internal control</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Compilation and Review Alert- AICPA, as modified by Author
F. ANALYTICAL PROCEDURES IN A REVIEW ENGAGEMENT

In conducting a review engagement, the accountant performs procedures consisting of inquiries of company personnel and analytical procedures applied to financial statement data. Generally, the accountant does not gather evidence as he or she does in an audit.

Analytical procedures include evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that plausible relationships among data exist. Analytical procedures may help identify potential material misstatements. The results of such procedures should be used as a basis for making additional inquiries and obtaining additional information. Using analytical procedures includes not only calculating ratios and trends, but also analyzing the results and identifying significant fluctuations and their cause.

The rules for applying analytical procedures are found in SSARS No. 19 and include the following:

a) Compare financial statements from year to year, for comparable periods.

b) Compare financial statements with budgeted/forecasted information for comparable periods.

c) Study relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on an entity’s experience and the industry.

Note further that Paragraph 17 of SSARS No. 19 emphasizes that the accountant should develop expectations prior to performing analytical procedures.

There are three (3) types of analytical procedures:

1. Trend analysis: Studying the change in accounts over time.

2. Reasonableness tests: Estimating a financial statement amount or the change in an amount from the prior year and comparing it to the existing financial statement amount.

3. Ratio analysis: Studying the relationship between two financial statement amounts.

When analytical procedures identify significant fluctuations and lead the accountant to believe that information may be incorrect, incomplete or otherwise unsatisfactory, SSARS No. 19 requires the accountant to perform the additional procedures he or she deems necessary to achieve limited assurance that no material modifications should be made to the financial statements.

In applying analytical procedures in a review engagement, the accountant may achieve both effectiveness and efficiency by using the following decision approach:
### Types of account balances

<table>
<thead>
<tr>
<th>Types of account balances</th>
<th>Procedures to Apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Immaterial account balances:</td>
<td>Apply no analytical procedures if the risk of understatement is low.</td>
</tr>
<tr>
<td>a. Significant other accounting procedures have already been applied.</td>
<td>Consider whether the existing evidence is adequate and whether any material errors are likely to occur. Analytical procedures are usually not needed.</td>
</tr>
</tbody>
</table>
| b. Significant other procedures have not been applied. | Analytical procedures should be applied:  
  a. Develop expectations using historical trends.  
  b. Compare the actual balance to the expected balance. If the result is close, no additional procedures are applied.  
  c. If the result is a large difference, material errors could exist. Inquiry about valid business reasons for the difference should be made.  
  d. Other analytical procedures should be applied if needed. |

---

**Are analytical procedures required for a compilation engagement?**

CPAs are fearful that if analytical procedures are performed in a compilation engagement, the engagement will be upgraded to a review. This thinking, of course, is not true. Paragraph 1 of SSARS No. 19 (AR 90) states that an accountant must comply with the provisions for a review engagement if he or she has been engaged to review financial statements. Therefore, an accountant only issues a review report if he or she has been hired to conduct a review engagement. The fact that review-type procedures (such as inquiry and analytical procedures) have been performed during a compilation engagement does not, in itself, upgrade the engagement to a review.

Paragraph 13 of SSARS No. 19 (AR 80) reaffirms the fact that review-type procedures may be performed in a compilation engagement without the risk of the accountant’s engagement being elevated to a review engagement. Specifically, Paragraph 13 states:

“The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have made inquiries or performed other procedures.”

---
The author believes that selected analytical procedures should be performed in a compilation engagement even though not specifically required in SSARS No. 19. The reason is that Paragraph 13 of SSARS No. 19 (AR 80) states that an accountant who performs a compilation is still responsible for researching incorrect, incomplete or otherwise unsatisfactory information received by the client.

In particular, Paragraph 13 states:

“In circumstances where the accountant believes that the financial statements may be materially misstated, the accountant should obtain additional or revised information.”

For example, if the gross profit percentage changes from year to year by 12%, the accountant would be required to research that difference. The only way that the accountant would know about this difference is to actually calculate a gross profit percentage.

At the conclusion of a compilation engagement, the author suggests that the accountant calculate a few key ratios such as a gross profit %, number of days in receivables, and number of days in accounts payable. Because the results of these ratios are not required to be part of the compilation work program, the accountant could quickly review these ratios and, if consistent, dispose of them.

**What if the accountant who is performing a compilation engagement discovers information that suggests that the financial statements could be materially misstated?**

If the accountant believes that there may be a material misstatement of the financial statements, he or she is required to perform additional procedures to research the incorrect or incomplete information. If the client will not provide the requested information, the accountant should withdraw from the engagement.

Additionally, SSARS No. 19 adds a new documentation requirement for CPAs who perform compilation engagements.

Paragraph 15 of SSARS No. 19 (AR 80) requires an accountant who performs a compilation engagement to document any findings or issues that, in the accountant’s judgment, are significant. This additional documentation would include, for example, the results of compilation procedures that indicate that the financial statements could be materially misstated, actions taken to address such findings, the extent to which the accountant had any questions or concerns as a result of the procedures, and how those issues were resolved.

This additional documentation was not required under the previously issued SSARS No. 1.

**G. USING STAFF IN A COMPILATION OR REVIEW ENGAGEMENT**

**Question:** Is an accountant permitted to delegate the performance of a compilation or review engagement to a staff person or paraprofessional?
Response: SAS No. 108, *Planning and Supervision*, provides guidance on using and supervising staff in conducting an audit. However, similar guidance is not available for compilation and review engagements. The SSARSs are silent as to what guidance an accountant should follow in planning and supervising his or her compilation or review engagement including whether a staff person or paraprofessional is permitted to work on such an engagement. Although not codified in the SSARSs, it is assumed that an accountant may, but is not required to, follow the SAS No. 108 guidance or other guidance (e.g., textbooks, articles, etc.) on planning and supervision for a compilation and review engagement.

The general answer is that an accountant may delegate the performance of compilation and review engagements to staff persons and paraprofessionals, as long as the person(s) are qualified to perform the work. Delegating responsibility to a staff person or paraprofessional does not reduce the responsibility that the owners, partners or shareholders of the firm have in connection with the engagement.

Observation: Prior to the issuance of SSARS No. 19, Interpretation No. 5 of SSARS No. 1, *Planning and Supervision*, permitted, but did not require, an accountant to follow auditing standards in planning and supervising a compilation and review engagement. Interpretation No. 5 was withdrawn in December 2010. Therefore, current compilation and review standards are silent on whether an accountant is permitted to following SAS No. 108 for planning and supervising the compilation or review engagement. Clearly, an accountant is not required to follow SAS No. 108.

H. TITLES ON COMPILED OR REVIEWED FINANCIAL STATEMENTS

Question: What are the titles that can be used for compilation or review reports?

Response: SSARS No. 19 adds a new requirement that a compilation or review report must have a title. This requirement has existed for audit engagements but to date has not existed for compilation and review reports under the previous SSARS No. 1.

Paragraph 2.17 of SSARS No. 19 states that the accountant’s compilation report should have “a title that clearly indicates that it is the accountant’s compilation report.”

Although not required, SSARS No. 19 also states that the accountant may indicate that he or she is independent in the title, although there is no requirement to use the word “independent” in the compilation report title.

Appropriate compilation report titles include:

“Accountant’s Compilation Report” or
“Independent Accountant’s Compilation Report”

For a review report, Paragraph 3.28 of SSARS No. 19 requires that a review report have two elements:

- A title that clearly indicates that it is the accountant’s review report, and
- Includes the word *independent*. 

Practice Issues: Compilation and Review
An appropriate title for a review report is:

“Independent Accountant’s Review Report”

Notice that SSARS No. 19 requires that the word “independent” be used in a review report but it is not required for a compilation report. Some accountants will simply use the word “independent” in all compilation and review reports to keep it simple. Moreover, if an accountant lacks independence in a compilation engagement, clearly use of the word “independent” in the compilation report title would not be appropriate.

I. LEGENDS ON COMPILED OR REVIEWED FINANCIAL STATEMENTS

Facts: SSARS No. 19 requires that each page of compiled (or reviewed) financial statements bear the legend such as:

Compilation:
“See accountant’s compilation report” or
“See independent accountant’s compilation report”

Review:
“See independent accountant’s review report”

Question 1: Must the legend be placed on pages that contain footnote disclosures?

Response: Paragraph 4 of SSARS No. 19 (AR 60) defines a financial statement as “structured presentation of financial data that includes related notes….”

Therefore, each page of the footnotes is considered a part of the financial statements and the legend should be placed on those pages, as well. However, placing the legend on the footnote pages may not be necessary provided each page of the financial statements (balance sheet, income statement, cash flows statement and changes in equity) contains a legend “See Notes to Financial Statements which are an integral part of these statements” or similar language.

Question 2: Should the legend “See Accountant’s Compilation Report” or “See Independent Accountant’s Compilation (Review) Report” be placed on pages that contain supplementary information?

Response: Yes. The definition of a financial statement excludes supplementary information. Yet, paragraph 53 of SSARS No. 19 (AR 80) states that if supplementary information is presented with financial statements, the accountant should clearly indicate the degree of responsibility he or she is taking for the supplementary information. Because the compilation or review report identifies the level of service performed on the supplementary information, the best way to communicate to the user is to refer to the Accountant’s report.

Question 3: Same facts as Question 2 except that the supplementary information is not included in the compilation (review) report and, instead, is provided in a second and separate report referred to as Accountant’s Report on Supplementary Information.
**Response:** In this situation, making reference to “See Accountant’s Compilation Report” or “See Independent Accountant’s Compilation (Review) Report” would be useless because the compilation report makes no reference to the supplementary information. Instead, a more meaningful legend to place on the pages of supplementary information may be “See Accountant’s Report on Supplementary Information.”

**Question 4:** How should the legend be worded in the event of either of the following scenarios?

a. Current period is reviewed and supplementary information is compiled.

b. Current period financial statements have been reviewed while previous year's statements were compiled.

c. Current period financial statements have been reviewed while previous year's statements were audited.

**Response:** In either of the above situations, the most appropriate legend is “See Accountant’s Report” or “See Independent Accountant’s Report.”

**Question 5:** Is it appropriate to use a more generic legend for all compilation and review engagements such as “See Accountant’s Report”?

**Response:** The author notes that several commentators believe that the use of a generic legend is acceptable. The author believes otherwise. SSARS No. 19 specifically refers to the use of “See Accountant’s Compilation Report,” “See Independent Accountant’s Compilation Report”, or “See Independent Accountant’s Review Report.” In each instance, the reader specifically knows the type of engagement being performed without reading the report itself. If, instead, the generic term “See Accountant’s Report” is used, there is now the question as to what type of engagement was performed. If the report is detached from the financial statements, the reader may not be aware of the accountant's degree of responsibility in connection with the financial statements.

**Observation:** The author's conclusion on the generic legend issue is influenced by a court decision against a CPA firm in a compilation engagement. In this case, the accountant firm issued a compilation report with no notes or cash flow statement and forgot to include the "See Accountant’s Compilation Report" legend in the financial statement pages. Subsequently, the client received the statements, intentionally removed the compilation report from the package and sent the financial statements (absent the report) to a third party. The third party was somehow damaged and sued the accounting firm claiming that the "audited" financial statements had deficiencies. The accounting firm claimed that it had issued compiled financial statements and ultimately lost the case because it had failed to include the appropriate legend on the financial statements. The author believes the same type of risk of misunderstanding could exist in cases where the generic legend "See Accountant’s Report" is used and a third party claims that the "report" was an audit report rather than a compilation or review.

**Question 6:** Does the word “independent” have to be included in the legend?
Response: Paragraphs 2.18 and 3.29 of SSARS No. 19 provide the following examples of appropriate legends:

**Compilation:**
- See Accountant’s Compilation Report, or
- See Independent Accountant’s Compilation Report

**Review:**
- See Independent Accountant’s Review Report

There is an inconsistency in SSARS No. 19 in addressing the need to include the word “independent” in a review report title as compared to the requirement to reference that word in the legend. Paragraph 3.28 of SSARS No. 19 requires that the word “independent” be included in the title to a review report such as “Independent Accountant’s Review Report. However, as it relates to a legend, Paragraph 3.29 states that “each page of the financial statements reviewed by the accountant should include a reference, such as “See Independent Accountant’s Review Report.”

As it relates to a legend in a review engagement, Paragraph 3.29 appears to give use of the word “independent” as an example, but not as a mandate.

Although the author can make an intellectual argument that the word “independent” may be excluded from a review report legend, using pure logic suggests that an accountant should include the word “independent” in the review engagement legend, consistent with its use in the related review report.

Therefore, the compilation and review reports and related legends should look like this:

<table>
<thead>
<tr>
<th>Type of report</th>
<th>Report Title</th>
<th>Legend Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compilation</td>
<td>Accountant’s Compilation Report, or Independent Accountant’s Compilation Report</td>
<td>See Accountant’s Compilation Report, or See Independent Accountant’s Compilation Report</td>
</tr>
</tbody>
</table>

**J. GOING CONCERN: COMPILATION AND REVIEW**

Questions continue to exist regarding the accountant’s responsibility for going concern in a compilation or review engagement.

SAS No. 59, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*, provides guidance on evaluating the adequacy of going-concern disclosure in audited financial statements. SAS No. 59 is the only authoritative literature for going concern disclosure. Continuation of an entity as a going concern is assumed in financial reporting in the absence of information to the contrary.
In an audit engagement, if there is **substantial doubt** of an entity’s ability to continue as a going-concern for one year from the balance sheet date, the accountant must **seek factors that mitigate** this fact such as alternative sources of financing, management's plan of action, etc.

If, after seeking mitigating factors, the auditor believes there is still **substantial doubt**, SAS No. 59 requires a disclosure and an audit report modification as follows:

**Separate paragraph in the audit report:**

| As discussed in Note A, the Company has suffered continued losses from operations and, at December 31, 20X1, has a deficiency in stockholders' equity. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management has a plan of action that is described in Note A. The financial statements do not reflect any adjustments that might result from the outcome of this uncertainty. |

**What about going concern as it relates to compilation and review?**

The concept of going concern is the same for compilation and review engagements as with audit engagements, except that the accountant does not gather evidence in a compilation or review engagement, while he or she does in an audit. Exclusive of the evidence issue, there are some differences in terminology and execution, but the concept is the same.

In 2007, the ARSC issued Interpretation No. 29 of SSARS No. 1, *Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern*, to address how an accountant should report an uncertainty (including uncertainty about going concern) in a compilation or review report.

In 2008, the ARSC issued SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services-2008*. In SSARS No. 17, the ARSC included a guidance on going concern issues related to compilation and review engagements, separate and distinct from reference to auditing literature.

Effective for years ending on or after December 15, 2010, SSARS No. 17 and Interpretation 29 became part of SSARS No. 19. Interpretation 29 is now relabeled in two sections of SSARS No. 19: Interpretation No. 12 of AR Section 80 and Interpretation No. 7 of AR Section 90. SSARS No. 19 makes no significant changes to the accounting and reporting for uncertainties and going concern in compilation and review engagements.

SSARS No. 19 requires an accountant performing a compilation or review engagement to request that management consider the possible effects of a going concern uncertainty on the financial statements. After management communicates back to the accountant, the accountant must determine whether management’s conclusions are unreasonable or the disclosure of the uncertainty not adequate.
Thus, one key change found in the SSARSs is that management makes the initial assessment of uncertainty as to going concern, while an auditor makes that assessment in an audit. Also, the term **substantial doubt**, which is used in auditing, is not applicable to compilation and review engagements because there is no evidence obtained by the accountant.

The specific rules found in SSARS No. 19 related to going concern in a compilation or review engagement follow:

a. During the performance of a compilation or review engagement, information may come to the accountant’s attention indicating that there may be an **uncertainty** about an entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the balance sheet date.

- In such circumstances, the accountant should request that **management** consider the possible effects of the going concern uncertainty on the financial statements, including the need for a disclosure.

- After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions (and management’s plans) including the adequacy of the related disclosures, if applicable.

- If the accountant determines that management’s conclusions are unreasonable or the disclosures of the uncertainty is not adequate, he or she should follow the guidance for departures from GAAP.

- The accountant may emphasize an uncertainty (emphasis of a matter) about an entity’s ability to continue as a going concern provided the uncertainty is also disclosed in the financial statements.

  **Note:** If there is an uncertainty in connection with a three-paragraph compilation engagement (e.g., no footnotes), emphasis of a matter would not be allowed because the uncertainty is not also disclosed.

**Observation:** There is one key difference between how one considers going concern for a compilation or review engagement as compared with an audit. In SAS No. 59, the auditor considers whether there is substantial doubt as to an entity’s ability to continue as a going concern for at least one year from the balance sheet date. Under SSARS No. 17, the accountant asks management to consider whether they have uncertainty as to going concern. Management communicates back to the accountant its conclusions and the accountant considers the reasonableness of management’s conclusions.

b. **Going concern considerations:**

SSARS No. 19 provides non-authoritative guidance related to an entity’s ability to continue as a going concern. Many of the considerations found in the following exhibit mirror those found in auditing literature in SAS No. 59.
### Going Concern Considerations

**Conditions or events that may indicate an uncertainty about going concern**

<table>
<thead>
<tr>
<th>Condition</th>
<th>Examples of conditions</th>
</tr>
</thead>
</table>
| Negative trends | - Recurring operating losses and working capital deficiencies  
- Negative cash flows  
- Adverse key financial ratios such as the **Altman Z Score** |
| Indications of possible financial difficulties | - Default on loan or similar agreements  
- Arrearage in dividends  
- Denial of usual trade credit  
- Restructuring of debt  
- Noncompliance with statutory capital requirements  
- Need to seek new sources or methods of financing  
- Disposal of substantial assets  
- Unusually liberal credit terms to customers including dating of receivables  
- Maximizing a working capital line of credit |
| Internal matters | - Work stoppages or other labor difficulties  
- Substantial dependence on the success of a particular project  
- Uneconomic long-term commitments  
- Need to significantly revise operations |
| External matters that have occurred | - Legal proceedings, legislation, or similar matters that might jeopardize an entity’s ability to operate  
- Loss of key franchise, license, or patent  
- Loss of key customer or supplier  
- Uninsured or underinsured catastrophe such as a drought, earthquake, or flood |

### Altman Z score:

The Altman Z Score has become generally accepted as a ratio that is highly correlated with bankruptcy. It works on companies within most traditional industries, such as retailers, wholesalers and manufacturers. For others, such as real estate developers and certain highly leveraged industries, the score may be distorted.

**ALTMAN Z SCORE**: Consists of a weighted average of four separate ratios:

- **Ratio 1:** Working Capital  
  Total assets
Ratio 2: Retained earnings
Total assets

Ratio 3: Net earnings before interest and income taxes
Total assets

Ratio 4: Net worth
Total debt

All four ratios are weighted to compute an overall Z score as follows:

$$6.56 \text{ (ratio 1)} + 3.26 \text{ (ratio 2)} + 6.72 \text{ (ratio 3)} + 1.05 \text{ (ratio 4)} = Z \text{ score}$$

Results:

1.00 or less: Headed toward bankruptcy
1.00 to 2.50: Could have problems
2.50 or greater: Strong, unlikely risk of bankruptcy

**Observation:** In most engagements involving strong, solvent companies, the ratio usually is in the 5.00 to 9.00 range. Several accounting software packages include the Altman Z score as part of the analytical procedures (ratios). The author recommends that practitioners compute the Altman Z Score for all engagements.

Once an accountant has identified conditions and events that may indicate that there is an uncertainty as to an entity’s ability to continue as a going concern, the accountant should request that management consider the possible effects of the going concern uncertainty on the financial statements, and to provide management’s plans to deal with the conditions and events.

Management’s plans can be categorized as:

- Plans to dispose of assets
- Plans to borrow money or restructure debt
- Plans to reduce or delay expenditures
- Plans to increase ownership equity

The following chart presents examples of actions that management might take as part of its plan to deal with the conditions and events identified by the accountant.
### Examples of Management’s Plans in Dealing With the Conditions or Events Related to the Certainty

<table>
<thead>
<tr>
<th>Management’s plan</th>
<th>Examples of the plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plans to dispose of assets</td>
<td>• Restrictions on disposal of asset, such as covenants limiting such transactions in loan agreements</td>
</tr>
<tr>
<td></td>
<td>• Apparent marketability of assets that management plans to sell</td>
</tr>
<tr>
<td></td>
<td>• Direct or indirect effects of disposal of assets</td>
</tr>
<tr>
<td>Plans to borrow money or restructure debt</td>
<td>• Availability of debt financing</td>
</tr>
<tr>
<td></td>
<td>• Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity</td>
</tr>
<tr>
<td></td>
<td>• Possible effects on management’s borrowing plans of existing restrictions on additional borrowings</td>
</tr>
<tr>
<td>Plans to reduce or delay expenditures</td>
<td>• Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or R&amp;D projects, or to lease rather than purchase assets</td>
</tr>
<tr>
<td>Plans to increase ownership equity</td>
<td>• Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital</td>
</tr>
<tr>
<td></td>
<td>• Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors</td>
</tr>
</tbody>
</table>

After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions (and management’s plans) including the adequacy of the related disclosures, if applicable.

**What if a disclosure is required?**

Disclosure requirements with respect to uncertainties are included in Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties (ASC 275)*, and Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies (ASC 450)*, and other authoritative accounting literature. However, accounting literature does not provide specific guidance on disclosure of uncertainties caused by concern about an entity’s ability to continue as a going concern.

There is disclosure guidance found in SSARS No. 19. In accordance with SSARS No. 19, the accountant should disclose an uncertainty about an entity’s ability to continue as a going concern, whether a review or compilation engagement is performed.
SSARS No. 19 provides that when management concludes that there is uncertainty about an entity’s ability to continue as a going concern for a reasonable period of time (not more than one year from the balance sheet date), management should consider the following disclosures as to the uncertainty:

1. Pertinent conditions and events giving rise to the assessment of the uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time (not more than one year from the balance sheet date)
2. The possible effects of such conditions and events
3. Management’s evaluation of the significance of those conditions and events and any mitigating factors
4. Possible discontinuance of operations
5. Management’s plan, including relevant prospective financial information
6. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

When management concludes that the uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time is alleviated, the entity should consider the need for disclosure of the principal conditions and events that initially caused it to believe there was an uncertainty, including the possible effects of such conditions and events, and any mitigating factors, including management’s plans.

**Question:** If there is an uncertainty about an entity’s ability to continue as a going concern and a disclosure is made, what report modification must be made for a compilation or review engagement?

**Response:** Generally, no report modification is required for a compilation or review engagement provided. However, an accountant may elect to include an explanatory paragraph in the compilation or review report.

**Question:** Although a report modification is not required in a compilation or review when there is a going concern issue, may the accountant add a paragraph to the report to emphasize a matter?

**Response:** Yes. The accountant may, but is not required to, include a *separate emphasis of a matter paragraph* in the report.

Specific guidance is found in Interpretation No. 12 of AR Section 80 and Interpretation No. 7 of SSARS No. 19, both of which state that if the accountant concludes that management’s disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is adequate but further decides to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant's compilation or review report, he or she may use the following language:

“As discussed Note X, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.”

Therefore, it would seem that emphasizing a going concern issue in the report as well as the footnotes, is appropriate.
SSARS No. 19 further warns an accountant that there are limitations in using an “emphasis of a matter” paragraph in a compilation or review report. Following are some guidelines for use of an emphasis of a matter paragraph, as noted by SSARS No. 19 and augmented by the author:

1. The paragraph should not introduce new information to the reader.
2. The paragraph should only highlight or emphasize a matter already disclosed in the financial statements.
3. An emphasis of a matter paragraph differs from a GAAP violation paragraph.

**Example:** If an accountant believes that certain information is not properly disclosed, he or she is required to state, in a separate paragraph of the report, this GAAP departure. This kind of paragraph differs from an emphasis of a matter paragraph because its purpose is to make the reader aware of a financial statement deficiency. The purpose of an emphasis of a matter paragraph is to point out additional information that is already disclosed in the financial statements.

4. Emphasis of a matter paragraph should not contain information about procedures the accountant has or has not performed or conclusions or opinions concerning the entity's status as a going concern.
5. Emphasis of a matter should not use the term “substantial doubt” which is an auditing term and not appropriate for a compilation or review engagement that does not gather audit evidence.

**Question:** What if the footnote disclosure of the uncertainty of going concern is not adequate?

**Response:** If the accountant determines that the disclosure of the uncertainty regarding the entity's ability to continue as a going concern is not adequate, he or she should follow the guidance in SSARS No. 19 with respect to departures from generally accepted accounting principles. That guidance would generally require that a GAAP departure due to an inadequate disclosure be included in the report.

**Question:** What if an accountant issues a compilation report on financial statements that omits substantially all disclosures required by GAAP?

**Response:** There is no requirement to disclose the uncertainty in the accountant’s report in this situation. Therefore, because footnotes are not presented, the reader may not become aware of the going concern problem.

SSARS No. 19 is quite clear that an emphasis of matter paragraph should not be used in lieu of management disclosures. Paragraph 2.26 of AR Section 80 (SSARS No. 19) states:

“Because an emphasis of matter paragraph *should not be used* in lieu of management disclosures, the accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures *unless the matter is disclosed in the financial statements.*"
Therefore, the accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless that matter is also disclosed in the financial statements.

Thus, if no footnotes are provided, emphasizing an uncertainty in a compilation report would not be appropriate.

Observation: Although there is no requirement to disclose the uncertainty in the compilation report where there are no footnotes, an accountant should be extremely careful in this situation. Given the litigious environment, an accountant could conceivably be held liable if the reader is not informed of the going concern problem. An injured third party could argue that the omission of the disclosures was intentional to disguise the going concern problem. Yet, SSARS No. 19 will not allow an accountant to emphasize a matter, such as an uncertainty of going concern, if it is not otherwise disclosed in the notes. The author believes that where there is uncertainty of going concern in a compilation engagement, the accountant should issue a compilation report with full footnotes with disclosure of the uncertainty in both the footnotes and emphasis of matter in the compilation report.

Question: Is an emphasis of a matter paragraph in a compilation report allowed for an uncertainty of going concern, if the entity includes selected disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled “Selected Information – Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example, “Accounting Principles Generally Accepted in the United States of America”)] Are Not Included.”

Response: The SSARSSs do not specifically address this situation. However, based on guidance given by SSARS No. 19 in other matters, an emphasis of a matter paragraph for an uncertainty of going concern would be permitted in a compilation report as long one of the selected disclosures included the uncertainty of going concern.

K. RESPONSIBILITY FOR INCOMPLETE INFORMATION – COMPILATION ENGAGEMENT

Facts: An accountant compiles financial statements for a client and notices that the client’s cash disbursements journal shows monthly disbursements for certain leased equipment. When the accountant asks the client whether the equipment is rented or whether the client is making payments on purchased equipment, the client indicates that she is uncertain. The client does not have documentation concerning the leased equipment, and telephone calls to the lessor do not resolve the matter. This is the first year of the engagement and the accountant does not have information from prior years.

Question: How much work must an accountant perform in a compilation engagement to discharge his or her responsibility for identifying financial statement misstatements?

Response: Paragraph 2.13 of SSARS No. 19 states the following in connection with a compilation engagement:
“The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have made inquiries or performed other procedures. The results of such inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory or that fraud or an illegal act may have occurred.”

In circumstances when the accountant believes that the financial statements may be materially misstated, the accountant should obtain additional or revised information.”

In the above situation, the accountant should request that the client contact the lessor and obtain copies of the lease agreements.

An accountant should not issue a compilation report indicating that management has not determined the appropriateness of the accounting treatment for the leases and that any potential GAAP departures have not been determined. The use of such language is not appropriate because it allows the accountant to avoid responsibility for identifying GAAP departures.

Observation: Absent information to the contrary, SSARS No. 19 does not require an accountant to search for additional information or perform additional procedures, such as inquiries, etc., when performing a compilation engagement. What it does require is for an accountant to obtain additional information if it is obvious that the submitted information is incorrect or incomplete. In this situation, the accountant is not allowed to disregard the obvious signs that the financial statements are incorrect.
REVIEW QUESTIONS

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 accountants who perform write-up services for clients:
   a) such engagements are risk free
   b) malpractice cases against accountants in such engagements have risen dramatically in recent years
   c) such engagements may result in a lack of independence for the accountant
   d) the accountant should obtain an engagement letter for such services

2. John is an accountant who is asked to perform certain activities for a client. Which of the following would not impair John's independence:
   a) John prepares purchase orders for the client
   b) John is the custodian for certain investments of the client
   c) John is an advisor to the board of directors
   d) John serves as an escrow agent on behalf of the client

3. If an accountant is in the practice of public accounting and performs controllership services as an employee of the entity, the accountant:
   a) must comply with the requirements of SSARS No. 19
   b) must communicate, preferably in writing, the accountant’s relationship to the entity
   c) either a or b above
   d) none of the above

4. Which of the following is true regarding the issuance of draft financial statements:
   a) an accountant may not issue draft financial statements
   b) an accountant may issue draft financial statements to provide a client with the opportunity to read and analyze the financial statements before their final issuance
   c) if draft statements are issued, they should not contain any special markings
   d) an accountant has full control over the distribution of draft financial statements that he or she submitted to the client
5. As defined in SSARS No. 19, an intentional act that results in a misstatement in compiled or reviewed financial statements is considered a(an):

   a) fraud
   b) illegal act
   c) error
   d) none of the above

6. As it relates to fraud, an accountant is:

   a) not responsible for considering fraud in a compilation or review engagement
   b) responsible for the prevention of fraud
   c) not required to inform management of any fraud that comes to their attention if a compilation or review is performed
   d) is not required to inquire as to whether any frauds have occurred

7. For which of the following engagements is the accountant required to evaluate internal controls, including risks of material misstatement due to fraud:

   a) compilations
   b) reviews
   c) audits
   d) all of the above

8. Which of the following is an analytical procedure that studies the relationship between two financial statement amounts:

   a) trend analysis
   b) reasonableness tests
   c) ratio analysis
   d) Altman Z Score

9. Which of the following is true regarding analytical procedures:

   a) if performed in a compilation engagement, the engagement must be upgraded to an audit
   b) if performed in a compilation engagement, the engagement must be upgraded to a review
   c) the fact review-type procedures are performed, in itself, does not upgrade a compilation engagement to a review
   d) analytical procedures should never be performed in a compilation engagement

10. SSARS No. 19 requires that each page of compiled or reviewed financial statements:

    a) be numbered
    b) be placed on the accountant’s letterhead
    c) bear a legend like “See Independent Accountant’s Compilation (Review) Report”
    d) be initialed by the accountant
11. Which of the following is not true regarding going concern:

   a) SSARS No. 19 provides guidance on going concern in a compilation and review engagement
   b) the concept of substantial doubt is the basis for going concern in a compilation or review engagement
   c) a report modification is generally required for a compilation or review engagement when there is a going concern issue
   d) an accountant may add a paragraph to a report to emphasize a going concern matter

12. Which of the following is true regarding the Altman Z Score:

   a) it has become generally accepted as a ratio that is highly correlated with bankruptcy
   b) it works well for real estate developers
   c) it consists of a weighted average of three separate ratios
   d) all of the above
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** These types of engagements are not risk free.

   B: Incorrect. Malpractice cases have increased. Undetected fraud is the number one charge against accountants in write-up engagements involving cash and accounts receivable.

   C: Incorrect. Depending on the degree of services provided, accountants may have a lack of independence.

   D: Incorrect. One way to mitigate risk associated with performing write-up services is to obtain an engagement letter.

   (See page 110 of the course material.)

2. **A: Incorrect.** Preparing source documents, such as purchase orders, does impair independence.

   B: Incorrect. Acting as a custodian of client assets impairs independence.

   **C: Correct.** Acting as an advisor to the board of directors does not impair independence. However, meeting with the board on behalf of management would impair independence.

   D: Incorrect. Acting as an escrow agent or registrar for the client does impair independence.

   (See page 111 of the course material.)

3. **A: Incorrect.** The accountant has a choice to either comply with SSARS No. 19 or to communicate the accountant’s relationship to the entity.

   B: Incorrect. The accountant has a choice to either comply with SSARS No. 19 or to communicate the accountant’s relationship to the entity.

   **C: Correct.** The accountant has a choice to either comply with SSARS No. 19 or to communicate the accountant’s relationship to the entity.

   D: Incorrect. The accountant has a choice to either comply with SSARS No. 19 or to communicate the accountant’s relationship to the entity, so “none of the above” is not correct.

   (See page 112 of the course material.)
4. A: Incorrect. An accountant may submit draft financial statements under certain situations.

B: Correct. This is one situation when an accountant may issue draft financial statements to a client.

C: Incorrect. If draft financial statements are issued, they should be clearly labeled as “Preliminary Draft, For Discussion Purposes Only.”

D: Incorrect. An accountant cannot control the distribution of draft financial statements they have issued.

(See page 120 of the course material.)

5. A: Correct. This is the definition of fraud.

B: Incorrect. An illegal act is defined as a violation of laws or governmental regulations, excluding fraud.

C: Incorrect. Error is not defined in SSARS No. 19.

D: Incorrect. Because this is the definition of fraud, none of the above is not correct.

(See page 122 of the course material.)

6. A: Correct. An accountant is not responsible for considering fraud in either a compilation or review engagement.

B: Incorrect. Management, not the accountant, is responsible for the prevention of fraud.

C: Incorrect. SSARS No. 19 does require the accountant to inform management of any material errors, fraud, or illegal acts that come to the accountant’s attention, regardless of whether a compilation or review engagement is performed.

D: Incorrect. SSARS No. 19 requires that an accountant inquire as to whether any frauds have occurred.

(See pages 123 to 124 of the course material.)

7. A: Incorrect. This is not a requirement for compilations.

B: Incorrect. This is not a requirement for reviews.

C: Correct. This is a requirement for audit engagements.

D: Incorrect. Since this is not a requirement for compilations or reviews, all of the above cannot be a correct answer.

(See page 131 of the course material.)
8. A: Incorrect. A trend analysis studies the change in accounts over time.

   B: Incorrect. Reasonableness tests estimate a financial statement amount or the change in an amount from the prior year and compare it to the existing financial statement amount.

   C: Correct. Ratio analysis is the study of the relationship between two financial statement amounts.

   D: Incorrect. The Altman Z Score is a financial ratio that consists of a weighted average of four separate ratios.

   (See page 132 of the course material.)

9. A: Incorrect. The fact that review-type procedures are performed during a compilation engagement does not, in itself, upgrade a compilation engagement to an audit or a review.

   B: Incorrect. SSARS No. 19 states specifically that the only way an accountant should issue a review report is if the accountant is hired to conduct a review.

   C: Correct. The performance of analytical procedures does not automatically upgrade the engagement to a review or an audit.

   D: Incorrect. Selected analytical procedures should be performed in a compilation engagement even though not specifically required in SSARS No. 19.

   (See page 133 of the course material.)

10. A: Incorrect. Page numbering is not a requirement.

    B: Incorrect. Letterhead is not a requirement.

    C: Correct. A proper legend like “See Independent Accountant’s Compilation (Review) Report” is required by SSARS No. 19.

    D: Incorrect. The accountant’s initials are not required.

    (See page 135 of the course material.)
11. A: Incorrect. SSARS No. 19 does provide guidance on an accountant's responsibility for going concern in a compilation or review engagement.

B: Incorrect. The concept of substantial doubt is inappropriate because it is an audit term relating to audit evidence. The term uncertainty should be used for compilation and review engagements.

C: Correct. A report modification is generally not required for a compilation or review engagement.

D: Incorrect. An accountant may elect to include an explanatory paragraph to the report to emphasize the matter.

(See page 140 of the course material.)

12. A: Correct. The Altman Z Score is a financial ratio used to indicate a going concern problem.

B: Incorrect. The Altman Z Score works on companies within most traditional industries, such as retailers, wholesalers, and manufacturers. It may be distorted for real estate developers and other highly leveraged industries.

C: Incorrect. The Altman Z Score consists of a weighted average of four separate ratios, not three.

D: Incorrect. Since only A is correct, “all of the above” is not a correct answer.

(See page 141 of the course material.)
L. USING OCBOA FINANCIAL STATEMENTS FOR ENGAGEMENT PROFITABILITY

1. General

As CPAs seek ways to reduce overall engagement time for compilations and reviews, they seem to overlook using OCBOA more aggressively. From discussions in his lecture classes, the author notes that few CPAs use OCBOA for engagements beyond limited disclosure compilation reports. That is, the majority of engagements relating to closely held entities (e.g., full disclosure compilations, reviews and even audits) continue to be conducted using traditional GAAP.

More than ever, major differences now exist between GAAP and taxable income due to the upheaval of the tax code starting in the 1980s through the current period. As a result, small business owners find a continued conflict between balancing a desired lower taxable income for tax planning with higher financial statement income necessary to appease the bank or third party investor. In certain cases, tax basis statements act to bridge this gap so that tax and financial statements are more congruent. This is particularly true with respect to a traditional closely held manufacturer, retailer or wholesaler who may be a perfect candidate for tax-basis accrual financial statements. With respect to cash-basis statements, many smaller businesses, in particular professional practices, could easily use cash or hybrid basis financial statements instead of a more costly accrual basis GAAP format. Let's not forget that the accountant can benefit from use of OCBOA statements if the time saved can be used to either reduce the billing to the client or retained by the accountant to make the engagement more profitable.

The definition of an Other Comprehensive Basis of Accounting (OCBOA) is found in SSARS No. 19 to include any of the following:

a. **Income tax basis**: 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.

b. **Cash or modified basis**: Cash basis of accounting and modifications of the cash basis having substantial support.

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. Example: recording depreciation on fixed assets.

c. **Regulatory basis**: 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.

Example: a basis of accounting that insurance companies use pursuant to the rules of a state insurance commission.

For most situations, income tax basis-accrual financial statements are the most meaningful and are defined as:

*Income tax basis of accounting based on the principles and rules for accounting under the federal income tax laws and regulations.*
Income tax basis may include the cash, modified cash, accrual or any method that clearly reflects income under Section 446 of the IRC.

**Observation:** One of the advantages of income tax basis statements is that there are few accounting issues that need to be addressed. Essentially, all transactions are accounted for in accordance with the Internal Revenue Code. Of course, there may be instances where the tax treatment of an item is at issue.

### 2. When to Use Income Tax Basis Financial Statements

In determining whether income tax basis financial statements are appropriate for a client, major factors that should be considered include who the users of the financial statements will be and whether there are any contractual agreements or regulatory requirements that prohibit issuance of OCBOA financial statements.

Generally, income tax basis financial statements are best used and most useful in the following situations:

a. There is a less financially sophisticated closely held client who is:
   - Tax motivated and interested in cash flows, and/or
   - Actively involved in the day-to-day operations.

b. The company is in a strong financial position and will not be forced into debt covenant violations by presenting a lower net income.

c. There is incentive to reduce overall engagement time.
   - The accountant is motivated to reduce overall engagement time either through pressure from the client or to improve the profitability of the engagement.

**Observation:** The author believes that the accountant should seriously consider the time savings in selling the use of income tax basis financial statements to his or her client. Based on experience, the author estimates an overall engagement time savings of 10% for compilations, 15-18% for reviews, and 15-25% for audits. For fixed-fee engagements, any savings will usually inure to the benefit of the accounting firm. Moreover, most third parties, particularly banks, will accept income tax basis financial statements. If loan documents do not make reference to GAAP in the description of the financial statements to be issued at year-end, the author believes that the accountant may issue income tax basis financial statements as a matter of right.

### 3. When Not to Use OCBOA Financial Statements

It may be prudent not to use income tax basis financial statements if the statements may be perceived to be intentionally misleading by a third party, or may violate loan covenants. Examples of situations in which a third party may perceive the use of OCBOA to be intentionally misleading include:
a. Having a large amount of uncollectibles for which OCBOA would not provide an allowance for doubtful accounts.

b. Having a large contingency for environmental liabilities and litigation for which an accrual would not be recorded using OCBOA.

4. Income Tax Basis Accrual Statements – Differences from GAAP

When using income tax basis financial statements, all deferred M-1 items are eliminated while permanent, flow-through M-1 items are retained. Deferred M-1 items are all M-1 items that reverse and, on which, deferred income taxes are computed. Conversely, permanent M-1 items consist of all M-1s that do not reverse such as meal and entertainment and key man life insurance. A listing of these items follows:

a) All deferred M-1 items are eliminated:
   - Depreciation – MACRS is used for financial statements, including the Section 179 deduction.
   - UNICAP difference – 263A adjustment is capitalized to financial statement inventory.
   - No unrealized gains on securities – ASC 320 (formerly FASB No. 115) securities are recorded at tax cost.
   - No related party or vacation-pay accruals – all on a cash basis.
   - Amortization – most intangibles, including goodwill, are amortized over their tax life of 15 years.
   - No allowance for bad debts – direct write-off method is used.
   - No impairment of assets issued – assets are recorded at cost.
   - No goodwill impairment.

b) All permanent differences are retained such as:
   - Meals and entertainment
   - Key man life insurance
   - Dividend exclusion
   - Penalties and fines
   - Non-taxable interest income

c) Deferred income taxes are eliminated

d) No statement of cash flows is required per ASC 230 (formerly FASB No. 95)

e) OCBOA statements can be perfect for non-profits that wish to avoid the requirements of ASC 958 (formerly FASB Nos. 116 and 117) such as:
   - Donated services are not recorded.
   - Statement of cash flows is not required.
• Statement of functional expenses and the presentation of the amount of unrestricted, temporarily restricted and permanently restricted net assets are not required.

f) GAAP consolidation rules do not apply:

• Consolidation of variable interest entities under ASC 810 (formerly FIN 46R) is not applicable.

Note: ASC 810 is not applicable so there is no risk that a rental entity would have to be consolidated with its related party operating entity lessee.

• Consolidation is based on the IRC threshold of 80% ownership for income tax basis financial statements.

5. OCBOA Financial Statement Titles:

In general, an OCBOA financial statement title is appropriate if a user can differentiate the OCBOA title from a GAAP financial statement title.

SSARS No. 15 provides examples of appropriate financial statement titles for GAAP and OCBOA financial statements:

<table>
<thead>
<tr>
<th>Appropriate GAAP Titles</th>
<th>Appropriate OCBOA Titles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet</td>
<td>Balance sheet- cash basis</td>
</tr>
<tr>
<td>Statement of financial position (condition)</td>
<td>Statement of assets and liabilities arising from cash transactions</td>
</tr>
<tr>
<td>Statement of assets and liabilities</td>
<td>Statement of assets, liabilities, and stockholders’ equity- income tax basis</td>
</tr>
<tr>
<td></td>
<td>Balance sheet- income tax basis</td>
</tr>
<tr>
<td>Statement of income</td>
<td>Statement of revenue collected and expenses paid</td>
</tr>
<tr>
<td>Statement of operations</td>
<td>Statement of revenue and expenses- income tax basis</td>
</tr>
<tr>
<td>Statement of revenue and expenses</td>
<td>Statement of income- statutory basis</td>
</tr>
<tr>
<td>Statement of activities</td>
<td>Statement of operations- income tax basis</td>
</tr>
<tr>
<td>Statement of operations by product lines</td>
<td></td>
</tr>
<tr>
<td>Summary of operations</td>
<td></td>
</tr>
<tr>
<td>Statement of comprehensive income</td>
<td>Not applicable to OCBOA</td>
</tr>
<tr>
<td>Statement of retained earnings</td>
<td>Statement of retained earnings- income tax basis</td>
</tr>
<tr>
<td>Statement of changes in owners’ equity</td>
<td>Statement of stockholders’ equity- income tax basis</td>
</tr>
<tr>
<td>Statement of stockholders’ equity</td>
<td>Statement of retained earnings- cash basis</td>
</tr>
<tr>
<td></td>
<td>Statement of retained earnings- income tax basis</td>
</tr>
</tbody>
</table>

Those titles noted in *italic* are not listed within SSARS No. 15, but instead are provided by the author as additional acceptable titles.
Observation: Some commentators believe that GAAP terms such as “balance sheet” or “income statement” are not appropriate in presenting OCBOA financial statements. The fact is that use of GAAP titles is appropriate as long as the title is modified so that the reader can recognize the statement as a non-GAAP statement.

Although SSARS No. 19 does not deal with OCBOA titles, SAS No. 62, Special Reports, does reference that “unmodified” GAAP titles are not appropriate for OCBOA financial statements. Clearly, use of an unmodified title such as “balance sheet” or “statement of income” violates SAS No. 62 while a modification such as “balance sheet- income tax basis” or “statement of income- income tax basis,” is appropriate because the user can ascertain from the title that the statements are not prepared on a GAAP basis.

6. Income Tax Basis Disclosures

For years, the authority for OCBOA financial statement disclosures was limited to SAS No. 62, Special Reports. Given the overall ambiguity of SAS No. 62, CPAs were able to make their own interpretations as to the adequacy of OCBOA disclosures, despite objectives from peer reviewers and other third parties.

In January 1998, the auditing standards board issued Interpretation No. 14, Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting: Interpretation of SAS No. 62, Special Reports, which essentially closed the loophole. This Interpretation applies to cash, modified cash and income tax basis presentations commonly referred to as OCBOA (other comprehensive basis of accounting) financial statements.

Disclosure rules:

Financial statements prepared on an other comprehensive basis of accounting (OCBOA) should include the following disclosures:

- Summary of significant accounting policies
- Basis of accounting and how it differs from GAAP
- Similar informative disclosures to those required by GAAP

The basis of accounting footnotes may be brief with only the primary differences from GAAP being described. For example, assume that there are several differences between OCBOA and GAAP as follows:

<table>
<thead>
<tr>
<th>Allowance for bad debts</th>
<th>Insignificant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation difference</td>
<td>Significant</td>
</tr>
<tr>
<td>Unicap- Section 263A adjustment</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

In the basis of accounting footnote, only a brief description of the depreciation difference would be required with no mention of the other insignificant differences. Quantifying the differences is not required.
Example:

**Basis of Accounting:**

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which **differs** from the accrual basis of accounting required under accounting principles generally accepted in the United States of America. The **primary difference** between the Company's method and the method required by accounting principles generally accepted in the United States of America is that **depreciation has been recorded using accelerated methods authorized by the Internal Revenue Code.**

1. OCBOA statements are required to have similar disclosures to GAAP statements when such OCBOA financial statements contain items that are the same as, or similar to, those in GAAP statements.

   a) If OCBOA statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide a relevant disclosure or provide information that effectively communicates the substance of that disclosure.

   • Qualitative information may be substituted for quantitative information required by GAAP.

   • Modification of the financial statement format is **not required.**

   **Example:** GAAP requires disclosure of the future principal payments on long-term debt over the next five years. For OCBOA statements, this disclosure could be satisfied by merely disclosing the repayment terms of significant long-term borrowings without quantifying it in a schedule.

   b) GAAP disclosures that are not relevant to OCBOA statements are not required.

   Examples include:

   1) Fair value information required for investments accounted for at fair value in accordance with FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities ASC 320*. Fair value information would not be relevant for OCBOA since investments are recorded at cost.

   2) Information based on actuarial calculations that FASB No. 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans (ASC 715)*, would require for defined benefit plans would not be relevant to income tax or cash basis financial statements.

   c) The OCBOA financial statement format should comply with GAAP requirements or provide information that communicates the substance of those requirements. Such information may be communicated using qualitative information without modifying the financial-statement format.
d) **Statement of Cash Flows Issues:**
A statement of cash flows is not required for OCBOA statements. However, if the cash receipts and disbursements basis of accounting is used, the income statement is effectively a cash flow statement. If a statement of cash flows is presented in OCBOA statements, the cash flow statement should either conform to the requirements for a GAAP statement of cash flows, or disclose the substance of those requirements.

**Example:** A Company issues income-tax basis accrual financial statements and decides to include a statement of cash flows, although not required.

**Conclusion:** In accordance with the Interpretation, the cash flow statement should either conform to the GAAP requirements for a cash flow statement, or the same types of cash flow disclosures should be made either on the statement or in the notes. For example, noncash transactions such as purchasing a fixed asset with borrowings should be disclosed in the notes.

e) **Other disclosures:**
If GAAP would require disclosure of other matters such as contingent liabilities, going concern, and significant risks and uncertainties, the CPA should consider the need for that same disclosure. However, disclosures that are irrelevant to OCBOA need not be included.

**Example:** A disclosure about the use of estimates that is required by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties (ASC 275)*, would not be relevant in a cash receipts and cash disbursements basis of accounting which has no estimates.

7. **The Move Toward the Income Tax Basis Review**

The author is not alone in opining that recent FASB statements have gone too far and are inundating small, closely held businesses with irrelevant disclosures and GAAP implementation standards. In particular, two issued statements led to a practitioner revolt as these statements apply to both SEC and nonpublic entities:

1. FASB Interpretation No. 46R: *Consolidation of Variable Interest Entities (ASC 810)*
2. FASB No. 150: *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (ASC 480)*

Both of the above statements have an extreme impact on small businesses. Interpretation No. 46R requires the consolidation of certain off-balance sheet entities (variable interest entities), while FASB No. 150 (ASC 480) requires that mandatorily redeemable shares of stock be classified as liabilities on an entity’s balance sheet.

Both statements were adopted by the FASB to resolve the problems with SEC companies. However, under pressure from the AICPA and other groups, the FASB has permanently deferred the application of FASB No. 150 (ASC 480) to nonpublic entities with respect to mandatory redeemable shares of stock. The Statement still applies to public entities.
In addition to the changes in GAAP, the Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, which requires auditors to expand the amount of audit work conducted with respect to fraud. The Auditing Standards Board followed up with the issuance of a series of standards, SAS No. 104-111, collectively referred to as the risk assessment standards.

The result of the expanded GAAP changes, coupled with the changes in auditing standards initiated by the adoption of SAS No. 99 and SAS No. 104-111, has CPA firms moving toward what is likely to be the engagement of the future - the OCBOA review.

**OCBOA Review Engagement = Most Profitable Engagement**

By OCBOA, the author is referring to *income-tax basis accrual financial statements*, and other forms of OCBOA (such as cash basis).

The following chart illustrates the profit drainers and profit gainers for each type of engagement.

<table>
<thead>
<tr>
<th>OCBOA Versus GAAP</th>
<th>Audit Versus Review</th>
<th>Profit Drainers</th>
<th>Profit Gainers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit- GAAP</td>
<td>Least Profitable</td>
<td>SAS No. 99</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td>SAS No. 104-111</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Expanded GAAP</td>
<td></td>
</tr>
<tr>
<td>Profit gainers:</td>
<td></td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

| Audit- OCBOA      | More Profitable     | SAS No. 99     | Savings from OCBOA |
|                   |                     | SAS No. 104-111|               |

| Review- GAAP      | More Profitable     | None           |               |
|                   |                     | Expanded GAAP  |               |
| Profit gainers:   |                     | No SAS No. 99  |               |
|                   |                     | No SAS No. 104-111 |           |

| Review- OCBOA     | Most Profitable     | None           |               |
|                   |                     | No SAS No. 99  |               |
|                   |                     | No SAS No. 104-111 |           |
| Profit gainers:   |                     | Savings from OCBOA |             |

The result of the above chart illustrates the following:

1. Accountants should push their clients downstream from an audit to a review.
2. Accountants should push their clients from GAAP to OCBOA.
In doing so, the OCBOA review becomes the engagement of choice in many, but not all, instances.

**Oh, but the banks won’t accept OCBOA!**

The author continues to hear the skeptics; that is, accounting firms who claim that the banks will not accept OCBOA financial statements.

From experience, the author notes the following:

1. Most bankers have no idea what OCBOA (income tax basis) statements are.

2. Most bankers will go along with OCBOA statements if the accountant pushes them.
   a. Make sure the loan commitment letter does not state “GAAP financial statements.”
   b. Ask the bank for a waiver.

3. Selling the client on OCBOA is easy based on:
   a. The statements are more in line with the tax returns- easier to understand.
   b. Using OCBOA will save time and keep the review (or audit) fee down.

**Observation:** The author notes that in recent years, he has converted several clients from GAAP to OCBOA. The reason for the change was to avoid the costly exercise of consolidating an operating entity with a related-party real estate leasing company, as required under FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (ASC 810). The author convinced certain clients to convert to income tax basis accrual financial statements based on the argument that there would be a significant increase in accounting fees if the company remains on GAAP financial statements due to the consolidation requirements.

**Sample Commitment Letter Language:**

Following is a section of a bank commitment letter related to one of the author’s clients on which the author’s firm prepares an OCBOA review.

<table>
<thead>
<tr>
<th><strong>ANNUAL FINANCIAL STATEMENTS:</strong></th>
<th>The Borrower will provide monthly accounts receivable and inventory listings as well as a Borrowing Base Certificate to the Bank in addition to at least quarterly management prepared financial statements. The Borrower and the Trust guarantor must also furnish the Bank, within NINETY (90) days after the end of each fiscal year, a balance sheet, a statement of annual income and expenses and a statement of changes in financial position in form and substance and in detail satisfactory to the Bank, <strong>reviewed, with a review report thereon, by a certified public accountant.</strong> Borrower may elect to prepare income-tax basis accrual financial statements. The Borrower will also provide, promptly, such other information, concerning the Borrower or any guarantor, as the Bank may request from time to time. The individual guarantors shall provide personal financial statement and tax returns on an annual basis which must be satisfactory to the Bank in all respects. Prior to closing, the Borrower will provide the Bank with a 20X2 financial projection and cash flow budget.</th>
</tr>
</thead>
</table>

Practice Issues: Compilation and Review 163
8. OCBOA Reports and Financial Statements- Compilation and Review

EXAMPLE 1: OCBOA Compilation Report- Substantially All Disclosures Omitted- “C” Corporation

The following is an example of a compilation report under SSARS No. 19 and financial statements where substantially all disclosures and the statement of cash flows have been omitted.

Accountant’s Compilation Report

Board of Directors
XZZ Company
55 North Street
Boston, Massachusetts 02113

I (we) have compiled 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 revenue, expenses and retained earnings- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared in accordance with 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 assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

Observation: Notice that in the above report, the language “ordinarily included” has been used in lieu of the traditional language “Management has elected to omit substantially all disclosures and the statement of cash flows required by GAAP.” The reason for this change in language is due to the fact that there is no authority as to which disclosures are specifically required by OCBOA. Further, a statement of cash flows is not required by OCBOA and, therefore, not mentioned in this report paragraph.
### XYZ Company
Statement of Assets, Liabilities and Stockholders’ Equity - Income Tax Basis
December 31, 20XX
(See Accountant's Compilation Report)

#### ASSETS

**Current assets:**
- Cash $200,000
- Accounts receivable-trade 300,000
- Inventories 450,000
- Prepaid expenses 50,000

**Total current assets** 1,000,000

**Plant and equipment:**
- Cost 1,200,000
- Less accumulated depreciation 500,000

**Total plant and equipment** 700,000

**$1,700,000**

#### LIABILITIES AND STOCKHOLDERS’ EQUITY

**Current liabilities:**
- Accounts payable $300,000
- Accrued expenses 100,000
- Short-term note payable 500,000

**Total current liabilities** 900,000

**Long-term debt** 700,000

**Stockholders’ equity:**
- Common stock 100
- Retained earnings 99,900

**Total stockholders’ equity** $100,000

**$1,700,000**
### XYZ Company

Statement of Revenues, Expenses and Retained Earnings-
Income Tax Basis

For the Year Ended December 31, 20XX

(See Accountant's Compilation Report)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales- tax return</td>
<td>800,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
</tr>
</tbody>
</table>

**Deductible expenses:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Officer's compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total deductible expenses</strong></td>
<td>148,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable state income</td>
<td>52,000</td>
</tr>
<tr>
<td>State income taxes</td>
<td>(5,000)</td>
</tr>
<tr>
<td><strong>Taxable federal income</strong></td>
<td>47,000**</td>
</tr>
</tbody>
</table>

**Non-taxable and non-deductible items:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income tax expense</td>
<td>(7,500)</td>
</tr>
<tr>
<td><strong>Nondeductible life insurance</strong></td>
<td>(12,000)</td>
</tr>
<tr>
<td><strong>Nondeductible meals and entertainment</strong></td>
<td>(2,500)</td>
</tr>
<tr>
<td><strong>Non-taxable interest</strong></td>
<td>3,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>28,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>99,900</td>
</tr>
</tbody>
</table>

**Observation:** The income statement format is one that is a copy of a Form 1120 with a subtotal that agrees with the tax return. The advantage of this format is that it is user-friendly for the less financially sophisticated user.
EXAMPLE 2: S Corporation Income Statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ Company (An S Corporation)</td>
<td></td>
</tr>
<tr>
<td>Statement of Revenues, Expenses and Retained Earnings- Income Tax Basis</td>
<td></td>
</tr>
<tr>
<td>For the Year Ended December 31, 20XX</td>
<td></td>
</tr>
<tr>
<td>(See Accountant’s Compilation Report)</td>
<td></td>
</tr>
<tr>
<td><strong>Net sales</strong></td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Cost of sales- tax return</strong></td>
<td>800,000</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Deductible expenses:</strong></td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>25,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>21,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>12,000</td>
</tr>
<tr>
<td>State excise taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total deductible expenses</strong></td>
<td>153,000</td>
</tr>
<tr>
<td><strong>Taxable ordinary income</strong></td>
<td>47,000*</td>
</tr>
<tr>
<td>Other taxable income (deductible expenses):</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>1,000</td>
</tr>
<tr>
<td>Ordinary dividends</td>
<td>5,000</td>
</tr>
<tr>
<td>Additional depreciation deduction</td>
<td>(19,000)</td>
</tr>
<tr>
<td><strong>Total taxable income</strong></td>
<td>34,000**</td>
</tr>
<tr>
<td><strong>Non-taxable and non-deductible items:</strong></td>
<td></td>
</tr>
<tr>
<td>Nondeductible life insurance</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Nondeductible meals and entertainment</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Non-taxable interest</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$22,500</td>
</tr>
<tr>
<td><strong>Retained earnings:</strong></td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>$94,400</td>
</tr>
</tbody>
</table>

*Agrees with ordinary income on page 1 of form 1120S.
**Agrees with total per Schedule K of Form 1120S.
Example 3: OCBOA Compilation Report- Full Disclosure

Accountant’s Compilation Report

Board of Directors
XYZ Company
55 North Street
Boston, Massachusetts 02113

I (we) have compiled 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 revenue, expenses and retained earnings- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)
Example 4: OCBOA Review Report, Financial Statements and Disclosures

Independent Accountant’s Review Report

Board of Directors
XYZ Company
55 North Street
Boston, Massachusetts 02113

I (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 revenue, expenses and retained earnings, and cash flows – income tax basis for the year then ended. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis for accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provides a reasonable basis for our report.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis of accounting, as described in Note 1.

James J. Fox & Company, CPA

[Date]
XYZ Company  
Statement of Assets, Liabilities and Stockholders’ Equity-  
Income Tax Basis  
December 31, 20XX  
(See Independent Accountant’s Review Report)

<table>
<thead>
<tr>
<th>ASSETS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>Accounts receivable-trade</td>
<td>300,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>450,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

| **Plant and equipment:**   |          |
| Cost | 1,050,000 |
| Less accumulated depreciation | 500,000 |
| **Total plant and equipment** | 550,000 |

| **Other assets:** |          |
| Agreement not to compete | 100,000 |
| Investments | 50,000  |
| **Total other assets** | 150,000 |

**$1,700,000**

| LIABILITIES AND STOCKHOLDERS’ EQUITY |          |
| **Current liabilities:** |          |
| Accounts payable | $500,000 |
| Accrued expenses and taxes | 300,000 |
| Current portion of long-term debt | 100,000 |
| **Total current liabilities** | 900,000 |

| **Long-term debt** | 700,000 |

| **Stockholders’ equity:** |          |
| Common stock | 100 |
| Retained earnings | 99,900 |
| **Total stockholders’ equity** | $100,000 |

**$1,700,000**

See notes to financial statements.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales- tax return</td>
<td>800,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Deductible expenses:</strong></td>
<td></td>
</tr>
<tr>
<td>Officer’s compensation</td>
<td>25,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>15,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>10,000</td>
</tr>
<tr>
<td>Advertising and promotion</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>6,000</td>
</tr>
<tr>
<td>Payroll taxes and fringe benefits</td>
<td>7,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>50,000</td>
</tr>
<tr>
<td>Sundry other expenses</td>
<td>10,000</td>
</tr>
<tr>
<td>Total deductible expenses</td>
<td>148,000</td>
</tr>
<tr>
<td>Taxable state income</td>
<td>52,000</td>
</tr>
<tr>
<td>State income taxes</td>
<td>(5,000)</td>
</tr>
<tr>
<td><strong>Taxable federal income</strong></td>
<td>47,000**</td>
</tr>
<tr>
<td><strong>Non-taxable and non-deductible items:</strong></td>
<td></td>
</tr>
<tr>
<td>Federal income tax expense</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Nondeductible life insurance</td>
<td>(12,000)*</td>
</tr>
<tr>
<td>Nondeductible meals and entertainment</td>
<td>(2,500)*</td>
</tr>
<tr>
<td>Non-taxable interest</td>
<td>3,000*</td>
</tr>
<tr>
<td>Net income</td>
<td>28,000</td>
</tr>
<tr>
<td>Retained earnings:</td>
<td></td>
</tr>
<tr>
<td>Beginning of year</td>
<td>71,900</td>
</tr>
<tr>
<td>End of year</td>
<td>$99,900</td>
</tr>
</tbody>
</table>

See notes to financial statements.

* M-1 items
** agrees with taxable income per tax return
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash flow from operating activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net income</td>
<td></td>
<td>$28,000</td>
</tr>
<tr>
<td></td>
<td>Adjustments to reconcile net income</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>to net cash provided by operating activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Depreciation and amortization</td>
<td></td>
<td>85,000</td>
</tr>
<tr>
<td></td>
<td>Change in trade receivables</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Change in inventories</td>
<td></td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>Change in accounts payable</td>
<td></td>
<td>(50,000)</td>
</tr>
<tr>
<td></td>
<td>Change in prepaid expenses</td>
<td></td>
<td>(10,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>223,000</strong></td>
</tr>
<tr>
<td></td>
<td>Cash flows from investing activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Purchases of investments</td>
<td></td>
<td>(50,000)</td>
</tr>
<tr>
<td></td>
<td>Purchases of equipment</td>
<td></td>
<td>(100,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(150,000)</td>
</tr>
<tr>
<td></td>
<td>Cash flows from financial activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Repayment of long-term debt</td>
<td></td>
<td>(100,000)</td>
</tr>
<tr>
<td></td>
<td>Increase in cash and cash equivalents</td>
<td></td>
<td>(27,000)</td>
</tr>
<tr>
<td></td>
<td>Cash and cash equivalents:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Beginning of year</td>
<td></td>
<td>227,000</td>
</tr>
<tr>
<td></td>
<td>End of year</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Supplementary cash flow disclosures:</strong></td>
</tr>
<tr>
<td></td>
<td>Interest paid</td>
<td></td>
<td>$16,000</td>
</tr>
<tr>
<td></td>
<td>Income taxes paid</td>
<td></td>
<td>12,000</td>
</tr>
</tbody>
</table>

See notes to financial statements.

**Observation:** A statement of cash flows is not required to be presented in OCBOA financial statements. If a statement of cash flows is included in OCBOA financial statements, all the requirements related to the statement of cash flows must be followed including the various disclosures that are required. It is not appropriate to treat a statement of cash flows as supplementary information in OCBOA financial statements.
NOTE 1. NATURE OF OPERATIONS

The Company is a manufacturer of fine widgets used in the medical community. The Company has three retail outlets located in Notown, Everytown and Whichtown, Massachusetts. The majority of the company's sales are made to customers engaged in medical distribution within New England.

Note: The above disclosure satisfies the nature of business and the concentration of accounts receivable (ASC 275 (formerly SOP 94-6)).

NOTE 2. BASIS OF ACCOUNTING

The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax purposes which differs from the accrual basis of accounting required under generally accepted accounting principles. The primary differences between the Company’s method and the method required by generally accepted accounting principles is that a) Depreciation has been recorded using accelerated methods authorized in the Internal Revenue Code, b) Uncollectible accounts on accounts receivable are recorded when deemed uncollectible without use of an allowance account, c) Certain accruals for compensation and other expenses are recorded when paid rather than when incurred, and d) Certain costs are capitalized to inventory that are not typically capitalized under generally accepted accounting principles.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash equivalents policy:

(Only if a statement of cash flows is presented.) For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

The majority of the Company's cash is placed within one local banking institution. At times, the balance on deposit exceeds federally insured limits. To date, the Company has not experienced any losses in such account and believes it is not exposed to any significant credit risk on its cash and cash equivalents. [ASC 815 (formerly FASB No. 133)].
Uncollectible accounts:

Trade receivables are recorded at net realizable value. Interest is not accrued on past due balances. At December 31, 20XX, trade receivables had a balance in the amount of $xxx.

The Company uses the direct write-off method to account for uncollectible accounts that are not recoverable. Using the direct writeoff method, trade receivable balances are written off to bad debt expense when an account balance is deemed to be uncollectible.

\[
\text{Note: The above disclosure is the income tax basis equivalent of the ASC 942 (formerly SOP 01-6) disclosure requirement in which an entity must disclose, among other items, the method for bad debts, and the basis at which receivables are presented on the balance sheet.}
\]

Investments:

Investments are stated at amortized cost and consist of amounts deposited in a mutual fund with a balance of $50,000 and a fair value of $70,000 (based on quoted prices) at year-end.

\[
\text{Note: Because the statements are presented on an income tax basis, fair value accounting for investments per ASC 320 (formerly FASB No.115) does not apply. However, the cost and fair value of the investments are generally disclosed.}
\]

Intangibles:

Certain agreements not to compete and goodwill in connection with asset acquisitions are amortized over fifteen years.

Computer software costs are amortized over three years.

Inventories:

The Company values its inventories at cost using the first-in, first-out (FIFO) basis. Additionally, in accordance with Internal Revenue Code, certain general and administrative, and storage costs are capitalized which approximates 5% of ending inventory.

Tax positions:

The Company's policy is to record interest expense and penalties in deductible expenses. For the year ended December 31, 20XX, there was no interest and penalties recorded and no accrued interest and penalties.

The Company's federal and state tax returns are open for examination for the years 20XX, 20XX, and 20XX.
Plant and equipment:

Plant and equipment is stated at cost. Depreciation is computed using accelerated methods authorized under the Internal Revenue Code based on the following recovery periods:

<table>
<thead>
<tr>
<th>Recovery period (in years)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Motor vehicles</td>
<td>5</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>7</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>39</td>
</tr>
<tr>
<td>Building</td>
<td>39</td>
</tr>
</tbody>
</table>

In accordance with the Internal Revenue Code, the Company records additional depreciation in the year of acquisition of certain assets. In 20X2, the Company recorded additional first-year depreciation in the amount of $20,000. After deducting first-year depreciation, the remaining cost is depreciated using the recovery periods noted above.

**Note:** It may make sense to segregate the accelerated portion of the depreciation related to the section 179 deduction from the remainder of the tax depreciation.

Advertising:

Advertising is expensed as incurred and totaled $5,000.

Use of estimates:

The preparation of financial statements in conformity with the income tax basis of accounting requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**NOTE 4: INVENTORIES**

Inventories consist of the following, by component:

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw materials and supplies</td>
<td>$150,000</td>
</tr>
<tr>
<td>Work in process</td>
<td>100,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>170,000</td>
</tr>
<tr>
<td>Building</td>
<td>420,000</td>
</tr>
<tr>
<td>Additional general and administrative and storage</td>
<td>30,000</td>
</tr>
<tr>
<td>costs capitalized</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$450,000</strong></td>
</tr>
</tbody>
</table>
NOTE 5: RELATED PARTY TRANSACTIONS

From time to time, the company borrows from a shareholder to accommodate cash flow requirements. Interest is payable at 10% per annum and is recorded as an expense when paid in accordance with Internal Revenue Code requirements.

NOTE 6: PLANT AND EQUIPMENT

The components of fixed assets and related costs are as follows:

Cost:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and equipment</td>
<td>$100,000</td>
</tr>
<tr>
<td>Computer and office fixtures</td>
<td>50,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>900,000</td>
</tr>
<tr>
<td>Total</td>
<td>1,050,000</td>
</tr>
</tbody>
</table>

Less accumulated depreciation

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net book value</td>
<td>$550,000</td>
</tr>
</tbody>
</table>

Depreciation expense was $75,000 including $20,000 of additional depreciation on certain equipment.

NOTE 7: LONG-TERM DEBT

Long-term debt consisted of the following at December 31, 20XX:

Bank Note: Mortgage loan payable in monthly principal payments of $3,400 (annual of $40,000) plus interest at 8%. The unpaid note balance is due on December 31, 20XX. The note is secured by a first mortgage on certain company real estate

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$500,000</td>
</tr>
</tbody>
</table>

Shareholder: Unsecured term note requiring semiannual principal payments of $10,000 through June 30, 20XX, plus interest at 110% of the treasury bill rate (7.3% rate at December 31, 20XX)

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>200,000</td>
</tr>
<tr>
<td>700,000</td>
</tr>
<tr>
<td>100,000</td>
</tr>
</tbody>
</table>

Less current portion

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$600,000</td>
</tr>
</tbody>
</table>
A summary of the annual maturities of long-term debt for the five years subsequent to year-end follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>20XX</td>
<td>$100,000</td>
</tr>
<tr>
<td>20XX</td>
<td>100,000</td>
</tr>
<tr>
<td>20XX</td>
<td>100,000</td>
</tr>
<tr>
<td>20XX</td>
<td>100,000</td>
</tr>
<tr>
<td>20XX</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**Note:** The five-year amortization is not required in this example. The reason is that the reader can obtain the principal payments for the five years based on the description of the loan terms above. Interpretation No. 14 of SAS No. 62 states that a GAAP format does not have to be followed for disclosures provided the reader can obtain the same result from the information given. Qualitative information prevails. Also, interest expense would normally be disclosed in this note. However, it is already disclosed on the face of the statement of income.

**NOTE 8: INCOME TAXES**

The provision for income taxes consists of federal and state income taxes currently payable. A summary of the provision follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income taxes</td>
<td>$7,500</td>
</tr>
<tr>
<td>State income taxes</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>$12,500</td>
</tr>
</tbody>
</table>

**Note:** Using the format of this statement of income, this disclosure is not required because the components of federal and state taxes are already presented on the statement of income.

**NOTE 9: LEASES**

The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20XX.

A summary of the future minimum lease payments under these operating leases follows.
XYZ Company  
Notes to Financial Statements  
For the Year Ended December 31, 20XX  
(See Independent Accountant’s Review Report)

<table>
<thead>
<tr>
<th>Minimum lease payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
</tr>
<tr>
<td>20XX</td>
</tr>
<tr>
<td>20XX</td>
</tr>
<tr>
<td>20XX</td>
</tr>
<tr>
<td>20XX</td>
</tr>
<tr>
<td>Beyond 20XX</td>
</tr>
<tr>
<td>Total minimum lease payments</td>
</tr>
</tbody>
</table>

Total rent expense under these leases was $94,000.

Note: Similar to the long-term debt note, the table above could be replaced with qualitative information that provides the reader with the same information. For example, insert the following additional language into the description and remove the table as follows:
The Company has entered into various equipment leases with total monthly payments of $8,000 and various expiration dates through 20XX. Total lease payments under these leases will approximate $50,000 per year during the next five years, with the balance beyond five years totaling approximately $75,000. Total rent expense under these leases was $94,000.

NOTE 10: PENSION PLANS

The Company is the sponsor of a profit-sharing plan. All employees, exclusive of those covered by collective bargaining agreements, are eligible to enter the Plan within one year of the commencement of employment. Contributions to the Plan were $23,000.

NOTE 11: CONTINGENCIES

The Company has been named in a lawsuit that involved use of the company’s product by a customer. The possible loss from this lawsuit could range from $50,000 to $200,000. Management believes that this suit is frivolous and, the liability, if any, will not have a material effect on the company.

NOTE 12: SUBSEQUENT EVENT

On February 5, 20X1, the Company entered into an agreement to purchase certain assets of ABC Corporation for $300,000. The assets to be purchased consist of certain plant and equipment, inventories and selected accounts receivable, along with a three-year agreement not to compete from an officer of ABC Corporation.

Company X has evaluated subsequent events through March xx, 20X1, which is the date through which the financial statements were available to be issued.
NOTE 13: CAPITAL STRUCTURE

At December 31, 20XX, the company has 1,000 shares of no-par common stock issued and outstanding. Dividends are paid at the discretion of the board of directors.

NOTE 14: AGREEMENT NOT TO COMPETE

As part of a 20XX acquisition of Z Company, the company entered into an agreement with the former owner of Z Company. The terms of the agreement provide that for a payment of $150,000, the owner will not compete in the medical market for a period of five years through September 30, 20XX. The agreement is amortized over a fifteen-year period in accordance with Internal Revenue Code requirements. At December 31, 20XX, the unamortized balance of the agreement was $100,000.

NOTE 15: MAJOR CUSTOMERS

Approximately 30% of the company's sales were made to one customer.

*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. 19 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. 19.

*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. 19 rather than GAAP). SSARS No. 19 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. 19.

Following are sample reports:
Compilation Report- Income Tax Basis of Accounting with Report Exception

Accountant's Compilation Report

Board of Directors
XYZ Company
55 North Street
Boston, Massachusetts 02113

We have compiled 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 revenue, expenses and retained earnings- income tax basis for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. During our compilation, we did become aware of a departure from the income tax basis of accounting that is described in the following paragraph.

The income tax basis of accounting 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 in accordance with 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 assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA
[Date (date of completion of compilation engagement)]
Independent Accountant’s Review Report

Board of Directors
XYZ Company
55 North Street
Boston, Massachusetts 02113

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 revenue, expenses and retained earnings, and cash flows – income tax basis for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis for accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provides a reasonable basis for our report.

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 income tax basis of accounting 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.

James J. Fox & Company, CPA
[Date]
In July 2010, the AICPA issued a Technical Practice Aid that, although applies to audit engagements, has a parallel effect on compilation and review engagements on income tax basis financial statements.

Inquiry—Paragraph .04 of AU section 623, (SAS No. 62) Special Reports (AICPA, Professional Standards, vol. 1), provides as an example of an other comprehensive basis of accounting (OCBOA) “a basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.” In the case of brother-sister corporations in which each entity maintains its books and records on the basis of accounting used, or expected to be used, to file each entity’s income tax return, may an auditor report on combining financial statements in accordance with the income tax basis of accounting even though a combined income tax return is not filed?

Reply—Nothing in AU section 623 (SAS No. 62) prohibits or precludes an auditor from reporting on a combining presentation as long as the basis of accounting for each of the entities presented is the basis that they use, or expect to use, to file their income tax returns. In many instances, combining financial statements of brother-sister companies is more useful to users than the individual uncombined financial statements. As with all OCBOA presentations, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

Observation: The author believes that an accountant should follow the same conclusion made for this practice aid for a compilation or review engagement. Specifically, if an accountant performs a compilation or review engagement involving combined financial statements of related entities that do not file a combined tax return, the accountant is permitted to issue that report under OCBOA. Even though a combined tax return is not filed with the IRS, the accountant is permitted to report on an income tax basis combined financial statement as long as the financial statements of the individual entities are on the same basis used to file each entity’s federal income tax return.

M. MISCELLANEOUS PRACTICE ISSUES

In this section, the author has included several practice issues that were previously addressed in SSARS No. 9 which was part of SSARS No. 1. Effective for years ending on or after December 15, 2010, these issues become part of SSARS No. 19.

1. An accountant’s name that is included in a written document or communication containing unaudited financial statements.

There may be instances in which an accountant’s name may be included in a document or written communication that also contains unaudited financial statements of a nonpublic entity.
Example: A client prepared a financial package to be submitted to a bank or other third party. The package included various legal and financial documents including tax returns, client-prepared cash flows, and client-prepared financial statements that have not been audited, reviewed or compiled by the accountant. The client also includes the accountant’s name and address in the package as a contact person.

For publicly held entities, auditing literature offers language that can be included with the unaudited information. Yet, the SSARSs do not include similar language.

SSARS No. 19 states the following:

An accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity unless:

a. The accountant has compiled or reviewed the financial statements in compliance with the provisions of SSARS No. 19, or

b. The financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them.

For example, the indication may be worded as follows:

The accompanying balance sheet of X Company as of December 31, 20X1, the related statements of income, and cash flows for the year then ended were not audited, reviewed, or compiled by us and, accordingly, we do not express an opinion or any other form of assurance on them.

If the accountant becomes aware that his or her name is being used improperly in a client-prepared document containing unaudited financial statements, the accountant should advise the client that the use of his or her name is inappropriate and should consider taking other actions, including consulting with his or her attorney.

Observation: The SSARS does not indicate where the report should be placed within the communications or document. Logically, the report should be positioned immediately before the financial statements similar to the placement of other reports.

One situation in which the report might be needed is where a client submits a financial package to the bank or other third party. The package includes two years of financial statements compiled by the accountant. Additionally, the package includes a current six-month statement that has not been compiled or reviewed by the accountant. In fact, the accountant has no association with the statements. In such a case, the accountant should ask the client to insert the report immediately before the six-month financial statements to ensure that the bank or other third party is fully aware that he or she has nothing to do with the six-month financial statements.
2. Reporting responsibility related to the statements of retained earnings and comprehensive income

**Retained earnings:**

There is confusion in practice as to whether the change in retained earnings must be presented in the financial statements or related notes; moreover, if presented, whether the report must reference the statement.

A statement of retained earnings is not required by GAAP. However, ASC 310 (formerly APB No. 12, *Omnibus Opinion*) requires that all changes in capital must be disclosed. The change can be presented in one of three ways:

1. Separate statement of retained earnings
2. Combination statement of income and retained earnings
3. Disclosure of the change in the notes to financial statements

SSARS No. 19 state that:

a. A statement of retained earnings is not a required statement, and

b. If a statement of retained earnings is not presented, reference to the statement is *not required* in the compilation and review report.

If the change is presented in statement form either as a separate statement or as the statement of income and retained earnings, the statement should be referenced in the compilation or review report.

If the change in retained earnings is not presented in statement form, ASC 310 still requires that the change be disclosed in the notes, in which case, there is still no need to reference the statement of retained earnings in the compilation report.

**Observation:** Although disclosing the change in retained earnings (either in statement or footnote format) is useful to the reader, there are instances in practice where not presenting the change may be useful. Assume for example, that a compilation report is issued whereby substantially all disclosures are omitted. The accountant may wish to merely issue a compilation report, balance sheet and statement of income all of which are generated from a standard format such as QuickBooks®. The program may not present the change in retained earnings on the statement of income, thus requiring the accountant to export the data and customize it. In such cases, the accountant may wish to not present the change in retained earnings on the statement of income. If so, no reference to retained earnings needs to be made in the compilation report. Note, however, that in a review engagement, disclosure of the change in retained earnings (in financial statement or footnote format) is required and, not to do so results in a GAAP departure.
**What if the accountant issues a compilation report in which management omits substantially all disclosures required by GAAP. Is the accountant required to present the change in retained earnings in the financial statements?**

No. APB No. 12 (ASC 310) requires that the change in capital be disclosed. If management elects to omit substantially all disclosures, presumably one of those disclosures is the change in capital (retained earnings). Absent the footnotes, the accountant is not required to present the change in financial statement form such as a separate statement of retained earnings or a statement of income and retained earnings.

**Should the change in retained earnings be disclosed if OCBOA (income tax basis) statements are presented?**

Yes. Interpretation No. 14 of SAS No. 62, *Special Reports*, states that if OCBOA financial statements are presented, all disclosures that are similar to GAAP should be presented. Therefore, with OCBOA statements, the change in capital (retained earnings) must be either disclosed or presented in financial statement format. However, if, using OCBOA statements, management elects to omit substantially all disclosures required for OCBOA statements, one of the disclosures omitted is the change in capital (retained earnings).

Following are sample reports that illustrate the application of the requirements with respect to the change in retained earnings.

**Example 1:** XYZ Corporation discloses the change in retained earnings in the form of a statement of income and retained earnings.

**Conclusion:** Because the change in retained earnings is presented in a statement form, it should be presented in the compilation report.
Sample Compilation Report – Change in Retained Earnings
Presented in a Statement Form

Accountant’s Compilation Report

Board of Directors
XYZ Corporation

We have compiled the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income and retained earnings, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company
March 31, 20X3

Example 2: XYZ Corporation discloses the change in retained earnings in the form of a footnote.

Conclusion: Because the change in retained earnings is presented in a footnote, and not in a statement form, there is no requirement to mention it in the report.
Sample Compilation Report – Change in Retained Earnings
Presented in the Notes to Financial Statements

Accountant’s Compilation Report

Board of Directors
XYZ Corporation

We have compiled the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company
March 31, 20X3

Example 3: The accountant for XYZ Corporation issues a compilation report in which management elects to omit substantially all disclosures and the statement of cash flows, and does not disclose the change in retained earnings in a footnote or financial statement format.

Conclusion: ASC 310 (formerly APB No. 12) requires that the change in capital (retained earnings) be disclosed either in statement form or in the notes to financial statements. But, because management has elected to omit substantially all disclosures, one of those disclosures would have been the change in retained earnings. Thus, there is no disclosure of the change in retained earnings either in statement or footnote form and no reference to the change anywhere in the compilation report.
Sample Compilation Report- Change in Retained Earnings Is Not Presented in a Report or in the Notes to Financial Statements

Accountant’s Compilation Report

Board of Directors
XYZ Corporation

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

James J. Fox & Company
March 31, 20X3

Example 4: XYZ Corporation discloses the change in retained earnings in the form of a footnote. A review report is issued.

Conclusion: Because the change in retained earnings is presented in a footnote, and not in a statement form, there is no requirement to mention it in the report.
Sample Review Report - Change in Retained Earnings
Presented in the Notes to Financial Statements

Independent Accountant's Review Report

Board of Directors
XYZ Corporation

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

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

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

James J. Fox & Company
March 31, 20X3

Example 5: XYZ Corporation does not disclose the change in retained earnings in the form of a footnote or in a statement form. A review report is issued.

Conclusion: Because the change in retained earnings is not presented in a footnote or statement form, and a review report is being issued, there is a GAAP violation of ASC 310 (formerly APB No. 12). Thus, a report modification should be presented as noted in bold below.
Sample Review Report-Change in Retained Earnings Is Not Presented in the Report or in the Notes to Financial Statements

Independent Accountant’s Review Report

Board of Directors
XYZ Corporation

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

Management (owners) is (are) responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

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 accounting principles generally accepted in the United States of America.

Generally accepted accounting principles require that the change in retained earnings be disclosed in the financial statements. The Company did not disclose the change in retained earnings in the accompanying financial statement.

James J. Fox & Company
March 31, 20X3
Comprehensive income:

ASC 220, Comprehensive Income (formerly FASB No. 130), requires a company to present all components of comprehensive income in a financial statement format if a full set of financial statements is presented.

The definition of comprehensive income is stated as follows:

\[
\text{Net income} \quad \text{xx} \\
+ \quad \text{Other comprehensive income items:} \\
\quad \text{[separately presented based on their nature]} \\
\quad \quad \text{Foreign exchange gains and losses} \quad \text{xx} \\
\quad \quad \text{Unrealized gains and losses on securities available for sale} \quad \text{xx} \\
\quad \quad \text{Loss on excess of pension liability over unrecognized prior service cost} \quad \text{xx} \\
\quad \quad \text{Unrealized gains and losses arising from certain derivative transactions} \quad \text{xx} \\
\]

\[= \quad \text{TOTAL COMPREHENSIVE INCOME} \quad \text{xx}\]

The formula includes four components of other comprehensive income: foreign exchange gains and losses; unrealized gains/losses on securities available for sale; the loss on excess pension liability; and changes in the market value of futures contracts.

ASC 220 (formerly FASB No. 130) requires that comprehensive income be presented in a financial statement format. The three options available are:

1. Present a separate statement of comprehensive income
2. Combine the statement of income and comprehensive income
3. Present comprehensive income as a section within the statement of stockholders’ equity.

The following are three examples of financial statements.
**Option 1: Separate Statement of Comprehensive Income:**

<table>
<thead>
<tr>
<th>XYZ Corporation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Comprehensive Income</td>
<td></td>
</tr>
<tr>
<td>For The Year Ended December 31, 20X2</td>
<td></td>
</tr>
</tbody>
</table>

| Net income            | $120,000       |
| Other comprehensive income: |            |
| Unrealized gain on securities available for sale (net of tax effect of $20,000) | 30,000       |
| Foreign currency translation adjustments (net of tax effect of $16,000) | 24,000       |
| Other comprehensive income | 54,000       |
| **Comprehensive income** | **$174,000**  |

See Independent Accountant’s Review Report
## Option 2: Combined Statement of Income and Comprehensive Income:

**XYZ Corporation**  
Statement of Income and Comprehensive Income  
For The Year Ended December 31, 20X2

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>$800,000</td>
</tr>
<tr>
<td>Income from operations</td>
<td>$200,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>$80,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$120,000</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Unrealized gain on securities available for sale (net of tax effect of $20,000)(^{10})</td>
<td>$30,000</td>
</tr>
<tr>
<td>Foreign currency translation adjustments</td>
<td></td>
</tr>
<tr>
<td>(net of tax effect of $16,000)</td>
<td>$24,000</td>
</tr>
<tr>
<td>Total other comprehensive income</td>
<td>$54,000</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$174,000</td>
</tr>
</tbody>
</table>

See Independent Accountant’s Review Report

---

\(^{10}\) Alternatively, the tax effect of other comprehensive income could be presented as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized gain</td>
<td>50,000</td>
</tr>
<tr>
<td>Foreign currency adjustments</td>
<td>40,000</td>
</tr>
<tr>
<td>Other comprehensive income, before taxes</td>
<td>90,000</td>
</tr>
<tr>
<td>Income tax expense allocated</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>54,000</td>
</tr>
</tbody>
</table>
### Option 3: Present Comprehensive Income As Part of the Statement of Stockholders’ Equity:

**XYZ Corporation**

**Statement of Stockholders’ Equity**

For The Year Ended December 31, 20X2

<table>
<thead>
<tr>
<th></th>
<th>Accumulated Other Comprehensive Income</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Retained earnings</td>
<td>Unrealized gains on</td>
<td>Foreign currency</td>
</tr>
<tr>
<td>Beginning balance</td>
<td>$2,525,000</td>
<td>$2,000,000</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>Comprehensive income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>120,000</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gains on securities available for sale (net of tax effect of $20,000)</td>
<td>30,000</td>
<td>30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency translation adjustments (net of tax effect of $16,000)</td>
<td>24,000</td>
<td>0</td>
<td>0</td>
<td>24,000</td>
</tr>
<tr>
<td></td>
<td>54,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Comprehensive income</strong></td>
<td>174,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$2,699,000</td>
<td>$2,120,000</td>
<td>$40,000</td>
<td>$39,000</td>
</tr>
</tbody>
</table>

See Independent Accountant’s Review Report

**Note:** If option (1) or (2) above is selected, the title of the financial statement will be changed to either *Statement of Comprehensive Income* or *Statement of Income and Comprehensive Income*.

For most companies, unrealized gains and losses on securities available for sale is the most likely component of comprehensive income. ASC 320 (formerly FASB No. 115) requires that unrealized gains and losses on securities available for sale must be presented in stockholders’ equity as a separate component, net of the tax effect. The unrealized gains or losses are presented under the caption, *accumulated other comprehensive income*. 

Practice Issues: Compilation and Review 194
If a company does not have any of the four components of other comprehensive income, ASC 220 (formerly FASB No. 130) does not apply and a presentation of comprehensive income is not required.

SSARS No. 19 states that if the statement of comprehensive income is presented, reference to the statement should be made in the appropriate paragraphs. Thus, if a statement of comprehensive income is required, the compilation and review reports should be modified to include reference to the statement as follows.

Example: Compilation Report-
Statement of Income and Comprehensive Income Presented

Accountant’s Compilation Report

Board of Directors
XYZ Corporation

We have compiled the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income and comprehensive income, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

James J. Fox & Company
March 31, 20X3
Example: Review Report- Statement of Income and Comprehensive Income Presented

Independent Accountant’s Review Report

Board of Directors
XYZ Corporation

We have reviewed the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income and comprehensive income, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

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

James J. Fox & Company
March 31, 20X3


ASC 220 (formerly FASB No. 130) has a special rule whereby if a full set of financial statements is not presented, a statement of comprehensive income does not have to be displayed in a financial statement format even though the company has one of the four components of other comprehensive income.

*How does this exemption impact the language found in the third paragraph of a compilation that omits substantially all disclosures and the statement of cash flows?*

The statement of comprehensive income is not required unless a full set of financial statements is presented. If management elects to omit the statement of cash flows in a compilation engagement, a full set of financial statements is not present and the statement of comprehensive income is not required.
Interpretation No. 10 of AR Section 80 of SSARS No. 19: Omission of the Display of Comprehensive Income in Compiled Financial Statements, deals with the reporting requirements for a compilation engagement in which a statement of comprehensive income is omitted.

**Question:** When an element of comprehensive income is present, can the display of comprehensive income be omitted when issuing a compilation report that omits substantially all disclosures required by accounting principles generally accepted in the United States of America?

**Interpretation:** Yes. ASC 220, Comprehensive Income (formerly FASB No. 130), requires the display of comprehensive income when a full set of financial statements is presented in conformity with accounting principles generally accepted in the United States of America. However, the display of comprehensive income may be omitted by identifying the omission in the compilation report or, if the engagement is to compile financial statements that are not expected to be used by a third party and the accountant does not report on those financial statements, in the engagement letter. The following is suggested modified wording (shown in italic) to the paragraph in the compilation report:

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

In addition, if the accountant compiles financial statements that omit substantially all disclosures and the display of comprehensive income but includes the statement of cash flows, the following is suggested modified wording (shown in italic) to the compilation report:

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

If the accountant compiles financial statements that include substantially all disclosures required by GAAP, but omit the display of comprehensive income, the omission is a departure from GAAP.

Additionally, if an element of comprehensive income has not been computed, for example, unrealized gains and losses arising from investments in marketable securities classified as “available for sale,” then the accountant should consider a departure from generally accepted accounting principles and follow that guidance.
3. Miscellaneous reporting issues

Dates of reports:

SSARS No. 19 provides the following requirements for determining the date of a compilation or review report:

In a compilation engagement, the date of the compilation report is the date of completion of the compilation. In a review engagement, the review report should be dated no earlier than the date on which the accountant has accumulated review evidence sufficient to provide a reasonable basis for concluding that the accountant has obtained 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 GAAP or another financial reporting framework. In other words, the review report date should be no earlier than the date on which the accountant has completed his or her review procedures sufficiently to report on the engagement.

Must the accountant’s report be printed on the firm’s letterhead?

No. The SSARSs do not require the accountant’s report to be printed on the firm’s letterhead. However, letterhead does add a level of formality to the presentation. Further, if the report does not appear on letterhead, a heading such as CPA’s Report may be useful to reduce any misunderstanding about the document.

To whom should the accountant’s report be addressed?

SSARS No. 19 states that the compilation or review report should be addressed as required by the circumstances, which is not very meaningful. Generally, the report (review or compilation) should be addressed to the owner, manager, board of directors, board of stockholders, or each, in a corporate setting.

Who should sign the report?

SSARS No. 19 states that the signature of the accountant is required, either in a manual or printed (stamped, electronic or typed) form. If there is a firm, the firm’s signature rather than the individual’s signature should accompany the report.

4. Supplementary information reporting

SSARS No. 19 includes guidance on reporting for supplementary information. However, the guidance is unclear related to separate reporting on supplementary information in a compilation engagement.
SSARS No. 19 allows for a separate report on supplementary information in a compilation engagement.

Specific language in SSARS No. 19 follows:

When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should refer to the other data or the accountant can issue a separate report on the other data. If the separate report is issued, the report should state that the other data accompanying the financial statements are presented only for supplementary analysis purposes and that the information has been compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data.

The following two reports illustrate the two reporting options when compiling supplementary information:

Facts:

An accountant is performing a compilation engagement. Management has elected to omit substantially all disclosures and the statement of cash flows.

The financial statements and supplementary information consist of the following:

- Balance sheet
- Statement of income and retained earnings
- Schedule of operating expenses (supplementary information)
Option 1: Report on the Compiled Supplementary Information with the Compilation Report

Accountant’s Compilation Report

Board of Directors
XYZ Company

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended, and the accompanying schedule of operating expenses, which is presented for supplementary analysis purposes only. I (we) have not audited or reviewed the accompanying financial statements and supplementary schedule and, accordingly, do not express an opinion or provide any assurance about whether the financial statements and supplementary schedule are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements and supplementary schedule in accordance with the accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements and supplementary schedule.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements and supplementary schedule without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements and supplementary schedule.

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

James J. Fox & Company
March 31, 20X3
Accountant’s Compilation Report

Board of Directors
XYZ Company

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

James J. Fox & Company
March 31, 20X3
Accountant's Report on Compiled Supplementary Information

The information included in the accompanying schedule on page 4 is presented only for supplementary analysis purposes and has been compiled from information that is the representation of management, without audit or review. We do not express an opinion or any other form of assurance on it.

James J. Fox & Company
March 31, 20X3

Other issues related to supplementary information

In the following section, the author addresses some of the more important issues that appear related to supplementary information in a compilation or review engagement.

a. Reporting Options

According to the AICPA's Peer Review Committee, one of the significant errors detected in peer reviews is the mishandling of the reporting on supplementary information. As a result, the author believes it is important to identify the rules associated with presenting supplementary information and the reporting thereon as it relates to compilation and review engagements.

The rules for dealing with supplementary information in compilation and review engagements are found in SSARS No. 19:

Paragraph 2.53 of SSARS No. 19 states the following in connection with supplementary information in a compilation engagement:

“When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he is taking with respect to such information.”

With respect to supplementary information in a review engagement, the accountant has two options according to Paragraph 3.60 of SSARS No. 19:
Option 1-Review the supplementary information: Report that:

“the other data accompanying the financial statements are presented only for purposes of additional analysis and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data.”

Option 2-Compile the supplementary information: Report that:

“the other data accompanying the financial statements are presented only for purposes of additional analysis and have not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or provide any assurance on such data.”

Supplementary information should not be reviewed when the basic financial statements have been compiled. The following table summarizes the options:

<table>
<thead>
<tr>
<th>Review Engagements</th>
<th>Compilation Engagements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Review the supplementary information and report on it.</td>
<td>1. Supplementary information may not be reviewed in a compilation engagement.</td>
</tr>
<tr>
<td>2. Compile the supplementary information.</td>
<td>2. Compile the supplementary information.</td>
</tr>
</tbody>
</table>

Observation: In a review engagement, most accountants will perform analytical procedures on supplementary information as part of the engagement. For example, analytical procedures are performed on many of the individual operating expenses listed in the operating expense schedule. Therefore, it is rare that an accountant compiles, rather than reviews, supplementary information in a review engagement.
Sample Review Report with Supplementary Information Reviewed

Independent Accountant’s Review Report

Board of Directors
XYZ Corporation

We have reviewed the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

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

Our review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America. The information included in the accompanying schedules on pages 14 and 15 is presented only for purposes of additional analysis and has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. We are not aware of any material modifications that should be made to this data in order for it to be in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company
March 31, 20X3
Independent Accountant’s Review Report

Board of Directors
XYZ Corporation

We have reviewed the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

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

Our review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America. The information included in the accompanying schedules on pages 14 and 15 is presented only for purposes of additional analysis and has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but was compiled from information that is the representation of management, without audit or review. Accordingly, we do not express an opinion or any other form of assurance on such data.

James J. Fox & Company
March 31, 20X3

Alternatively, a separate report on supplementary information may be placed behind the basic reviewed financial statements and notes.
b. What is supplementary information?

SSARS No. 19 does not define supplementary information. However, paragraph 2.53 of SSARS No. 1 describes such information as information presented for supplementary analysis purposes. There is no authority defining what SSARS No. 19 means. But SAS No. 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents, defines supplementary information to include the following categories of information, as modified by the author:
• Additional details of items in or related to the basic financial statements, unless the information has been identified as being part of the basic financial statements. Attached schedules that relate to line items on the financial statements including:

- Operating expense schedule(s)
- Schedule of cost of sales
- Schedule of selling and G&A expenses
- Details of marketable securities
- Schedule of property and equipment
- Aging analysis of accounts receivable
- Detailed analysis of sales by product line, territory, or salesman

• Modifications to basic financial statements
  Example: Budgeted financial information presented alongside historic income statement

• Graphs and charts of the information presented on the financial statements (e.g., pie charts, etc.)

• Schedule of financial data for individual companies within a consolidated group

• Condensed financial statements for previous years

• Statistical data including division analyses

• Detailed analysis of inventories and accounts receivable

• Supplementary information related to specialized industries (e.g., common interest realty association supplementary information)

• Other material, some of which may be from sources outside the accounting system or outside the entity

• Detailed analysis of companies included in consolidated financial statements along with the eliminating entries

Are percentages that accompany an income statement considered supplementary information?

Although statistical data is usually considered supplementary information, most practitioners do not treat financial statement percentages as supplementary information. For example, an income statement may present percentages in a separate column. Generally, this information would not be considered supplementary information and the author believes there is no additional reporting requirement in connection with this information.
Are charts and graphs considered supplementary information?

The advent and availability of easy-to-use computer software capable of generating graphs has resulted in an increase in the inclusion of graphs in financial statement presentations. As a result, many CPAs continue to inquire about their reporting responsibility for graphs that accompany financial statements in compilation and review engagements.

Graphs may depict information:

- Identified in the financial statements such as a pie chart depicting various components of sales, cost of sales and operating expenses.
- Derived from the accounting records such as a bar graph depicting sales by product line.
- Derived from sources outside the financial statements and accounting records: Example: a pie chart depicts square feet of selling space by product line.

Presently, SSARS No. 19 does not address the reporting on graphs accompanying financial statements. Yet, SSARS No. 19, paragraph 2.53 does make reference to supplementary information accompanying the basic financial statements. Absent authority, an accountant may wish to consider the graphs and charts as supplementary information and report on them as such.

Procedures for reviewing or compiling supplementary information

Although SSARS No. 19 does not identify procedures to follow in compiling or reviewing supplementary information, it would appear prudent to follow the same procedures that are utilized to compile or review the underlying financial statements.

Although not binding, it may be prudent that supplementary information in the form of graphs and charts be compiled regardless of whether the underlying financial statements are compiled or reviewed. By doing so, the accountant takes a more practical and conservative approach given the absence of authoritative standards and criteria for these presentations.

Examples of procedures that might be employed to compile supplementary information charts and graphs include:

- Read the title, captions, and numerical information included in the graph to determine whether that information agrees with the information presented in the financial statements.
- Consider whether the graph’s pictorial representation agrees with the quantities and relationships it purports to represent.

Example of a misrepresentation of a graph: Comparative financial statements might indicate that the increase in net income from 20X1 to 20X2 is ten percent, and the captions in the accompanying bar graph might accurately identify the amount of net income in each year consistent with the income statement. However, the graph is drawn so that the increase in the height of the bar is significantly greater than ten percent.
Conclusion: If an accountant concludes that there is a material inconsistency between the graph and the financial statements, the accountant should determine whether the financial statements, the graph, or both require revision, and, if appropriate, should ask the client to revise the incorrect or misleading information. If the information is not revised to eliminate the problem, the accountant should consider revising the report to describe the inconsistency or misleading information or should consider withdrawing from the engagement.

5. How to present supplementary information

There is no authority on how supplementary information should be presented. However, the author recommends that the pages of supplementary information be easily identified versus the financial statement pages. In order to do so, the author believes the following is good form:

a. Page Legend: Make sure each page of supplementary information makes reference to the Accountant's report.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Recommended Legend</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the report on supplementary information is included in the report on financial statements</td>
<td>See Accountant's Report, See Accountant’s Compilation Report, or See Independent Accountant's Review Report</td>
</tr>
<tr>
<td>If there is a separate report on supplementary information</td>
<td>See Accountant's Report on Supplementary Information</td>
</tr>
</tbody>
</table>

b. Titles on pages: Although not authoritative, titles should be selected that ensure that the reader clearly differentiates the supplementary information from the primary financial statements.

Examples:

ABC Company
Schedule of Operating Expenses
For the Year Ended December 31, 20X1
(See Accountant's Report on Supplementary Information)

ABC Company
Supplementary Analysis of Operating Expenses
For the Year Ended December 31, 20X1
(See Accountant's Report on Supplementary Information)

In addition to the above legends and titles, some practitioners include a separate introductory title page for supplementary information that follows the notes to financial statements. The author does not believe this is necessary provided the reader can differentiate between the financial statements and supplementary information.
c. Reporting on budgets presented alongside historic statements

At times, an accountant 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 an accountant 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 2.53 of SSARS No. 19.

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.

Sample Report: Compiled Financial Statements Are Accompanied by a Budgeted Income Statement for an Expired Period

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**Accountant’s Compilation Report**

*Board of Directors*

*XYZ Company*

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income- historical and budgeted, retained earnings and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements (including the budgeted income statement information) and, accordingly, do not express an opinion or provide any assurance about whether the financial statements and supplementary analysis are in accordance with accounting principles generally accepted in the United States of America. The budgeted income statement information is presented for supplementary analysis purposes only.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements and supplementary analysis in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements and supplementary analysis.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements and supplementary analysis without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements and supplementary analysis.

[Signature of accounting firm or accountant, as appropriate]

[Date] (date of completion of compilation engagement)
Sample Statement of Income: Actual and Expired Budgeted Income Statement

XYZ Company
Statement of Income- Historical and Budgeted
For The Year Ended December 31, 20XX
(See Accountant's Compilation Report)

<table>
<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Budgeted</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
<tr>
<td>Net sales</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Net operating income</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Other income</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Income taxes</td>
<td>xx</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>Net income</td>
<td>$xx</td>
<td>$xx</td>
<td>$xx</td>
</tr>
</tbody>
</table>

Prospective information presented for an unexpired period

If an accountant is asked to report on prospective financial information for an unexpired period, SSAE No. 10, Attestation Standards, would apply. The unexpired budgeted information is not supplementary information because it has not yet expired.

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

Under this provision:

- The accountant may report on the historical statements under SSARS No. 19, and
- Disclaim on the prospective budgeted financial information.

Further, the accountant is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:
a) Is labeled as budgeted,

b) Does not extend beyond the current fiscal year, and

c) Is presented with interim historical financial statements for the current year.

If the above criteria are met, the accountant 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 accountant’s knowledge, undertaken with the intention of misleading those who might use it.

The accountant 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: Harry Callahan, CPA prepares a twelve-month budget for the year ended December 31, 20X1. After six months, Harry compiles a six month historical statement for the six-month period ended June 30, 20X1.

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

- 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.

The report and related financial statement looks like this:
Compilation Report: Six Months Historical Financial Statements and Twelve Months Prospective Financial Statements

Accountant’s Compilation Report

Board of Directors
XYZ Company

We have compiled the accompanying balance sheet of XYZ Company as of June 30, 20X1, and the related statements of income, retained earnings and cash flows for the six month period then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

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 is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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 and Company, CPA
[Date] (date of completion of compilation engagement)
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)

<table>
<thead>
<tr>
<th></th>
<th>Six month period ended June 30, 20X1 (Compiled)</th>
<th>Year ended December 31, 20X1 (Budgeted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Net income before income taxes</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Income taxes</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Net income</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

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

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

N. COMMUNICATIONS BETWEEN PREDECESSOR AND SUCCESSOR CPAS

With respect to audits, SAS No. 84, Communications Between Predecessor and Successor Auditors, requires that a successor auditor communicate with a predecessor auditor prior to accepting an audit engagement.

For compilation and review engagements, SSARS No. 4, Communications Between Predecessor and Successor CPAs, provides guidance on communications between accountants when the successor accountant decides to communicate with the predecessor accountant regarding the acceptance of an engagement.
Unlike an audit engagement, SSARS No. 4 does not require successor CPAs to communicate with or obtain access to working papers of predecessor CPAs in accepting compilation or review engagements. However, SSARS No. 4 does not prevent an accountant from making a communication and, in certain circumstances, it may be helpful.

SSARS No. 19 provides additional guidance on the successor-predecessor accountant communication process as follows:

1. Definitions of predecessor and successor accountant

SSARS No. 19 provides the following definitions:

**Successor accountant:** An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted the engagement.

**Predecessor accountant:** An accountant who:

- Has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and
- Has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

2. A successor accountant is not required to communicate with a predecessor accountant in connection with acceptance of a compilation or review engagement. But, he or she may believe it is beneficial to obtain information that will assist in determining whether to accept the engagement.

3. The successor may consider making inquiries of the predecessor accountant when circumstances exist as follows:

   - The information obtained about the prospective client and its management and principals is limited or appears to require special attention,
   - The change in accountants takes place substantially after the end of the accounting period for which statements are to be compiled or reviewed, or
   - There have been frequent changes in accountants.

4. The successor accountant should be aware that the predecessor accountant and the client may have disagreed about accounting principles, procedures applied by the predecessor accountant, or similarly significant matters.

5. The successor should request permission from the prospective client to make any inquiries of the predecessor accountant.
Except as allowed by the AICPA Code of Professional Conduct, the accountant is precluded from disclosing any confidential information obtained in the course of the engagement unless the client specifically consents.

6. If the successor accountant decides to communicate with the predecessor, the successor accountant should request the client to:

- Permit the successor accountant to make inquiries of the predecessor accountant, and
- Authorize the predecessor accountant to respond fully to those inquiries.

7. If the prospective client refuses to permit the predecessor accountant to respond or limits the response, the successor should inquire about the reasons and consider the implications of that refusal in determining whether to accept the engagement.

8. If the successor decides to communicate with the predecessor, the inquiries should be specific and reasonable regarding matters that will assist the successor in determining whether to accept the engagement. Examples of such matters include:

- Information that might bear on the integrity of management or the owners,
- Disagreements with management or the owners about accounting principles or the necessity for the performance of certain procedures or similarly significant matters,
- The cooperation of management or the owners in providing additional or revised information,
- The predecessor’s knowledge of any fraud or illegal acts perpetrated within the client, and
- The predecessor’s understanding of the reason for the change of accountants.

9. The predecessor is required to respond promptly and fully to the inquiries on the basis of known facts.

- If the predecessor decides, due to unusual circumstances, such as impending, threatened, or potential litigation, disciplinary proceedings, or other circumstances, not to respond fully to the inquiries, the predecessor should indicate that the response is limited. The successor should consider the effect of such limited responses on his or her decision to accept the engagement.

**Note:** The SSARS indicates that unpaid fees are not considered to be an unusual circumstance for which the predecessor refuses to respond to inquiries.
10. If the successor wishes to review the predecessor’s working papers, the successor should request the client to authorize the predecessor to allow access.

- The predecessor should determine which working papers are to be made available for review and which may be copied.
- Usually, the predecessor should provide the successor with access to certain working papers related to matters of continuing accounting significance and contingencies.
- Valid business reasons including, but not limited to, unpaid fees may lead the predecessor to decide not to allow access to the working papers.
- The predecessor may wish to reach an agreement with the successor as to the use of the working papers. Such an agreement may be in writing in the form of a “Successor Accountant Acknowledgement Letter.”
- The predecessor should not be expected to make the working papers available until the client has designated an accountant as a successor.

Note: The SSARSs do not address the form and content of working papers for a review or compilation.

11. The successor is not permitted to reference the predecessor’s report or work in his or her own report except if financial statements for the prior year are presented comparatively and those statements were compiled or reviewed by the predecessor.

In such a case, the successor should include the following language in his report for the current period:

Review report for 20X3 would include language related to 20X2 as follows:

The 20X2 financial statements of XYZ Company were reviewed by other accountants whose report dated March 1, 20X3, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.
Compilation report for 20X3 would include language related to 20X2 as follows:

The 20X2 financial statements of XYZ Company were compiled by other accountants whose report dated March 1, 20X3, stated that they did not express an opinion or any other form of assurance on those statements.

12. If, during an engagement, the successor becomes aware of information that leads him or her to believe that the financial statements reported on by the predecessor may require revision, the successor should request the client to communicate this information to the predecessor.

If the client refuses to communicate with the predecessor or if the successor is not satisfied with the predecessor’s course of action, the successor should evaluate possible implications for the current engagement and whether to resign. Also, the accountant may wish to consult with legal counsel about the appropriate course of action.

What if the previous year’s financial statements were audited and the current year will be compiled or reviewed?

There is no requirement for the successor accountant to communicate with the predecessor auditor if the previous year was audited and the current year will be compiled or reviewed.

SSARS No. 4 does not require any communication in this situation. And, from the auditing side, SAS No. 84 applies only when both the previous and current year statements involve an audit. The same answer would apply if the opposite were true with the prior year statements compiled or reviewed with an upgrade to a current-year audit.

The following is a sample letter to be signed by the successor accountant before having access to the predecessor’s working papers.
Sample Successor Accountant Acknowledgment Letter

Roberts, Park and Roberts, CPA (Successor Accountant)
51 Main Street
Nowhere, MA, 49393

We have previously [reviewed or compiled], in accordance with Statements on Standards for Accounting and Review Services the December 31, 20X2, financial statements of XYZ Corporation (XYZ). In connection with your [review or compilation] of XYZ’s 20X3 financial statements, you have requested access to our working papers prepared in connection with that engagement. XYZ has authorized our firm to allow you to review those working papers.

Our [review or compilation], and the working papers prepared in connection therewith, of XYZ’s financial statements were not planned or conducted in contemplation of your [review or compilation]. Therefore, items of possible interest to you may not have been specifically addressed. Our use of professional judgment for the purpose of this engagement means that matters may have existed that would have been assessed differently by you. We make no representation about the sufficiency or appropriateness of the information in our working papers for your purposes.

We understand that the purpose of your review is to obtain information about XYZ and our 20X2 results to assist you in your 20X3 engagement of XYZ. For that purpose only, we will provide you access to our working papers that relate to that objective.

Upon request, we will provide copies of those working papers that provide factual information about XYZ. You agree to subject any such copies or information otherwise derived from our working papers to your normal policy for retention of working papers and protection of confidential client information. Furthermore, in the event of a third-party request for access to your working papers prepared in connection with your [reviews or compilations] of XYZ Corporation, you agree to obtain our permission before voluntarily allowing any such access to our working papers or information otherwise derived from our working papers, and to obtain on our behalf any releases that you obtain from such third party. You agree to advise us promptly and provide us a copy of any subpoenas, summons, or other court order for access to your working papers that include copies of our working papers or information otherwise derived therefrom.

Additional language to consider:
Because your review of our working papers is undertaken solely for the purpose described above and may not entail a review of all of our working papers, you agree that (1) the information obtained from the review will not be used by you for any other purpose, (2) you will not comment, orally or in writing, to anyone as a result of that review about whether our engagement was performed in accordance with Statements on Standards for Accounting and Review Services, and (3) you will not provide expert testimony or litigation services or otherwise accept an engagement to comment on issues relating to the quality of our engagement.
Is a successor accountant permitted to name a predecessor accountant in his or her compilation or review report?

Footnote 9 of SSARS No. 2, *Reporting on Comparative Financial Statements*, provides that a successor accountant may name the predecessor accountant if the predecessor’s practice was acquired by, or merged with, that of the successor accountant.

SSARS No. 11 amended SSARS No. 2 to permit the naming of a predecessor accountant if the practice was acquired by or merged with that of the successor accountant. Effective in 2010, SSARS No. 11 is superseded by SSARS No. 19 but the amendment to SSARS No. 2 is retained.

**Predecessor or successor accounting reporting on changed prior period financial statements**

SSARS No. 2 requires that either the predecessor or successor accountant report on changed prior period financial statements, as restated. The successor is precluded from reporting on the restatement adjustment. SSARS No. 2 would be amended to allow the successor to report on the restatement adjustment.

SSARS No. 2 allows the successor accountant to report on the restatement adjustment while indicating that a predecessor accountant reported on the financial statements of the prior period before restatement.
Sample Compilation Report

Accountant’s Compilation Report

Board of Directors
XYZ Company

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income and retained earnings, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America. We also compiled the adjustments described in Note X, that were applied to restate the 20X1 financial statements. The financial statements of XYZ Company as of December 31, 20X1, before the adjustments that were applied to restate the 20X1 financial statements, were compiled by other accountants whose report dated March 31, 20X2, did not express an opinion or any other form of assurance on those financial statements.

[Same second and third paragraphs]
Sample Review Report

Independent Accountant’s Review Report

Board of Directors
XYZ Corporation

We have reviewed the accompanying balance sheet of XYZ Corporation as of December 31, 20X2, and the related statements of income, retained earnings and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion. The financial statements of XYZ Company as of December 31, 20X1 before the adjustment(s) described in Note X that were applied to restate the 20X1 financial statements, were reviewed by other accountants whose report dated March 31, 20X2, stated that they were not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

We also reviewed the adjustments described in Note X that were applied to restate the 20X1 financial statements. Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company
March 31, 20X3
O. SELECTED INFORMATION – SUBSTANTIALLY ALL DISCLOSURES REQUIRED BY GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ARE NOT INCLUDED

Interpretation No. 9 of AR Section 80 of SSARS No. 19, Use of the Label ‘Selected Information—Substantially All Disclosures required by [the applicable financial reporting framework] Are Not Included’ in Compiled Financial Statements, clarifies the practice of disclosing selected information as required by GAAP.

In some instances, a client may wish to include only selected disclosures in compiled financial statements. For example, the bank may accept compiled financial statements that include only long-term debt, fixed asset and lease footnotes, thereby excluding the remainder of disclosures required by GAAP (or OCBOA).

If this is the case, may the accountant issue a compilation report indicating that substantially all of the disclosures and the statement of cash flows have been omitted?

Response:

Paragraph 2.20 of SSARS No. 19 states:

“An entity may request an accountant to compile financial statements that omit substantially all of the disclosures required by generally accepted accounting principles, including disclosures that might appear in the body of the financial statements. The accountant may compile such financial statements provided the omission of substantially all disclosures is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.”

The question is what is meant by "substantially all disclosures"?

SSARS No. 19 does not elaborate; however, it does appear that the SSARS No. 19 exception is not an all or nothing situation. Meaning, a client may select certain disclosures to accompany the financial statements provided certain criteria are met and come under the guise of the "substantially all" criteria.

Paragraph 2.20 of SSARS No. 19 continues by stating:

“When the entity wishes to include disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled, "Selected Information- Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included"
**Example:** Jimmy's client, Fred asks Jimmy to compile financial statements. Fred has little need for a statement of cash flows and most of the disclosures required by GAAP except that the local bank wants a disclosure of the long-term debt and operating leases.

**Conclusion:** Jimmy may issue a compilation report as follows along with the attached notes to financial statements.

```
Accountant’s Compilation Report

Board of Directors
XYZ Corporation
New Town, NY

We have compiled the accompanying balance sheet of XYZ Corporation as of........(standard first paragraph)

Management (owners) is (are) responsible  (standard second paragraph)

Our responsibility is to conduct the compilation  (standard third paragraph)

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

James J. Fox & Company

Date:
```
XYZ CORPORATION
SELECTED INFORMATION-
Substantially All Disclosures Required
by Generally Accepted Accounting
Principles Are Not Included
December 31, 20X1

Note 1: Long-term debt:

A summary of long-term debt at December 31, 20X1 follows:

**No Loan Bank**: Term loan with monthly payments of $10,000 plus interest at nine percent per annum through the year 20X6. Secured by a first mortgage on certain corporate real estate. $1,000,000

**Installment loans**: Several installment loans relating to the purchase of certain manufacturing equipment. The terms of these loans require monthly principal payments of $5,000 plus interest at 10% per annum through the year 20X6. 300,000

Less current portion (100,000)

$1,200,000

Interest expense was $118,000.

A summary of the annual maturities of long-term debt for the five years subsequent to 20X1 follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$100,000</td>
</tr>
<tr>
<td>20X3</td>
<td>120,000</td>
</tr>
<tr>
<td>20X4</td>
<td>140,000</td>
</tr>
<tr>
<td>20X5</td>
<td>160,000</td>
</tr>
<tr>
<td>20X6</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Note 2: Leases:

The Company leases its principal operating facility under a five-year non-cancelable operating lease. The terms of the lease require monthly payments of $15,000 with periodic increases through June 20X5. The company has a five-year option for renewal for the years 20X6 to 20X9 at an increased monthly rental rate.
The following consists of the future minimum rental payments due under this operating lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>$180,000</td>
</tr>
<tr>
<td>20X3</td>
<td>190,000</td>
</tr>
<tr>
<td>20X4</td>
<td>200,000</td>
</tr>
<tr>
<td>20X5</td>
<td>205,000</td>
</tr>
<tr>
<td>Total</td>
<td>$775,000</td>
</tr>
</tbody>
</table>

**What if all disclosures are included except one. Does the "substantially all" paragraph apply?**

**Response:** Interpretation No. 9 of AR Section 80 of SSARS No. 19, Use of the Label ‘Selected Information—Substantially All Disclosures required by [the applicable financial reporting framework] Are Not Included’ in Compiled Financial Statements, provides the rules.

**Question:** Can an accountant label notes to the financial statements “Selected Information- Substantially All Disclosures Required by [identify the applicable financial reporting framework such as “accounting principles generally accepted in the United States of America”] Are Not Included” when the client includes more than a few required disclosures?

**Response:** No. As discussed in paragraph 2.20 of AR Section 80 of SSARS No. 19, when the entity wishes to include disclosures about only a few matters in the form of notes to the financial statements, such disclosures should be labeled “Selected Information- Substantially All Disclosures Required by [identify the applicable financial reporting framework such as “accounting principles generally accepted in the United States of America”] Are Not Included.”

When the financial statements include more than a few disclosures, this guidance is not appropriate. The omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation or review report like any other departure from GAAP, and the nature of the departure and its effects, if known, should be disclosed.

The label “Selected Information- Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included” should not be used in situations where substantially all disclosures are included. The label “Selected Information-Substantially All Disclosures Required by [identify the applicable financial reporting framework such as “accounting principles generally accepted in the United States of America”] Are Not Included” is not intended to be used for the omission of (intentionally or unintentionally) one or more disclosures. In determining whether use of the label is appropriate, the accountant should use his or her judgment to all the facts and circumstances.
Example: A client wishes to include all notes to financial statements except a disclosure of risks and uncertainties as required by SOP 94-6 (ASC 275).

Conclusion: Because all but one required disclosure are included in the notes, the use of “Selected Information- Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included” is not appropriate. Instead, the missing disclosure should be treated as a GAAP departure, as follows:

Report:

We have compiled the accompanying balance sheet.....
(standard first paragraph)

Management (owners) is (are) responsible  (standard second paragraph)

Our responsibility is to conduct the compilation  (standard third paragraph)

The Company's financial statements do not disclose certain information regarding the company's nature of operations, use of certain estimates and certain significant risks. Disclosure of this information is required by accounting principles generally accepted in the United States of America.

Question: May disclosures be omitted in a review engagement?

Response: No. The exception only applies when financial statements have been compiled, not reviewed. Therefore, generally, an accountant would not accept an engagement to review financial statements that omit substantially all of the GAAP disclosures.

P. GATHERING REVIEW EVIDENCE UNDER SSARS NO. 19

SSARS No. 19 introduces a new term of review evidence which is defined as information used by the accountant to provide reasonable basis for the obtaining of limited assurance that there are no material modifications that should to be made to the financial statements in order for the statements to be in conformity with GAAP or another applicable financial reporting framework (e.g., OCBOA, etc.).

In a review engagement, an accountant is required to accumulate review evidence consisting of completing performance procedures and review procedures as follows:

1. Performance procedures:
   a. Understand the industry in which the client operates, including accounting principles
   b. Obtain knowledge of the client including its business and accounting principles and practices
   c. Be aware of the risk of financial statement misstatement
2. Design and perform review procedures:
   
a. Analytical procedures  
b. Inquiries  
c. Other procedures including:  
   • Read the financial statements  
   • Obtain reports from other accountants, if applicable, related to other significant components such as other subsidiaries.

In accumulating review evidence, first, the accountant is required to understand the industry in which the client operates and obtain knowledge of the client’s business and accounting principles and practices. In obtaining this understanding and knowledge, the accountant should be aware of the risk that the accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated.

Based on that understanding of the industry and knowledge of the client’s business, the accountant is required to design and perform review procedures consisting primarily of analytical procedures and inquiries. Other procedures include reading the financial statements and, if applicable, obtaining the reports from other accountants or auditors of financial statements of significant components of the reporting entity, such as other subsidiaries or investees.

**Will the accountant have to perform additional procedures in a review engagement under SSARS No. 19 as compared with previous procedures under SSARS No. 1?**

At first look, it appears that SSARS No. 19 added more procedures to a review engagement. However, this is actually not the case. Although SSARS No. 19 has added the concept of review evidence, that “evidence” consists of the same procedures that the accountant had to perform previously. For example, an accountant has always had to obtain an understanding of the industry and knowledge of the client’s business. Further, the accountant has had to perform analytical procedures and inquiry of management and others.

What is different is that SSARS No. 19 establishes a framework from which to perform the review engagement. First, the accountant obtains the understanding of the industry and knowledge of the client, keeping in mind the overall risk of a material misstatement in the financial statements. Then, based on that understanding and knowledge, the accountant designs and performs his or her analytical procedures and inquiry. Previously, many accountants have not used the understanding of the industry and knowledge of the client’s business to assist in designing the analytical procedures and inquiries.

Another point is that SSARS No. 19 adds an overall umbrella that the accountant should consider the risk that he or she may unknowingly issue a report on financial statements that are materially misstated.
Does SSARS No. 19 require an accountant to perform a risk assessment like an audit engagement requires?

No. Even though the concept of risk permeates through the review engagement, it does not require the accountant to perform a risk assessment.

Does the accountant really gather evidence in a review engagement?

No. The concept of review evidence is misleading as it suggests that an accountant is required to gather evidence similar to that in performing an audit engagement such as examining documents, etc. Arguably, SSARS No. 19 should have used a different term than “review evidence” to differentiate from procedures performed in an audit engagement.

Review evidence consists of understanding and obtaining knowledge of the industry and client’s business, and designing and performing analytical procedures and inquiries. No further procedures are required unless the results of those procedures result in incomplete, incorrect or unsatisfactory information.

Dealing with analytical procedures in SSARS No. 19

During a review engagement, SSARS No. 19 requires that an accountant develop and document expectations of analytical procedures and compare those expected amounts to actual results.

The SSARS No. 19 requirement is nothing new in that since its issuance in 1979, SSARS No. 1 included the requirement to develop expectations in performing analytical procedures. Yet, many, if not most, accountants have not complied with the requirement in performing analytical procedures.

What are expected amounts?

An expected amount represents an accountant’s predictions of recorded amounts used in ratios developed of those amounts. SSARS No. 19 states that the accountant should:

- Develop expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant’s understanding of the industry in which it operates and knowledge of the client.
- Use statistical techniques as trend analysis or regression analysis, performed either manually or with the use of computer-assisted techniques.

In developing expectations, an accountant may use various sources including, but not limited to:

- Prior period information
- Anticipated results such as management budgets and forecasts
- Relationships among elements within the period
- Information from the industry such as gross margin
- Relationship of financial information with nonfinancial information such as payroll costs to number of employees.
SSARS No. 19 states that analytical procedures may be performed at the financial statement level or at the detailed account level. Further, if analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected amounts by a significant amount, the accountant should investigate the differences by inquiring of management and performing other procedures needed.

*Should expectations be developed for each analytical procedure or in the aggregate?*

SSARS No. 19 does not indicate how to develop expectations thereby giving the accountant flexibility in applying the standard. However, in 2004, the ARSC issued a white paper which provides examples of how to apply the expectations requirement found in SSARS No. 19.

Although the standard does not state so, it would appear that expectations can be developed using a range (e.g., expected gross profit is 20-23 percent), rather than using one absolute amount. For example, an accountant can develop an expectation that the gross profit will decline by 2 to 5 percent.

Following is an example extracted from the ARSC’s white paper, as modified by the author.

**Example 1:**

**Facts:**
An accountant is performing a review engagement on a company that manufactures components for the United States Military.

Facts used to develop expectations include the following:

- The accountant expects sales to increase by 10 to 15 percent due to the overall world situation.
- The number of day’s sales in accounts receivable should also increase by 10 to 15 percent due to the increase in sales.
- Interest expense and the related loan payable should increase by 10 to 15 percent due to carrying a larger amount of receivables and inventories to accommodate additional sales.
- No significant change in either days supply in inventory or inventory turnover is expected as most of the sales increase is expected to occur at or near year end. Any increase in inventory of more than 5 percent will be *unexpected* and will be subject to additional procedures.
Specific data follows:

<table>
<thead>
<tr>
<th></th>
<th>Current year</th>
<th>Prior year</th>
<th>Change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,500,000</td>
<td>$2,175,000</td>
<td>$325,000</td>
<td>14.94%</td>
</tr>
<tr>
<td>CGS</td>
<td>1,780,000</td>
<td>1,566,000</td>
<td>214,000</td>
<td>13.67%</td>
</tr>
<tr>
<td>Gross profit</td>
<td>720,000</td>
<td>609,000</td>
<td>111,000</td>
<td>18.23%</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>230,000</td>
<td>184,000</td>
<td>46,000</td>
<td>25.00%</td>
</tr>
<tr>
<td>Interest expense</td>
<td>48,000</td>
<td>42,000</td>
<td>6,000</td>
<td>14.29%</td>
</tr>
<tr>
<td>AR</td>
<td>1,625,000</td>
<td>843,000</td>
<td>782,000</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>1,100,000</td>
<td>832,000</td>
<td>268,000</td>
<td></td>
</tr>
<tr>
<td>Loans payable</td>
<td>498,000</td>
<td>437,000</td>
<td>61,000</td>
<td>13.96%</td>
</tr>
</tbody>
</table>

Results of analytical procedures:

**Sales and cost of sales:** Sales and cost of sales increased by 14.94% and 13.67%, respectively, which are within the expected range of 10 to 15 percent. No additional procedures are required.

**Interest expense and debt:** Interest expense increased by 14.29% which is within the expected range of 10 to 15 percent. The increase in the loan payable was 14 percent ($61,000/$437,000) which is within the expected range of 10 to 15 percent consistent with the expected increase in interest expense.

**Number of days sales in AR:**

Current year:

<table>
<thead>
<tr>
<th>AR</th>
<th>$1,625,000 = 65% x 365 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

Prior year (given):

| % change | 68% |

Conclusion: Because the increase in the number of days is greater than the expected increase of 10 to 15 percent, the accountant should perform additional procedures including inquiries and documentation of the reason for the unexpected increase.
Number of days supply in inventory:

Current year:
- Inventory $1,100,000 = 62% x 365 days = 226 days
- CGS 1,780,000

Prior year (given): 194 days
% change 16%

Inventory turnover:

Current year:
- CGS $1,780,000 = 1.84 times
- Inventory 1,100,000

Prior year: (given): 2.05 times
% change (10)%

Conclusion: No significant change in either days supply in inventory or inventory turnover was expected. Any increase in inventory of more than 5 percent was to be unexpected and subject to additional procedures.

The results of the procedures resulted in both the number of days supply in inventory (an increase of 16%) and the inventory turnover (a decrease of 10%) changing by an unexpected amount of more than 5 percent. Thus, the accountant should perform additional procedures including making an inquiry of the client and documenting the reason(s) for the unexpected changes.

Other analytical procedures:

Selling expenses increased by 25 percent which is unexpected due to an increase in sales of only 14.94%. The accountant should perform additional procedures including making an inquiry of the client and documenting the reason(s) for the unexpected change.
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. In which of the following situations may it not be prudent to use income tax basis financial statements:
   a) when it may be perceived to be intentionally misleading to a third party
   b) when it may violate loan covenants
   c) both a and b above
   d) none of the above; OCBOA is always prudent

2. Which of the following is the engagement of choice in many, but not all, instances:
   a) audit – GAAP
   b) audit – OCBOA
   c) review – GAAP
   d) review – OCBOA

3. According to SSARS No. 19, 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) the SSARS 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

4. An accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity:
   a) under any circumstances
   b) unless the accountant has compiled or reviewed the financial statements in compliance with the provisions of SSARS No. 19
   c) unless the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them
   d) either b or c above
5. ASC 220 (formerly FASB No. 130) requires that comprehensive income be presented in a financial statement format. Which of the following is not one of the three options available:

a) present a separate statement of comprehensive income  
b) combine the statement of income and comprehensive income  
c) combine the statement of comprehensive income with the balance sheet  
d) present comprehensive income as a section within the statement of stockholders’ equity

6. In reporting on supplementary information, which of the following is not correct:

a) if a compilation report is issued for the financial statements, the supplementary information may be compiled  
b) if a compilation report is issued for the financial statements, the supplementary information may be reviewed  
c) if a review report is issued for the financial statements, the supplementary information may be reviewed  
d) if a review report is issued for the financial statements, the supplementary information may be compiled

7. Which of the following is an example of supplementary information:

a) percentages that are presented next to the numbers on an income statement  
b) aging analysis of receivables  
c) unexpired budgeted numbers presented next to historical numbers on an income statements  
d) legend on each page of the financial statements

8. An accountant is not required to apply any procedures typically required for prospective budgeted financial information as long as the information:

a) 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

9. A successor accountant may consider making inquiries of the predecessor accountant when:

a) the information obtained about the prospective client and its management and principals is limited or appears to require special attention  
b) the change in accountants takes place substantially after the end of the accounting period for which statements are to be compiled or reviewed  
c) there have been frequent changes in accountants  
d) all of the above
10. Which of the following is true regarding a successor accountant naming the predecessor accountant in his report:

a) SSARS No. 2 recommends that the successor accountant name the predecessor in his report under any circumstances
b) SSARS No. 11 requires that the successor accountant name the predecessor in his report under any circumstances
c) SSARS No. 11 allows the successor accountant to name the predecessor accountant if the predecessor accountant’s practice was acquired by, or merged with, that of the successor accountant
d) since a successor auditor does not have the ability to name a predecessor auditor, neither should a successor accountant be able to name a predecessor accountant

11. According to SSARS No. 19, which of the following is true regarding disclosing selected information as required by GAAP:

a) an accountant can review financial statements that omit substantially all of the disclosures required by GAAP under any circumstances
b) an accountant can compile financial statements that omit substantially all of the disclosures required by GAAP under any circumstances
c) an accountant can compile financial statements that omit substantially all of the disclosures required by GAAP provided the omission of substantially all disclosures is clearly indicated and is not intended to be misleading
d) SSARS No. 19 is silent regarding this issue

12. In which of the following situations may an accountant label notes to financial statements “Selected Information-Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included”:

a) no disclosures are included in the notes
b) two disclosures are included in the notes
c) 50 percent of the required disclosures are included in the notes
d) all but one disclosure are included in the notes

13. Which of the following is true regarding SSARS No. 19 as it relates to expectations:

a) the SSARS No. 19 requirement of developing expectations in performing analytical procedures is new
b) most accountants have complied with the requirement in performing analytical procedures
c) SSARS No. 19 indicates how to develop expectations
d) the accountant has flexibility in applying SSARS No. 19
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Although this is a situation when it may not be prudent to use income tax basis financial statements, it is not the only correct answer.

B: Incorrect. Although this is a situation when it may not be prudent to use income tax basis financial statements, it is not the only correct answer.

C: Correct. Both a and b are examples when it may not be prudent.

D: Incorrect. There are situations when it may not be prudent to use income tax basis financial statements.

(See page 156 of the course material.)

2. A: Incorrect. These are the least profitable, and not generally the engagement of choice.

B: Incorrect. These are not the most profitable, and therefore not generally the engagement of choice.

C: Incorrect. These are not the most profitable, and therefore not generally the engagement of choice.

D: Correct. These are the most profitable, and in many, but not all, instances the engagement of choice.

(See page 163 of the course material.)

3. A: Incorrect. Income tax basis accrual financial statements may be used only if the company also uses income tax basis accrual to prepare and file its income tax return.

B: Correct. Under the provisions of SSARS No. 19, 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. 19 specifically requires a company to issue OCBOA financial statements on the same basis as it prepares its tax return.

D: Incorrect. SSARS No. 19 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 179 of the course material.)
4. A: Incorrect. There are circumstances when consent may be given.

B: Incorrect. This is a circumstance that would be permitted, but not the only correct answer.

C: Incorrect. This is a circumstance that would be permitted, but not the only correct answer.

D: **Correct.** Both situations indicated in b and c above are circumstances identified in SSARS No. 19 where consent may be given.

(See page 183 of the course material.)

5. A: Incorrect. This is one of the options available per ASC 220.

B: Incorrect. This is one of the options available per ASC 220.

C: **Correct.** This is not one of the options available per ASC 220.

D: Incorrect. This is one of the options available per ASC 220.

(See page 191 of the course material.)

6. A: Incorrect. In a compilation engagement, the supplementary information may be compiled.

B: **Correct.** If a compilation report is issued for the financial statements, the supplementary information may not be reviewed.

C: Incorrect. If a review report is issued for the financial statements, the supplementary information may be either reviewed or compiled.

D: Incorrect. If a review report is issued for the financial statements, the supplementary information may be compiled or reviewed.

(See page 203 of the course material.)

7. A: Incorrect. Percentages that are presented next to historical numbers are not considered supplementary information.

B: **Correct.** An aging analysis of receivables is considered supplementary information on which the accountant must report.

C: Incorrect. Budgeted information that is expired is considered supplementary information.

D: Incorrect. A legend on each page of the financial statements is not considered supplementary information under the SSARSs.

(See page 207 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 accountant 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 212 of the course material.)

9. A: Incorrect. This is a circumstance that would warrant inquiries, but is not the only correct answer.
   B: Incorrect. This is a circumstance that would warrant inquiries, but is not the only correct answer.
   C: Incorrect. This is a circumstance that would warrant inquiries, but is not the only correct answer.
   **D: Correct.** All of the above are circumstances that would warrant inquiries.
   (See page 215 of the course material.)

10. A: Incorrect. Under SSARS No. 2, footnote 9, the successor should not name the predecessor in his report.
    B: Incorrect. SSARS No. 11 revised SSARS No. 2 to state that a successor accountant may name the predecessor accountant, but only under certain circumstances.
    **C: Correct.** SSARS No. 11 revised SSARS No. 2 to state that a successor accountant may name the predecessor accountant only if the predecessor’s practice was acquired by, or merged with, that of the successor accountant.
    D: Incorrect. SAS No. 58 allows a successor auditor to name the predecessor auditor if the predecessor’s auditor’s practice was acquired by, or merged with, that of the successor auditor.
    (See page 220 of the course material.)
11. A: Incorrect. According to SSARS No. 19, the accountant may compile, not review, these statements under certain provisions.

B: Incorrect. According to SSARS No. 19, the accountant may compile these statements with certain provisions.

C: Correct. According to SSARS No. 19, the accountant may compile such statements provided the omission of substantially all disclosures is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

D: Incorrect. SSARS No. 19 is not silent on this issue. Information is found in SSARS No. 19.

(See pages 226 to 227 of the course material.)

12. A: Incorrect. If there are no disclosures, use of the reference “Selected Information-Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included” is unnecessary because there are no notes to label.

B: Correct. The identified label is appropriate when there are disclosures about only a few matters in the form of notes to financial statements. Two disclosures would satisfy the “few matters” threshold.

C: Incorrect. 50 percent of the required disclosures is certainly more than “a few matters” so that use of the label is not appropriate.

D: Incorrect. SSARS No. 19 states that when the financial statements include more than a few disclosures, this guidance is not appropriate. Instead, the omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation or review report with a GAAP departure.

(See pages 226 to 227 of the course material.)

13. A: Incorrect. The SSARS No. 19 requirement is nothing new. Since the issuance of SSARS No. 1 in 1979, the requirement to develop expectations in performing analytical procedures has been present.

B: Incorrect. Most accountants have not complied with the requirement in performing analytical procedures.

C: Incorrect. SSARS No. 19 does not indicate how to develop expectations.

D: Correct. SSARS No. 19 does not indicate how to develop expectations, thereby giving the accountant flexibility in applying the standard.

(See pages 229 to 230 of the course material.)
Q. RESPONSIBILITY FOR MATERIALITY IN A COMPILATION AND REVIEW ENGAGEMENT

Question: Is an accountant who performs a compilation or review engagement required to plan materiality?

Response: No. Unlike an audit engagement, the SSARSs do not require an accountant to plan and document materiality in performing his or her compilation or review engagement. However, the accountant must consider, but not necessarily document, materiality, in performing his or her compilation or review engagement.

The review report does reference materiality as follows:

“Based on our review, we are not aware of any materiality modifications that should be made to the accompanying financial statements …….”

The compilation report does not reference materiality.

For either a compilation or review engagement, the accountant should consider materiality in the context of the applicable financial reporting framework (GAAP, OCBOA, etc.) which provides a frame of reference to the accountant in determining whether there are any material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

SSARS No. 19 states that although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

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

If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the accountant with such a frame of reference.

The accountant’s determination of materiality is a matter of professional judgment and is affected by the accountant’s perception of the financial information needs of users of the financial statements.

R. Restricting the Use of an Accountant’s Compilation or Review Report

SSARS No. 19 provides guidance to accountants on restricting the use of reports issued under the SSARSs.
The SSARS defines the terms general use and restricted use.

**General use:** Applies to reports that are not restricted to specified parties including reports on financial statements prepared in conformity with an applicable financial reporting framework that are ordinarily not restricted to use, such as GAAP or OCBOA.

- Reports on GAAP and OCBOA financial statements ordinarily are not restricted regarding use although nothing precludes an accountant from restricting the use of any report.

**Restricted use:** Applies to reports intended only for one or more specified third parties. The need to restrict use may result from a number of circumstances including, but not limited to:

- The purpose of the report
- Potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

An accountant should restrict use of a report when the subject matter of the report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or OCBOA.

1) The report should be restricted because:

- The basis, assumptions, or purpose of such presentations (contained in such agreements or regulatory provisions) are developed for and directed only to the parties to the agreement or regulatory agency responsible for the provisions, and
- The report may be misunderstood by those not adequately informed of the basis, assumptions, or purpose of the presentation.

2) If an accountant issues a single combined report covering both restricted and unrestricted subject matter, its use should be restricted to the specified parties.

3) The inclusion of a separate restricted-use report in a document that contains a general-use report does not affect the intended use of either report. The restricted use report remains restricted as to use, and the general-use report continues for general use.

4) The accountant may agree to add other parties as specified parties based on factors such as the identity of the other parties, their knowledge of the basis of the measurement or disclosure criteria, and the intended use of the report. The accountant should obtain acknowledgment from the added parties, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report.
a) If other parties are added after the report is issued, the report may be
reissued or the accountant may provide other written acknowledgement that
the other parties have been added as specified parties.

5) Accountant should consider informing his or her client that restricted-use reports
are not intended for distribution to nonspecified parties, regardless of whether
they are included in a document containing a separate general-use report.

Note: The Statement does not prevent an accountant, in connection with
establishing the terms of the engagement, from reaching an understanding with
the client that the intended use of the report will be restricted, and from obtaining
the client’s agreement that the client and the specified parties will not distribute
the report to parties other than those identified in the report. Moreover, an
accountant is not responsible for controlling a client’s distribution of restricted-use
reports.

Restricted Use Report Language:
The report that is restricted should contain a separate paragraph at the end of the report
that includes:

1) A statement indicating that the report is intended solely for the information and
use of the specified parties.

2) An identification of the specified parties to whom use is restricted.

3) A statement that the report is not intended to be and should not be used by
anyone other than the specified parties.

Sample report language:

“This report is intended solely for the information and use of [the specified
parties] and is not intended to be and should not be used by anyone other
than these specified parties.”

Note: The report paragraph may list the specified parties or refer the reader to the
specified parties listed elsewhere in the report.

S. COMPILATION OF SPECIFIED ELEMENTS, ACCOUNTS, OR ITEMS OF A
FINANCIAL STATEMENT

There are instances in which an accountant may wish to compile a specified element,
account or item of a financial statement in lieu of a full set of financial statements.

Prior to the issuance of SSARS No. 13, Compilation of Specified Elements, Accounts, or
Items of a Financial Statement (AR 110), the SSARSs only applied to compilation and
review engagements of financial statements, and not elements of such statements.

In 2005, SSARS No. 13 was issued to expand the scope of information that an
accountant may compile by allowing an accountant to compile specified elements,
accounts, or items of a financial statement.
1. Rules:

a. An accountant is permitted to perform a compilation engagement related to specified elements, accounts or items of a financial statement.

Examples of specified elements, accounts or items of a financial statement that an accountant may compile include schedules of:

- Rentals
- Royalties
- Profit participation
- Provision for income taxes

b. The compilation engagement may be undertaken as a separate engagement or in conjunction with a compilation of financial statements.

c. An accountant may prepare and assist a client in the preparation of a specified element, account or item of a financial statement, and submit such financial statement to the client without issuing a compilation report. **Exception**: A compilation report must be issued if the accountant has been engaged to compile such elements, accounts, or items of a financial statement.

**Observation**: An accountant is allowed the choice of preparing a presentation of an element, account or financial statement item with or without an accompanying compilation report. The accountant may prepare or assist in the preparation of an element, account or item of a financial statement as long as he or she has not been specifically engaged to execute a compilation engagement.

If an accountant prepares or assists a client in preparing a schedule of one or more specified elements, accounts, or items of a financial statement **without a compilation report being issued**, the accountant should consider the extent to which the presentation will be used, the potential of being associated with the presentation, and the likelihood that the user might inappropriately infer that an unintended level of assurance was provided by the accountant. If the accountant believes that he or she will be associated with the information prepared, the accountant should consider issuing a compilation report so that a user will not infer a level of assurance that does not exist.

**Example 1**: A client asks Joe CPA to assist her with the preparation of a schedule of gross sales for the bank. Joe prepares a schedule of sales in an Excel® format and delivers it to the client. Joe and the client have not executed an engagement letter for a compilation engagement, and the client has not specifically asked Joe to prepare a compilation report to accompany the schedule.

**Conclusion**: Joe is not required to issue a compilation report even though he prepared or helped prepare the schedule of gross sales.
**Example 2:** Same facts as Example 1 except the client has asked Joe to issue a compilation report on the schedule.

**Conclusion:** Joe should issue a compilation report on the schedule of gross sales as he has been engaged to do so.

**Example 3:** Same facts as Example 1. The client notifies the Bank that Joe CPA was involved in the preparation of the schedule of gross sales and Joe is aware that the Bank will be relying heavily on the schedule to increase the client’s line of credit. Joe has not been engaged to issue a compilation report on the schedule.

**Conclusion:** Joe should consider issuing a compilation report to accompany the schedule of gross sales even though Joe has not been engaged to do so. The reason is that there is a likelihood that the user (Bank) might inappropriately infer that an unintended level of assurance was provided by Joe and that Joe is associated with the schedule. If the accountant believes that he or she will be associated with the information prepared, the accountant should consider issuing a compilation report so that a user will not infer a level of assurance that does not exist.

2. **Performance and reporting requirements:** An accountant who compiles specified elements, accounts, or items of a financial statement should:

   a. Establish an understanding, in writing, regarding the services to be performed. The understanding should include:

   - A description of the nature and limitations of the services to be performed.

   - A description of the report.

   - That the engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

   - That the accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant’s attention during the engagement to compile one or more specified elements, accounts or items of a financial statement that fraud or an illegal act may have occurred.

   - That the accountant is not required to report any matters regarding illegal acts that may have occurred and are clearly inconsequential.

   b. Follow the communication requirements of SSARS No. 19 when he or she finds indications that fraud or an illegal act may exist.
c. Adhere to the compilation performance requirements contained in SSARS No. 19 including reading the compiled schedules and consider whether the information appears to be appropriate in form and free of obvious material errors.

d. When the accountant is engaged to compile specified elements, accounts, or items of a financial statement, certain basic elements should be included in the report which are presented in the sample reports below.

e. If an accountant is not independent, he or she should specifically disclose the lack of independence:

   We are not independent with respect to Pete’s Greasy Kitchen.

Note: Under SSARS No. 19, the accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired.

Sample Report- Specified Element

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Accountant’s Compilation Report

We have compiled the accompanying schedule of gross sales of Pete’s Greasy Kitchen for the year ended December 31, 20XX. We have not audited or reviewed the accompanying schedule of gross sales and, accordingly, do not express an opinion or provide any assurance about whether the schedule is in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the schedule in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the schedule.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of a schedule without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the schedule.

Management has elected to omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the schedule, they might influence the user’s conclusions about the company’s gross sales. Accordingly, the schedule is not designed for those who are not informed about such matters.

James J. Fox & Company
March 31, 20X1
Pete’s Greasy Kitchen
Schedule of Gross Sales
For the Year Ended December 31, 20XX

Gross sales:
- Hot and spicy chicken wings $500,000
- Greasy pork balls 100,000
- Juicy pork ribs 400,000
- Two-pound burger 600,000
- Low fat salads 5,000
- Beer and wine 900,000

$2,505,000

See Accountant’s Compilation Report

What about a review report on a specified element, account or financial statement item?

When a report is required for a specified element, account or other item of a financial statement, the authority followed depends on whether the accountant is to perform a traditional engagement (e.g., audit, review or compilation) or whether the engagement entails performing specific procedures determined by the user (referred to as an agreed-upon procedures engagement). The authority in this area is summarized as follows:

<table>
<thead>
<tr>
<th>Type of Engagement</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit</td>
<td>SAS No. 62, Special Reports</td>
</tr>
<tr>
<td>Review</td>
<td>SSAE No. 10, Attestation Standards</td>
</tr>
<tr>
<td>Compilation</td>
<td>SSARS No. 13, Compilation of Specified Elements, Accounts, or Items of a Financial Statement¹¹</td>
</tr>
<tr>
<td>Agreed-Upon Procedures</td>
<td>SSAE No. 10: Attestation Standards</td>
</tr>
</tbody>
</table>

SSARS No. 13 authorizes an accountant to issue a compilation report on a specified element, account or item of the financial statements. The SSARS does not change the application of a review engagement to a specified element, account or item of a financial statement.

Presently, a review engagement to a specified element, account or item is not authorized by the SSARSs and, instead, is found in SSAE No. 10. Although most practitioners are familiar with a review of financial statements authorized by the SSARSs, the application of a review under SSAE No. 10 and the SSARSs is essentially the same. That is, both reports provide negative assurance. In comparing a review under SSAE No. 10 to SSARS No. 19, there are two primary differences in the report language.

¹¹ Interpretation No. 8 of SSARS No. 1 states that a compilation or review of an element, account, or other item is not a financial statement, thus not covered by the SSARS. The Interpretation was withdrawn with the issuance of SSARS No. 13. Now, a compilation of an element, accountant, or other item is allowed under SSARS No. 13.
1. The second paragraph references the attestation standards in the SSAE No. 10 review report, with no reference to SSARS No. 19.

2. The third paragraph “negative assurance” language is different.

A comparison of the report language between the two types of reviews follows:

**SSARS No. 19 Review Language- Review Engagement:**
Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

**SSAE No. 10 Review Language- Review Engagement:**
Based on our review, nothing came to our attention that caused us to believe that the schedule of investment returns of XYZ Company for the year ended December 31, 20XX is not presented, in all material respects, in conformity with ABC criteria set forth in Note 1.

**EXAMPLE 1: Review Report Issued on Specified Element, Account or Financial Statement Item:**

Assume the accountant is asked to issue a review report on a schedule of accounts receivable. The SSAE No. 10 review report looks like this.

**SCHEDULE OF ACCOUNTS RECEIVABLE**

We have reviewed the accompanying schedule of accounts receivable of XYZ Corporation as of December 31, 20XX.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the schedule of accounts receivable. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the accompanying schedule of accounts receivable is not presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Jimmy Fox & Company
Date:
XYZ Corporation  
Schedule of Accounts Receivable  
December 31, 20XX  
(See Independent Accountant’s Review Report)

Accounts receivable:
Current $300,000
31-60 days 200,000
61-90 days 100,000
More than 90 days 50,000
$650,000
Allowance for uncollectible accounts (30,000)
$620,000

See Notes to Schedule.

XYZ Corporation  
Notes to Schedule of Accounts Receivable  
December 31, 20XX  
(See Independent Accountant’s Review Report)

1. Nature of Operations and Certain Concentrations:
The Company is a distributor of doors and windows with office and distribution facilities located in Boston, Massachusetts. The majority of sales are made to home construction contractors and retail home improvement centers in the Northeast United States.

Approximately 50% of the company’s 20XX sales were made to contractors located in Boston, Massachusetts. As a matter of normal practice, the Company grants credit to contractors and does not have a policy for requiring collateral for accounts receivable. At December 31, 20X1, $400,000 of accounts receivable were due from contractors.

2. Summary of Significant Accounting Policies:

Revenue recognition:
The Company uses the accrual basis of accounting whereby revenue is recognized when earned.

Trade receivables:
Trade receivables are recorded at net realizable value consisting of the carrying amount less the allowance for uncollectible accounts.

The Company uses the allowance method to account for uncollectible trade receivable balances. Under the allowance method, an estimate of uncollectible customer balances is made based on weighted-average percentages of balances that exceed 60 days old using factors such as the credit quality of the customer and the economic conditions in the market. Accounts are considered past due once the unpaid balance is 90 days or more outstanding, unless payment terms are extended by contract. When an account balance is past due and attempts have been made to collect the receivable through legal or other means, the amount is considered uncollectible and is written off against the allowance balance.
Use of estimates:
The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reporting amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Observation: Notice the different language that is used in the last paragraph of the review report as compared with the standard review report under SSARS No. 19 which states "We are not aware of any material modifications that should be made to the accompanying financial statements...." Further, notice that the first paragraph does not make reference to SSARS as required in the typical review report.

The legend to the Schedule of Accounts Receivable states "See Notes to Schedule" instead of "See Notes to Financial Statement." The reason for the language is because the schedule is not a financial statement. SSAE No. 10 does not address the specific language to be used. However, it is quite clear that reference should not be made to a "financial statement."

As for the disclosures, they should be limited to those that are relevant to the subject matter, in this case, the accounts receivable. In deciding which disclosures are relevant, the accountant should look not only at the subject matter, but also to all related accounts and elements. For example, footnotes that are relevant to accounts receivable also include those relating to sales.

The author's selection of the above notes is based on the following reasoning.

1. Nature of operations and certain concentrations: This is an overlap of disclosures required by ASC 275 (SOP 94-6) related to nature of operations, and ASC 815 (formerly FASB No. 133/107) related to concentrations of credit risk associated with accounts receivable.

2. Revenue recognition: This disclosure relates to sales.

3. Trade receivables and allowance account: Disclosures of trade receivables and the allowance account are required by ASC 942 (formerly SOP 01-6).

4. Use of estimates: The use of estimates note is required by SOP 94-6 (ASC 942) and relates to both receivables and sales. There is an estimate involved in the computation of allowance for uncollectible accounts and, presumably, an estimate may be used in the computation of sales returns and allowances.

References to other notes such as those related to long-term debt, tangible assets, etc. are not required since they have no relevance to the subject matter (accounts receivable).
Are disclosures required when reporting on a specified element or account?

Response: Yes. Regardless of whether the engagement related to one element versus a full set of financial statements, disclosures apply. The only difference is that the disclosures required are only those that relate to the specified element or account. The exception is where management elects to omit substantially all disclosures with respect to a compilation report.

Example: An accountant issues a review report on a schedule of accounts receivable.

Conclusion: Disclosures (notes) are required to accompany the schedule, but only those disclosures that relate to accounts receivable. For example, a disclosure of revenue recognition may be required, yet one relating to long-term debt would not be required as it does not relate to accounts receivable.

T. COMPILATION OF PRO FORMA FINANCIAL INFORMATION

An accountant may be asked to compile pro forma financial information relating to an important client transaction. By definition, presentations of pro forma financial information are not financial statements and have not been covered under the SSARSs. Thus, to date, an accountant was not authorized to issue a compilation report on pro forma information.

Pro forma information is defined as information the objective of which is to present historical financial information as if a proposed or consummated transaction had occurred at a date of the historical financial statements. The objective is to apply pro forma adjustments to historical financial information.

Pro forma financial information is prepared by making pro forma adjustments to the historical financial information. The adjustments are based on management’s assumptions and should reflect all of the significant effects that would be attributable to the proposed transaction or event.

Example: In 20X3, Company X is considering the acquisition of Company Y. Company X would like to know what X’s 20X2 financial statements would have looked like had the acquisition occurred on January 1, 20X2.

Conclusion: The client and CPA would prepare pro forma financial statements for 20X2 that would reflect all of the primary factors that would have affected the 20X2 financial statements assuming the acquisition had occurred on January 1, 20X2. Primary factors would include:

- Increased labor costs if the acquisition involves the use of employees covered by a union contract.
- The tax effects of operating in a new locality.
- The impact of redundant operations such as disposal of duplicate equipment, lost sales from competing sales to the same customers, etc.
Examples of transactions in which pro forma information is used include:

- Business acquisitions and combinations
- Change in capitalization
- Disposal of a portion of a business such as a division
- Change in the form of organization or status such as the incorporation of a sole proprietorship or changing from C to S corporation status
- Proposed sale of securities and the application of proceeds

Pro forma information is not information related to a financial forecast or projection.\(^{12}\)

SSARS No. 14, *Compilation on Pro Forma Financial Information*, permits the compilation of pro forma financial information using the following rules.

1. Pro forma financial information should be labeled as such to distinguish it from historical financial information.

2. If an accountant prepares or assists a client in preparing pro forma financial information, the accountant should consider how such a presentation of pro forma financial information will be used.
   a. When the information is likely to be used by a third party, the accountant should consider the potential of being associated with the pro forma financial information and the likelihood that a third party may inappropriately infer, through that association, an unintended level of assurance.
   b. If the accountant believes that he or she will be associated with the information, the accountant should consider issuing a compilation report so a user will not infer a level of assurance that does not exist.
   c. An engagement to compile pro forma financial information may be undertaken as a separate engagement or in conjunction with a compilation of financial statements.

**Note:** The accountant may agree to compile pro forma financial information if the document that contains the information includes, or incorporates by reference, complete historical financial information of the entity for the most recent year (or for the preceding year if financial statements for the most recent year are not yet available). If pro forma financial information is presented for an interim period, the document also includes (or incorporates by reference) historical interim financial information for that period (which may be presented in condensed form). In the case of a business combination, the document should include, or incorporate by reference, the appropriate historical financial information for the significant constituent parts of the combined entity.

\(^{12}\) The objective of pro forma financial information is to show what the significant effects on the historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. Although the transaction may be prospective, pro forma information is not considered prospective (e.g., forecast or projection) because it essentially relates to historical financial statements.
The historical financial statements of the entity on which the pro forma financial information is based must have been compiled, reviewed, or audited. The accountant’s compilation or review report or the auditor’s report on the historical financial statements should be included (or incorporated by reference) in the document containing the pro forma financial information.

3. An accountant who compiles pro forma financial information should:

   a. Establish an understanding, preferably in writing, regarding the services to be performed including a description of the services to be performed and a description of the report.

   b. Follow the communication requirements of SSARS No. 19 when he or she finds indications that fraud or an illegal act may exist.

      **Note:** The accountant is not required to report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

   c. Adhere to the compilation performance requirements contained in SSARS No. 19.

   d. Read such compiled pro forma financial information, including the summary of significant assumptions, and consider whether the information appears to be appropriate in form and free of obvious material errors.

4. An accountant may prepare and assist a client in the preparation of pro forma financial information, and submit such financial information to the client **without issuing a compilation report**.

   a. **Exception:** A compilation report must be issued if the accountant has been engaged to compile pro forma financial information.

   **Observation:** The amendment allows an accountant the choice of preparing a presentation of pro forma financial information with or without an accompanying compilation report. The accountant may prepare or assist in the preparation of the pro forma information as long as he or she has not been specifically engaged to execute a compilation engagement.
If an accountant prepares or assists a client in preparing pro forma financial information *without a compilation report being issued*, the accountant should consider the extent to which the presentation will be used, the potential of being associated with the presentation, and the likelihood that the user might inappropriately infer that an unintended level of assurance was provided by the accountant. If the accountant believes that he or she will be associated with the information prepared, the accountant should consider issuing a compilation report so that a user will not infer a level of assurance that does not exist.

5. If an accountant is not independent, he or she should specifically disclose the lack of independence:

   *We are not independent with respect to xxxxx.*

   Under SSARS No. 19, the accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired.

   When the accountant is engaged to compile pro forma financial information, certain basic elements should be included in the report.
Accountant’s Compilation Report

Board of Directors
XYZ Company

We have compiled the accompanying pro forma financial information of XYZ Company as of December 31, 20XX, reflecting the business combination of the Company and ABC Company. The historical condensed financial statements are derived from the historical unaudited financial statements of XYZ Company, which were compiled by us, and of ABC Company, which were compiled by other accountants. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the pro forma financial information in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the pro forma financial information.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of pro forma financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the pro forma financial information.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction occurred at an earlier date. However, the pro forma financial information is not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction actually occurred earlier.

[If the presentation does not include all applicable disclosures, this paragraph should be added]

Management has elected to omit all of the disclosures ordinarily included in pro forma financial information prepared in accordance with accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the pro forma financial information, they might influence the user’s conclusions about the company’s pro forma financial position and results of operations. Accordingly, this pro forma financial information is not designed for those who are not informed about such matters.

James J. Fox & Company CPA
[Date] (date of completion of compilation engagement)

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13 Report has been updated by the author to reflect changes made by SSARS No. 19.
Is an accountant permitted to issue a review or other report on pro forma financial information?

When it comes to performing engagements on pro forma financial information, the accountant has several options other than issuing a compilation report under SSARS No. 14. SSAE No. 10 allowed an accountant to perform the following types of engagements on pro forma financial statements:

- Agreed-Upon Procedures Engagement
- Examination
- Review

SSAE No. 10 does not address the issuance of a compilation report on pro forma financial statements. Instead, this authority is found solely in SSARS No. 14.

U. MANAGEMENT REPRESENTATION LETTER

A representation letter is required for a review engagement, but not for a compilation engagement.

SSARS No. 19 amends the illustrative management representation letter for a review engagement that was previously found in SSARS No. 15.

Review Engagement
Management Representation Letter
(Exhibit B of SSARS No. 19)

[Date]¹⁴

To John Jones, CPA

We are providing this letter in connection with your review of the [identification of financial statements] of [name of entity] as of [dates (for example, December 31, 20X1, and December 31, 20X2)] and for the [periods of review (for example, for the years then ended)] for the purpose of obtaining limited assurance that that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]. We confirm that we are responsible for the fair presentation of the financial statements in accordance with [the applicable financial reporting framework] and the selection and application of the accounting policies.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, (as of [the date of the accountant’s review report]) the following representations made to you during your review:

---

¹⁴ The date should be the date the client presents and signs the representation letter. The letter should not be presented and signed prior to the date of the accountant’s review report.
1. The financial statements referred to previously are fairly presented in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

2. We have made the following available to you:
   a. financial records and related data.
   b. minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. No material transactions exist that have not been properly recorded in the accounting records underlying the financial statements.

4. We acknowledge our responsibility for the preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

5. We acknowledge our responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

6. We acknowledge our responsibility to prevent and detect fraud.

7. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.

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

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

10. None of the following exist:
    a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies.¹⁵
    c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

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

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

13. The following have been properly recorded or disclosed in the financial statements:

¹⁵ If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

“We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.”
a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
b. Guarantees, whether written or oral, under which the company is contingently liable.
c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the FASB ASC 275, Risks and Uncertainties. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

[Add additional representations that are unique to the entity’s business or industry. See the following for additional illustrative representations.]

14. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company’s accounts (if applicable).
15. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.16
16. We have responded fully and truthfully to all inquiries made to us by you during your review.

[Name of Owner or Chief Executive Officer and Title]
[Name of Chief Financial Officer and Title, when applicable]

Observation: In designing an effective representation letter, an accountant may wish to consider the following:

1. Avoid the use of technical terms and, instead, use terms that are understandable to the client.

2. It is good practice to review the representation letter with the client before the letter is signed. By reviewing the letter in person, it may act as a “memory jogger” for the client concerning additional matters that may affect the financial statements. Discussions may make the client feel more comfortable about signing the letter.

3. In litigation, a more thorough explanation in person has helped some firms defend against management’s claim that they did not understand the level of service being performed.

16 If the accountant dual dates the report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.
4. Written representations should be obtained for all financial statements and periods covered by the accountant’s review report:

- If comparative financial statements are reported on, the representations at the completion of the most recent review should address all periods being reported on.

5. For a review of financial statements, specific representations should relate to the following matters:

- Management’s acknowledgement of its responsibility for the fair presentation in the financial statements in conformity with GAAP (or OCBOA, if applicable)
- Management’s belief that the financial statements are fairly presented in conformity with GAAP (or OCBOA, if applicable)
- Management’s full and truthful response to all inquiries
- Completeness of information
- Information concerning subsequent events
- Other information on matters specific to the entity’s business or industry.

6. The representation should be addressed to the accountant.

7. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the letter.

    Examples: CEO, CFO, or others with equivalent positions

- If the current management was not present during all periods covered by the accountant’s report, the accountant should nevertheless obtain written representations from the current management on all such periods.

8. Date of letter: The date of the letter should be the date that the letter is presented and signed by the client. In no event should the letter be presented prior to the date of the accountant’s review report.

9. Date of representations included in the letter: The representations should be made as of the date of the accountant’s review report.

Obtaining Representation Letters for All Periods Reported:

SSARS No. 19 requires that an accountant obtain a representation letter for all periods covered by the accountant’s report.
**But what happens when current management was not present in the previous period?**

The SSARS does not provide an exception when current management was not present in a prior year. In fact, management might reasonably be reluctant to sign a letter for a period during which it was not present.

**Example:** In 20X2, Harry purchases the common stock of Company X. The accountant is planning to issue comparative reviewed financial statements for 20X2 and 20X1. Harry was not involved in the operations in 20X1.

**Conclusion:** The accountant must obtain a representation letter for both 20X2 and 20X1. However, Harry might be reluctant to sign the representation letter for 20X1 since it was before he was involved in the company.

**Question:** Assuming the accountant received a representation letter from the previous owner for 20X1, doesn't that satisfy the need to obtain a representation letter for the 20X1 financial statements?

**Conclusion:** Apparently not. Even though a representation letter was obtained in 20X1 from the previous owner, a new representation letter covering both 20X2 and 20X1 must be obtained since the 20X1 financial statements are presented along with the 20X2 statements.

One solution is to present reviewed financial statements for 20X2 only without 20X1 information. By doing so, the new owner must only sign a representation letter for 20X2.

**Observation:** One way to convince management to sign a representation letter for a previous period during which management was not involved with the company is by pointing out the degree of representation. Additional language can be inserted into the letter to protect an absent management concerning representations that relate to a period during which it was not present, such as:

“To the best of my knowledge or belief”

If the current owner/manager refuses to sign a representation letter, a review report may not be issued.

**Question:** If management refuses to sign a representation letter that covers a period of time during which management was not present, may the accountant step down the engagement to a compilation to solve the issue?

**Response:** No. Stepping down to a compilation engagement is not appropriate in accordance with Paragraph 2.59 of SSARS No. 19 guidance which states:

“If in an audit or a review engagement a client does not provide the accountant with a signed representation letter, the accountant would ordinarily be precluded from issuing a compilation report on the financial statements.”
Question: If an accountant issues a review report for interim periods (e.g., three- or six-month statements), must he or she obtain a representation letter for each interim financial statement?

Response: Yes. The accountant must obtain a representation letter for each interim period.

Example: An accountant prepares monthly reviewed financial statements for a client.

Conclusion: The accountant must obtain twelve representation letters, one for each monthly financial statement issued.

Observation: Usually most firms prepare monthly compiled rather than reviewed statements. Therefore, the issue of obtaining interim representation letters is not applicable.

Observation: In designing an effective representation letter, an accountant may wish to avoid the use of technical terms and, instead, use terms that are understandable to the client. A good practice is to review the representation letter with the client before the letter is signed. By reviewing the letter in person, it may act as a “memory jogger” for the client concerning additional matters that may affect the financial statements. Discussions may make the client feel more comfortable about signing the letter. Finally, in litigation, a more thorough explanation in person has helped some firms defend against management’s claim that they did not understand the level of service being performed.

Additional Illustrative Representations:

The following are examples of additional illustrative disclosures that may be added into the basic management representation letter. Some of these representations are recommended by SSARS No. 19’s Exhibit B, while the remainder are disclosures that the author believes are relevant to review engagements.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Example of Additional Representation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The effect of a new accounting principle is not known.</td>
<td>We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board FASB ASC XXX, as discussed in Note X. The company is therefore unable to disclose the impact that adopting FASB ASC XXX will have on the financial statements and the results of operations when such Statement is adopted.</td>
</tr>
<tr>
<td>Change in accounting principle is made and management has justification making the change.</td>
<td>We believe that [description of the newly adopted accounting principle] is preferable to [description of the former accounting principle] because [description of management’s justification for the change in accounting principle].</td>
</tr>
<tr>
<td>Financial circumstances are strained, with disclosure of management’s intentions and the entity’s ability to continue as a going concern.</td>
<td>Note X to the financial statements discloses all of the matters of which we are aware that are relevant to the company’s ability to continue as a going concern, including significant conditions and events, and management’s plans.</td>
</tr>
<tr>
<td>The entity has used the work of a specialist.</td>
<td>We agree with the findings of the specialist in evaluating the [description of the assertion] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to the specialist with respect to the values or amounts derived in an attempt to bias his or her work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialist.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Disclosure has been made regarding an entity’s ability to continue as a going concern.</td>
<td>The financial statements disclose all of the matters of which we are aware that are relevant to the company’s ability to continue as a going concern, including significant conditions and events, and our plans.</td>
</tr>
<tr>
<td><strong>CASH</strong></td>
<td><strong>TRADE AND OTHER RECEIVABLES</strong></td>
</tr>
<tr>
<td>Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements.</td>
<td>Arrangements with financial institutions involving compensating balances or other arrangements involving restricted balances, lines of credit, or similar arrangements have been properly disclosed.</td>
</tr>
<tr>
<td><strong>INVENTORIES</strong></td>
<td><strong>INVESTMENT SECURITIES</strong></td>
</tr>
<tr>
<td>Excess or obsolete inventories exist.</td>
<td>A provision in the amount of $XX has been made to reduce excess or obsolete inventories to their estimated net realizable value.</td>
</tr>
<tr>
<td>The year-end inventory has been valued by the company.</td>
<td>Inventories, valued at LIFO, lower of cost or market value were $XX at December 31, 20X2 and $XX at December 31, 20X1.</td>
</tr>
<tr>
<td>The entity has investment securities which have been categorized into three (3) categories: held-to-maturity, trading, and available-for-sale.</td>
<td>Debt securities [with an amortized cost of $XX and $XX at December 31, 20X2 and 20X1, respectively], that have been classified as held-to-maturity have been so classified due to our intent to hold such securities to maturity and our ability to do so. All other debt securities have been classified as available-for-sale sale or trading.</td>
</tr>
</tbody>
</table>
Certain equity securities with a market value of $XX and $XX at December 31, 20X2 and 20X1, respectively, have been classified as trading securities as the company intends to sell such securities within the next operating cycle.

Certain debt and equity securities with a market value of $XX and $XX at December 31, 20X2 and 20X1, respectively, have been classified as available-for-sale as the company does not intend to hold such securities to maturity or does not have a plan to sell such securities within the next operating cycle.

Management considers the decline in value of debt or equity securities to be temporary.

We consider the decline in value of debt or equity securities as either available-for-sale or held-to-maturity to be temporary.

<table>
<thead>
<tr>
<th>INVESTMENTS- NON SECURITIES (NOT PUBLICLY TRADED)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General</strong></td>
</tr>
<tr>
<td>The cost method is used to account for the company’s investment in the common stock of [investee] because the company does not have the ability to exercise significant influence over the investee’s operating and financial policies.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INVESTMENTS ACCOUNTED FOR USING EQUITY METHOD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General</strong></td>
</tr>
<tr>
<td>The equity method is used to account for the company’s investment in the common stock of [investee] because the company does have the ability to exercise significant influence over the investee’s operating and financial policies.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FINANCIAL INSTRUMENTS (INCLUDING INVESTMENTS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management has determined the fair value of significant financial instruments that do not have readily determinable market values.</td>
</tr>
<tr>
<td>The methods and significant assumptions used to determine fair values of financial instruments are as follows: [describe methods and significant assumptions used to determine fair values of financial instruments]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FINANCIAL INSTRUMENTS (INCLUDING INVESTMENTS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are financial instruments with off-balance-sheet risk.</td>
</tr>
<tr>
<td>The following information about financial instruments with off-balance sheet risk has been properly disclosed in the financial statements:</td>
</tr>
<tr>
<td>a) The extent, nature, and terms of financial instruments with off-balance-sheet risk.</td>
</tr>
<tr>
<td>b) The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments.</td>
</tr>
<tr>
<td>Practice Issues: Compilation and Review</td>
</tr>
<tr>
<td>----------------------------------------</td>
</tr>
<tr>
<td><strong>c) Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments.</strong></td>
</tr>
<tr>
<td>The entity has the following financial instruments with concentrations of credit risk:</td>
</tr>
<tr>
<td>a) The majority of the entity’s trade receivables are due from customers concentrated within one geographic area.</td>
</tr>
<tr>
<td>b) The majority of the entity’s cash is deposited in one commercial bank with balances that, from time to time, exceed FDIC insurable limits.</td>
</tr>
<tr>
<td><strong>DEFERRED CHARGES</strong></td>
</tr>
<tr>
<td>Material expenditures have been deferred.</td>
</tr>
<tr>
<td><strong>FIXED ASSETS AND INTANGIBLE ASSETS</strong></td>
</tr>
<tr>
<td>There is the possibility that the value of specific significant long-lived assets or certain identifiable intangibles may be impaired.</td>
</tr>
<tr>
<td>The company has goodwill or intangibles with indefinite lives.</td>
</tr>
<tr>
<td><strong>ALL ASSETS</strong></td>
</tr>
<tr>
<td>General</td>
</tr>
<tr>
<td><strong>VARIABLE INTEREST ENTITIES</strong></td>
</tr>
<tr>
<td>The entity has a variable interest in another entity.</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
We have provided you with lists of all identified variable interests in (a) VIEs, (b) potential VIEs that we considered, but judged not to be VIEs, and (c) entities that were afforded the scope exceptions of FASB ASC 810, Consolidation.

We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FASB ASC 810.

We have made available all relevant information about financial interests and contractual arrangements with related parties, de facto agents, and other entities, including but not limited to their governing documents, equity and debt instruments, contracts, leases, guarantee arrangements, and other financial contracts and arrangements.

The information we provided about financial interests and contractual arrangements with related parties, de facto agents, and other entities includes information about all transactions, unwritten understandings, agreement modifications, and written and oral side agreements.

Our computations of expected losses and expected residual returns of entities that are VIEs and potential VIEs are based on the best information available and include all reasonably possible outcomes.

Regarding entities in which the Company has variable interests (implicit and explicit), we have provided all information about events and changes in circumstances that could potentially cause reconsideration about whether the entities are VIEs or whether the Company is the primary beneficiary or has a significant variable interest in the entity.

We have made and continue to make exhaustive efforts to obtain information about entities in which the Company has an implicit or explicit interest but that were excluded from complete analysis under FASB ASC 810, Consolidation, due to lack of essential information to determine one or more of the following: whether the entity is a VIE, whether the Company is the primary beneficiary, or the accounting required to consolidate the entity.
**DEFERRED TAX ASSET**

<table>
<thead>
<tr>
<th>A deferred tax asset exists at the balance sheet date.</th>
<th>A valuation allowance in the amount of $XXX at December 31, 20X2, has been determined pursuant to the provisions of FASB ASC 740, <em>Income Taxes</em>, including the company’s estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will more likely than not be realized. [Fill in with appropriate wording detailing how the entity determined the valuation allowance against the deferred tax asset.]</th>
</tr>
</thead>
</table>

A valuation allowance against deferred tax assets at the balance-sheet date is not considered necessary because it is more likely than not the deferred tax asset will be fully realized.

**DEBT**

| Short-term debt could be refinanced on a long-term basis and management intends to do so. | The Company has excluded short-term obligations totaling $XX from current liabilities because it intends to refinance the obligations on a long-term basis.  
- The Company has issued a long-term obligation [debt security] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis.  
- The Company has the ability to consummate the refinancing by using the financing agreement referred to in Note X to the financial statements. |
|-----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

**TAXES**

<table>
<thead>
<tr>
<th>The Company is an S Corporation.</th>
<th>At year-end, the Company has retained its S corporation tax status for federal and state tax purposes.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>The Company is an LLC and elects to be taxed as a partnership.</th>
<th>At year end, the Company has retained its election to be taxed as a partnership and not a corporation for federal and state tax purposes.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Tax-exempt bonds have been issued.</th>
<th>Tax-exempt bonds issued have retained their tax-exempt status.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Management intends to reinvest undistributed earnings of a foreign subsidiary.</th>
<th>We intend to reinvest the undistributed earnings of [name of foreign subsidiary].</th>
</tr>
</thead>
</table>

**CONTINGENCIES**

<table>
<thead>
<tr>
<th>Estimates and disclosures have been made of environmental remediation liabilities and related loss contingencies.</th>
<th>We have recorded a provision for any material loss in connection with environmental remediation where it is probable that a loss has been incurred and we can reasonably estimate the amount.</th>
</tr>
</thead>
</table>
In particular, we have recorded a provision for loss in connection with Site X. We believe that such estimate is reasonable based on available information and that the liability and related loss contingency and the expected outcome of uncertainties have been adequately described in the company’s financial statements.

There are no known environmental liabilities.

We are not aware of any asserted or unasserted claims remediation presented against the company by the EPA, governmental agencies or other third parties related to any environmental issues [ASC 410].

**AGREEMENT TO REPURCHASE ASSETS**

There is an agreement that may exist to repurchase assets previously sold.

An agreement to repurchase assets previously sold has been properly disclosed.

**PENSION AND POSTRETIREMENT BENEFITS**

An actuary has been used to measure pension liabilities and costs.

We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.

There is involvement with a multi-employer plan.

We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan, or

We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $XX.

Postretirement benefits have been eliminated.

We do not intend to compensate for the elimination of post-retirement benefits by granting an increase in pension benefits, or

We plan to compensate for the elimination of post-retirement benefits by granting an increase in pension benefits in the amount of $XX.

Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.

Current employee layoffs are intended to be temporary.

Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive commitment to increase benefit obligations.

We plan to continue to make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or

We do not plan to make frequent amendments to its pension or other postretirement benefit plans.
EQUITY

| There are capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements. | Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed. |

INCOME STATEMENT

| There may be a loss from sales commitments. | We have made provisions for losses to be sustained in the fulfillment of or from inability to fulfill sales commitments. |
| There may be losses from purchase commitments. | Provisions have been made for losses to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices. |
| Nature of the product or industry indicates the possibility of undisclosed sales terms. | We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions. |

Updated management representation letter

There are circumstances in which an accountant should consider obtaining an updated representation letter from management. Examples of such situations are identified in SSARS No. 19 and include:

- There is a significant amount of time between obtaining a representation letter and issuing the review report.

- A material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original management representation letter, but before the issuance of the report.

- A predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period.

SSARS No. 19 states that the updated management representation letter should state:

- Whether any information has come to management’s attention that would cause management to believe that any of the previous representations should be modified, and

- Whether any events have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.
Sample Updated Management Representation Letter
Review Engagement

Date (close to the issuance date)

To [Accountant]

In connection with your review of the [identify the financial statements] of [name of entity] as of [dates] and for the [periods of review] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles, you were previously provided with a representation letter under [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the accountant or date of previous representation letter] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

Name of Owner or Chief Executive Officer and Title

Name of Chief Financial Officer and Title [where applicable]

V. CONSIDERATIONS RELATED TO FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL STANDARDS

Question: There may be instances in which an accountant is asked to compile or review financial statements presented in accordance with International Financial Reporting Standards (IFRSs).

How would an accountant apply the reporting guidance when engaged to compile or review financial statements presented in accordance with International Financial Reporting Standards (IFRSs) as issued by the IASB?

Response: The answer is found in Interpretation No. 13 of AR Section 80 and Interpretation No. 8 of AR Section 90 of SSARS No. 19, both of which provide guidance regarding accountant’s reports issued in connection with either GAAP or an other comprehensive basis of accounting.
The IASB has been designated by the Council of the AICPA as the body to establish international financial reporting standards for both private and public entities pursuant to Rule 202, *Compliance With Standards*, and Rule 203, *Accounting Principles*, of the AICPA Code of Professional Conduct. Accordingly, an accountant may apply the reporting guidance in SSARS No. 19 when reporting on financial statements presented in accordance with IFRS as issued by the IASB.

Sample reports provided by the Interpretations follow:

**Compilation report on financial statements presented in accordance with IFRSs:**

<table>
<thead>
<tr>
<th>Accountant’s Compilation Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Appropriate Salutation]</td>
</tr>
<tr>
<td>I (we) have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board. Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements. My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.</td>
</tr>
<tr>
<td>[Signature of accounting firm or accountant, as appropriate]</td>
</tr>
<tr>
<td>[Date]</td>
</tr>
</tbody>
</table>

If the accountant compiles financial statements that omit substantially all disclosures but are otherwise in conformity with IFRSs as issued by the IASB, the accountant may wish to modify the third paragraph of the standard report as follows:

Management has elected to omit substantially all disclosures (and the statement of cash flows) required by International Financial Reporting Standards as issued by the International Accounting Standards Board. 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.
Independent Accountant’s Review Report

[Appropriate Salutation]

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

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the reviews in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (we) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

[Signature of accounting firm or accountant, as appropriate]
[Date]

Question: May a U.S. accountant perform a compilation or review of historical financial statements of a U.S. entity in accordance with ISRS 4410, Engagements to Compile Financial Statements, or ISRE 2400, Engagements to Review Financial Statements, both issued by the International Audit and Assurance Standards Board? The financial statements may have been prepared in accordance with IFRS or accounting principles generally accepted in the United States of America.

Interpretation: Yes. Interpretation No. 15 of AR Section 80 and Interpretation No. 10 of AR Section 90, both of SSARS No. 19, provide guidance. An accountant performing a compilation or review of historical financial statements of a U.S. entity is required to follow the compilation and review standards as promulgated by the AICPA’s Accounting
and Review Services Committee. However, those standards do not prohibit an accountant from indicating that the compilation or review also was conducted in accordance with another set of compilation or review standards. In an engagement to compile the historical financial statements in accordance with ISRS 4410, the accountant may perform the compilation in accordance with SSARSs as well as ISRS 4410. Such a compilation report may read as follows:

Accountant’s Compilation Report

[Appropriate Salutation]

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and in accordance with the International Standard on Related Services (ISRS 4410) issued by the International Audit and Assurance Standards Board applicable to compilation engagements. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Date]

In an engagement to review the historical financial statements in accordance with ISRE 2400, the accountant may perform the review in accordance with SSARS No. 19 as well as ISRE 2400. Such a review report may read as follows:
Independent Accountant’s Review Report

[Appropriate Salutation]

I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit in accordance with auditing standards generally accepted in the United States of America or in accordance with International Standards on Auditing, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and in accordance with International Standard on Review Engagement (ISRE 2400) issued by the International Audit and Assurance Standards Board. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on our review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

[Signature of accounting firm or accountant, as appropriate]
[Date]

If the report is for use only outside the United States, the accountant is still required to apply the SSARSs, except for requirements related to report form and content.
W. PREPARATION OF FINANCIAL STATEMENTS FOR USE BY AN ENTITY’S AUDITORS

The definition of third party:

SSARS No. 19 allows for issuance of management-use only financial statements as an alternative to the traditional compilation report engagement. Using SSARS No. 19, an accountant who compiles financial statements is permitted to issue management-use only financial statements if the financial statements are not expected to be used by a third party (e.g., management-use only).

If the accountant submits financial statements to a client that are not reasonably expected to be used by a third party, the accountant has two options available:

Option 1: Issue a compilation report and follow the rules for a traditional compilation engagement in accordance with SSARS No. 19, or

Option 2: Follow the rules for management-use only financial statements as follows:

1. Document an understanding with the entity through the use of an engagement letter, preferably signed by management, regarding the services to be performed and the limitations on the use of those financial statements (e.g., the financial statements are not to be issued to any third parties).

2. Issue management-use only financial statements without a compilation report.

3. Include a reference on each page of the financial statements restricting their use, such as:

   Restricted for Management’s Use Only, or

   Solely for the Information and Use by the Management of XYZ Corporation and not intended to be and should not be used by any other party

What is the definition of a third party for purposes of applying the management-use only financial statement provision?

SSARS No. 19 defines a third party as “all parties, including those charged with governance, except for those members of management.”

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

Those charged with governance represent the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.
Examples:

- Board of directors or committee of board
- Committee of management, partners or equivalent persons

**Note:** Notice that SSARS No. 19 states that those responsible for governance of an entity are considered third parties and not members of management. The result is that under SSARS No. 19, management-use financial statements may not be issued to the board of directors or others involved in governance as they are considered third parties. If such statements are issued to board members, those statements are not management-use only statements and therefore must include a compilation report.

A second key point is that the definition of members of management includes all members of management regardless of their level of knowledge about those financial statements. When the management-use only concept was introduced under the original SSARS No. 8, the definition of management required that a member of management also be generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. Subsequently, that definition was amended so that the current definition of management allows that all members of management may receive management-use only financial statements regardless of their level of knowledge about those financial statements.

It means that the parties to whom management-use only financial statements may be issued is limited to a smaller group of management, exclusive of members of the board of directors.

**What about a board member who is also an officer?**

As previously stated, a board member is not part of management and is therefore considered a third party for purposes of determining whether he or she can receive management-use financial statements under SSARS No. 19. However, if a board member is also a manager (e.g., owner-manager), that person is considered a member of management and may receive management-use financial statements.

The following chart summarizes those positions that are considered management as compared with those that are not part of management (third parties).
Who Is a Member of Management
Management-Use Financial Statements

<table>
<thead>
<tr>
<th>Position</th>
<th>Not member of management [Third parties]</th>
<th>Member of management</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>CFO</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>VP- financial functions</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>VP- non-financial functions (1)</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Members of board of directors and those responsible for governance (2)</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Board member-officer (3)</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

(1): All management positions, including those of individuals in non-financial positions, are considered members of management to whom management-use financial statements may be issued.

(2): Board members and others responsible for governance are not members of management and cannot receive management-use financial statements.

(3): Those charged with governance who also perform management functions (e.g., board member-officer) are considered members of management and may receive management-use financial statements.

What happens when an accountant is asked to prepare unaudited financial statements to be provided to the outside auditors for the annual audit?

In the situation where a client engages an accountant, other than its auditor, to prepare unaudited financial statements on behalf of management and where those financial statements are provided by management to its outside auditor for the purposes of the annual audit, is the client’s outside auditor deemed to be a third party using the financial statements?

Interpretation No. 16 of AR Section 80 of SSARS No. 19, Preparation of Financial Statements for Use by an Entity’s Auditors, provides guidance.

“Although the client’s outside auditor is a third party, the auditor is not deemed to be using the financial statements. The auditor’s role is to apply auditing procedures to those statements in order to obtain sufficient appropriate audit evidence to support his or her opinion on those statements. Accordingly, the requirements in paragraphs .22 to .24 of AR Section 80 (management-use only rules) are applicable.”

What this means is that the accountant is not required to issue a compilation report but is required to comply with the performance requirements in SSARS No. 19 as they apply to compilation engagements. Those performance requirements provide that the
accountant should include a reference on each page of the financial statements restricting their use, such as "Restricted for Management's Use Only" or "Solely for the information and use by the management of [name of entity] and not intended to be and should not be used by any other party."

X. APPLICABILITY OF STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

In February 2009, the Auditing Standards Board issued SAS No. 116, *Interim Financial Information*. SAS No. 116 amends SAS No. 100, *Interim Financial Information*, to establish standards and provide guidance when an accountant reviews interim financial information of a non-issuer, including companies offering securities under the SEC Rule 144A or participating in private equity exchanges.

In instances where SAS No. 116 applies, there must be authority to clarify that the SSARSs do not apply. Otherwise, there could be a situation in which both a review under SAS No. 116 and a review under the SSARSs could simultaneously apply to the same engagement.

SSARS No. 19 states that in a situation in which the provisions of SAS No. 116, *Interim Financial Information*, apply, the SSARSs do not apply.

In particular, SSARS No. 19 states:

1. Statements on Standards for Accounting and Review Services are not applicable to reviews of interim financial information if:

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

   b. The accountant has been engaged to audit the entity’s current year financial statements, or the accountant audited the entity’s latest annual financial statements and expects to be engaged to audit the current year financial statements, and

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

   Accountants engaged to perform reviews of interim financial information when the previously mentioned conditions above are met should perform such reviews in accordance with AU section 722, (SAS No. 116), *Interim Financial Information*.

*Note:* The interim guidance found in SSARS No. 19 was previously issued as part of SSARS No. 18, which amended SSARS No. 1. SSARS No. 19 replaces SSARS No. 1 effective for years ended on or after December 15, 2010.
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. In which of the following types of engagements must an accountant plan materiality:
   a) audit engagement only
   b) audit and review engagements only
   c) audit, review and compilation engagements
   d) review and compilation engagements only

2. A restricted use report should contain a separate paragraph at the end of the report that includes all of the following except:
   a) a statement indicating that the report is intended solely for the information and use of the specified parties
   b) an explanation for how to use the statements for nonspecified parties
   c) an identification of the specified parties to whom use is restricted
   d) a statement that the report is not intended to be and should not be used by anyone other than the specified parties

3. SSARS No. 13 permits an accountant to perform a compilation engagement related to specified _______ of a financial statement.
   a) elements
   b) accounts
   c) items
   d) all of the above

4. Which of the following is not true regarding a review of a specified element, account or item:
   a) a review engagement is authorized by the SSARSs
   b) a review engagement is authorized by SSAE No. 10
   c) the review report provides negative assurance
   d) the review report for a specified element, account or item is similar to that of a financial statement
5. Which of the following is not true regarding compilation engagements associated with pro forma financial information:

a) the accountant should label pro forma information to distinguish it from historical financial information
b) the accountant should establish an understanding regarding the services to be performed
c) the accountant cannot prepare pro forma financial information, and submit such information to the client without issuing a compilation report
d) if the accountant is not independent, he or she should specifically disclose the lack of independence

6. Which of the following should be the date of a management representation letter for a review:

a) the last day of the related fiscal year being reviewed
b) the date that the letter is presented and signed by the client
c) the date of the accountant’s review report
d) the last date that the accountant and the client had contact

7. If a current owner/manager refuses to sign a representation letter for a period of time during which management was not present:

a) a review report may not be issued
b) the accountant can step down to a compilation engagement
c) the accountant should notify all shareholders of the owner/manager’s refusal
d) all of the above

8. Which of the following is an example of a circumstance when an accountant should consider obtaining an updated representation letter from management for a review engagement:

a) the review report is not issued for a significant period of time after the original management representation letter was obtained
b) a material subsequent event occurs after obtaining the original management representation letter, but before the issuance of the report
c) a predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period
d) all of the above
9. Facts: A U.S. accountant is asked to compile or review historical financial statements of a U.S. company in accordance with International Standards. Which of the following is correct:

a) the accountant is precluded from issuing a compilation or review report under the international standards
b) the accountant is permitted to issue the report under the international standards as long as he or she does not follow the AICPA’s compilation and review standards
c) the accountant is permitted to issue the report under the international standards as long as he or she also follows the AICPA compilation and review standards
d) the accountant is permitted to issue a compilation or review report under the international standards regardless of whether U.S. standards are followed

10. An accountant is asked to prepare unaudited financial statements for a company to be provided to an auditor for the company’s annual audit. Which of the following is correct:

a) the client’s outside auditor is considered a third party and a compilation report must be issued by the accountant
b) the client’s outside auditor is considered a third party and a compilation report is not required to be issued by the accountant
c) the client’s outside auditor is not considered a third party and the accountant is not required to issue a compilation report
d) the client’s outside auditor is not considered a third party but the accountant is required to issue a compilation report
1. **A: Correct.** Planning materiality is required for an audit engagement only and not for compilation and review engagements.

   B: Incorrect. Although planning materiality is required for an audit, it is not required for a review engagement.

   C: Incorrect. Review and compilation engagements do not have a requirement to plan materiality.

   D: Incorrect. Review and compilation engagements are not subject to planning materiality per the SSARSs.

   (See page 240 of the course material.)

2. A: Incorrect. This is one of the items that should be included in the separate paragraph.

   B: Correct. The report should not be used for nonspecified parties, and this is not one of the items to be included in the separate paragraph.

   C: Incorrect. This is one of the items that should be included in the separate paragraph. The paragraph may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

   D: Incorrect. This is one of the items that should be included in the separate paragraph.

   (See page 242 of the course material.)

3. A: Incorrect. This is now permitted based on SSARS No. 13, but is not the only correct answer.

   B: Incorrect. This is now permitted based on SSARS No. 13, but is not the only correct answer.

   C: Incorrect. This is now permitted based on SSARS No. 13, but is not the only correct answer.

   D: Correct. SSARS No. 13 expanded the SSARS to permit an accountant to perform a compilation engagement related to specified elements, accounts or items of a financial statement.

   (See page 246 of the course material.)
4. **A: Correct.** Authorization comes from SSAE No. 10 rather than SSARS No. 19.

   B: Incorrect. Authorization for a review engagement of a specified element, account, or item is found in SSAE No. 10.

   C: Incorrect. The review report does provide negative assurance, with wording such as "Based on our review, nothing came to our attention..."

   D: Incorrect. The review report language under SSAE No. 10 and the SSARS is essentially the same.

   (See page 246 of the course material.)

5. A: Incorrect. The pro forma financial information should be properly labeled.

   B: Incorrect. The accountant should establish an understanding, preferably in writing, regarding the services to be performed including a description of the services and a description of the report.

   C: **Correct.** The accountant may prepare and submit pro forma financial information to a client without issuing a compilation report.

   D: Incorrect. If the accountant is not independent, they should disclose the lack of independence with a statement such as, "We are not independent with respect to xxxx."

   (See pages 251 to 252 of the course material.)

6. A: Incorrect. The date should be the date the letter is presented and signed by the client.

   B: **Correct.** This is the date that the management representation letter should be dated for a review.

   C: Incorrect. The representations with the letter should be made as of the date of the accountant's review report, but not the actual date of the letter.

   D: Incorrect. This is not the correct date for the letter.

   (See page 255 of the course material.)

7. **A: Correct.** Under these circumstances, a review report may not be issued.

   B: Incorrect. The accountant may not step down to a compilation engagement.

   C: Incorrect. There is no indication that the accountant should notify shareholders.

   D: Incorrect. Since b and c are not true, all of the above cannot be true.

   (See page 259 of the course material.)
8. A: Incorrect. This is an example, but it is not the only correct answer.
   B: Incorrect. This is an example, but it is not the only correct answer.
   C: Incorrect. This is an example, but it is not the only correct answer.
   D: Correct. All of the answers given are correct examples.
   (See page 267 of the course material.)

9. A: Incorrect. The accountant is not preclude from issuing a compilation or review report under the international standards.
   B: Incorrect. Although it is true that the accountant is permitted to issue the report under the international standards, there is no restriction that the accountant not follow the AICPA’s compilation and review standards.
   C: Correct. The accountant is permitted to issue a report under the International Standards as long as the U.S. AICPA compilation and review standards are also followed.
   D: Incorrect. The accountant is permitted to issue a compilation or review report under the international standards but also must follow U.S. standards.
   (See pages 270 to 271 of the course material.)

10. A: Incorrect. The client’s outside auditor is considered a third party but a compilation report is not required.
    B: Correct. Interpretation No. 16 states that the client’s outside auditor is considered a third party, but a compilation report is not required to be issued by the accountant.
    C: Incorrect. The client's outside auditor is considered a third party making the statement incorrect.
    D: Incorrect. The accountant is not required to issue a compilation report.
    (See page 275 of the course material.)
II. Practice Issues

Objectives:

- Explain how the rules for personal financial statements are applied.
- Review the rules for supplementary information.
- Identify the changes in peer review and deficiencies found in peer review engagements.
- Describe 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 client’s financial affairs (for example, individuals seeking public office).

1. Authority for Personal Financial Statements:

ASC 274, *Personal Financial Statements (formerly SOP 82-1)*, 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:

\[
\text{Estimated FMV of net assets} \quad \text{xx} \\
\text{- Tax basis of net assets} \quad \text{xx} \\
\text{Hypothetical gain} \quad \text{xx} \\
\text{Tax rate(s)} \quad \text{x} \quad \text{xx}\% \\
\]

\[
= \text{Estimated income tax on difference between the fair value and tax basis of net assets} \quad \text{xx}
\]

[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 paragraph of the report.

**Sample Compilation Report- Substantially All Disclosures Omitted**

**Accountant’s Compilation Report**

Fred and Mary Jones  
20 Main Street  
Winchester, Massachusetts

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. These financial statements are intended to present the assets of Fred and Mary Jones at estimated current values and their liabilities at their estimated current amounts.

We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Fred and Mary Jones are responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Fred and Mary Jones have elected to omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about Fred and Mary Jones’ financial condition and change in net worth. Accordingly, the financial statements are not designed for those who are not informed about such matters.

James J. Fox & Company, CPA  
[Date] (date of completion of compilation engagement)
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:

An accountant 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. 19 (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 accountant 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 accountant's attention during the engagement that would cause the accountant 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 accounting principles generally accepted in the United States of America 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 accountant 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*, allows an alternative to a SSARS No. 19 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 preprinted form."
Accountant’s Compilation Report

Board of Directors
X Corporation
Boston, Massachusetts

We have compiled the accompanying balance sheet of X Corporation as of December 31, 20XX, and the related statement of income and retained earnings for the year then ended included in the accompanying prescribed form. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the form prescribed by No Loan Bank.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the requirements of No Loan Bank, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

These financial statements (including related disclosures) are presented in accordance with the requirements of No Loan Bank which differ from accounting principles generally accepted in the United States of America. Accordingly, this report is intended solely for the information and use of No Loan Bank and is not intended to be and should not be used by anyone other than No Loan Bank.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

Note: The above-referenced SSARS No. 3 has been modified by the author to reflect changes made by SSARS No. 19. In particular, the last paragraph includes restricted use language found in paragraph 2.39 of SSARS No. 19 as follows:

“…this report is intended solely for the information and use of No Loan Bank and is not intended to be and should not be used by anyone other than No Loan Bank.”
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 accountant must modify the compilation report by adding an additional paragraph as follows:

---

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

Accountant’s Compilation Report

Board of Directors
X Corporation
Boston, Massachusetts

We have compiled the accompanying balance sheet of X Corporation as of December 31, 20XX, and the related statement of income and retained earnings for the year then ended included in the accompanying prescribed form. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the form prescribed by No Loan Bank.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the requirements of No Loan Bank, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. However, we did become aware of a departure from the requirements of the prescribed form that is 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 accounting principles generally accepted in the United States of America. Accordingly, this report is intended solely for the information and use of No Loan Bank and is not intended to be and should not be used by anyone other than No Loan Bank.

James J. Fox & Company, CPA
[Date] (date of completion of compilation engagement)

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

Sample of Prescribed Form Personal Financial Statement
Compilation Report: SSARS No. 3

Accountant's Compilation Report

Fred and Mary Jones
20 Main Street
Winchester, Massachusetts

We have compiled the accompanying personal financial statement of Fred and Mary Jones as of December 31, 20XX included in the accompanying prescribed form. We have also compiled the supplementary information presented in the prescribed form. We have not audited or reviewed the accompanying financial statement and, accordingly, do not express an opinion or provide any assurance about whether the financial statement is in accordance with the form prescribed by No Loan Bank.
Fred and Mary Jones are responsible for the preparation and fair presentation of the financial statements in accordance with the requirements of No Loan Bank, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statement.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of a financial statement without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statement.

This financial statement (including related disclosures) is presented in accordance with the requirements of No Loan Bank which differ from accounting principles generally accepted in the United States of America. Accordingly, this report is intended solely for the information and use of No Loan Bank and is not intended to be and should not be used by anyone other than No Loan Bank.

James J. Fox & Company, CPA
[Date] (date of completion of compilation engagement)

**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, real estate, life insurance details, 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 SSARSs, each page of the prescribed form should state “See Accountant's Compilation Report.”

**B. 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:** An accountant, 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. 19.

**Special Exception:** Interpretation No. 7 of AR Section 80 of SSARS No. 19, Applicability of Statements on Standards for Accounting and Review Services to Litigation Services, exempts such financial statements from the applicability of SSARS No. 19 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 accountant'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 accountant 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. 19 does not apply if the accountant is specifically engaged to compile the financial statements or, if others do not have the opportunity to analyze and challenge the accountant's work under the rules of the proceedings.

**C. CAMPAIGN REPORTS**

**Question:** What is an accountant'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 an accountant is serving as a treasurer for the candidate or campaign committee, the accountant 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 accountant is a member of management and should not report on his or her own representation. This is the case regardless of whether the accountant notes his or her lack of independence within the compilation report. This opinion is based on Technical Practice Aid 22 which is non-authoritative.

D. FINANCIAL STATEMENTS SUBMITTED ELECTRONICALLY

Regulatory bodies or other users of financial statements may request that financial statements that have been compiled or reviewed be submitted on a computer disk (e.g., CD or USB) or electronically as email attachments.

1) SSARSs are applicable to financial statements submitted:
   - On a CD, USB disk or electronically.

At a minimum, an accountant must at least compile the financial statements.

   - The accountant's report may be included on the CD or transmitted electronically as part of the financial statements.

   - A hard copy of the financial statements and accountant's report does not have to be submitted. 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 accountant 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® or other word processing format with the report presumably scanned onto the accountant firm's letterhead, there is the risk that the client could change the financial statements and report prior to submitting them to a third party. If, instead, the financial statements and report are scanned into a PDF format (using Adobe® Acrobat), and then sent electronically to the client, it is less likely that the client is going to override the financial statements that are in a PDF format. There is no authority as to which format is appropriate. The author believes that a practical approach should be applied toward sending information electronically. If a client's goal is to change the accountant's financial statements, that goal can be easily
achieved regardless of the format in which they are received. This is the case whether the financial statements are in an electronic or paper format. Yes, it would be more prudent to send the financial statements in a PDF format; however, there is no requirement to do so.

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

**Response:** SSARS No. 19 allows an accountant’s report signature to be either manual or printed. Therefore, an accountant may use a scanned or printed electronic signature in a report that is sent electronically. Most firms scan the firm’s signature into the Word® or PDF file.

**Should the report include the firm’s letterhead?**

**Response:** Although professional standards do not require the accountant’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.
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 ASC 274, Personal Financial Statements:
   a) ASC 274 requires that assets be stated at their estimated current values
   b) ASC 274 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. 19 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. Which of the following is not one of the four criteria that must be met for Interpretation No. 7 of SSARS No. 19 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 accountant 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 accountant is specifically engaged to compile the financial statements

5. Which of the following is true regarding financial statements submitted electronically:
   a) SSARS are not applicable
   b) at a minimum, an accountant 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
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 283 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 285 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 286 of the course material.)

4. 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. 19 exemption does not apply if the accountant is specifically engaged to compile the financial statements.
   (See page 291 of the course material.)
5. A: Incorrect. SSARSs are applicable to financial statements submitted on computer disk/USB and through a data transmission network.

B: Correct. At a minimum, an accountant 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 292 of the course material.)
E. PEER REVIEW STANDARDS

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

The new model:

1. Reduces the previous 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 “substandard.”

3. Introduces terms to measure the quality of the peer review engagement:
   - Matter
   - Finding
   - Deficiency
   - Significant deficiency.

4. Establishes a new grading system that includes:
   - Pass
   - Pass with deficiency
   - Fail

5. Changes the timing of initial selection of engagements provided to the reviewed firm to no earlier than three weeks.

6. Creates a more understandable, shorter and easier to use peer review report written in “plain English.”

The current two types of peer reviews:

The current 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

<table>
<thead>
<tr>
<th>Old Program</th>
<th>New Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>System review</td>
<td>System review</td>
</tr>
<tr>
<td>Engagement review</td>
<td>Engagement review*</td>
</tr>
<tr>
<td>Report review</td>
<td></td>
</tr>
</tbody>
</table>

* 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) or 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 accountant’s inquiry and analytical procedures, etc.

  Engagement reviews include compilations that omit substantially all disclosures as well as management-use only compilations in which no compilation report is issued.

  The following table summarizes the current peer review structure:
<table>
<thead>
<tr>
<th>Highest Level of Service Conducted by Firm</th>
<th>Type of Peer Review Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audits and/or examinations of prospective information (attestation engagements).</td>
<td><strong>System review</strong>— An opinion given on the firm's system of quality control.</td>
</tr>
<tr>
<td>Firms that are not required to have a system review.</td>
<td><strong>Engagement review</strong>— Consists of:</td>
</tr>
</tbody>
</table>
| Example:  
• Reviews  
• Compilations including management-use only compilation engagements. |  
• Separate report, letter of comments, technical review actions apply.  
• Committee acceptance and monitoring.  
Additional requirements: workpaper documentation is in conformity with the SSARSs and/or SSAEs. Examples include management representation letter, documentation of matters covered in the accountant's inquiry and analytical procedures, etc. |

**Current measurement standards:**

The current peer review program drastically changed both the terminology and means by which a reviewed firm is evaluated, as compared with the previous standards.

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

The current peer review program includes terms to measure the quality of the peer review engagement:

- Matter
- Finding
- Deficiency
- 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 is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

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

A significant deficiency exists when the peer reviewer concludes results that deficiencies are evident on all of the engagements submitted for review. The exception is when more that 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 review reports that can be issued:

- **Pass:** There are no deficiencies or significant deficiencies.
- **Pass with deficiency:** There was one or more deficiencies but no significant deficiencies.
- **Fail:** There was one or more significant deficiencies.

**Other changes:**

There are several other important requirements under the current peer review program.

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

b. The reviewed firm must provide a representation letter to the peer reviewer.

• The representation regarding compliance is stipulated as negative assurance.
• A firm’s refusal to furnish 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 too 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 current 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 current 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

F. PEER REVIEWS: RECURRING DEFICIENCIES NOTED IN COMPILATION AND REVIEW ENGAGEMENTS

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

Following are the deficiencies noted in peer reviews as published by the AICPA’s peer review committee in its report entitled “Common Deficiencies Noted During Peer Reviews.” Although this course is limited to compilation and review engagements, the author has included the entire list of deficiencies including those related to audit engagements.
<table>
<thead>
<tr>
<th>Significant engagement deficiencies-engagement is considered substandard</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Failure to:</strong></td>
</tr>
<tr>
<td>• Appropriately qualify an auditor’s report for a scope limitation or departure from the basis of accounting used for the financial statements.</td>
</tr>
<tr>
<td>• Issue a report on compliance and internal controls for audits subject to Government Auditing Standards.</td>
</tr>
<tr>
<td>• Disclose the lack of independence in a compilation report.</td>
</tr>
<tr>
<td>• Disclose the omission of substantially all disclosures in a compilation that omits disclosures.</td>
</tr>
<tr>
<td>• Disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Include a material amount or balance necessary for the basis</td>
</tr>
<tr>
<td>• Departures from standard wording where the report does not contain the critical elements of applicable standards.</td>
</tr>
<tr>
<td>• Issuance of an audit or review report when the accountant is not independent.</td>
</tr>
<tr>
<td>• Inclusion of material balances that are not appropriate for the basis of accounting used.</td>
</tr>
<tr>
<td>• Significant departures from the financial statement formats prescribed by industry accounting and auditing guides.</td>
</tr>
<tr>
<td>• Omission of the disclosures related to significant accounting policies applied (GAAP or OCBOA).</td>
</tr>
<tr>
<td>• Omission of significant matters related to the understanding of the financial statements, such as the cumulative material effect of a number of deficiencies.</td>
</tr>
<tr>
<td>• Improper accounting for a material transaction such as recording a capital lease as an operating lease.</td>
</tr>
<tr>
<td>• Misclassification of a material transaction or balance.</td>
</tr>
<tr>
<td>• Failure to include a summary of significant assumptions in a forecast or projection.</td>
</tr>
<tr>
<td>• Failure to segregate the statement of cash flows into the categories of investing, operating and financing.</td>
</tr>
<tr>
<td>• Omission of significant required disclosures related to material financial statement balances or transactions.</td>
</tr>
<tr>
<td>• Failure to disclose the cumulative effect of a change in accounting principle.</td>
</tr>
</tbody>
</table>
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).

- Omission of the statement of income and retained earnings when referred to in the report.

### Minor engagement deficiencies

#### Supplementary information:
- Failure to report on supplementary information.
- Supplementary information was not clearly segregated or marked.
- Titles of supplementary information did not coincide with the descriptions and titles presented in the financial statements.

#### Reports:
- Minor departures from standard report language.
- Report did not cover all periods presented.
- Minor report dating departures.

#### Other:
- Failure to accrue income taxes where the accrual is not material.
- Inclusion of the reference about the omission of the statement of cash flows for financial statements prepared under OCBOA.
- Failure to reference the accountant’s report on each page of the financial statements.
- Failure to identify within the audit report the country of origin.

#### Disclosures:
- Omitted or inadequate disclosures related to minor account balances or transactions such as inventory, valuation allowances, long-term debt, related-party transactions, and concentrations of credit risk.

#### Financial statement display:
- Minor departures from the financial statement formats recommended by industry accounting guides.
- Use of financial statement titles that are not appropriate for the basis of accounting used.
- Failure to include the title “Selected Information- Substantially All Disclosures Required by 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:

#### Failure to:
- Use a written audit program.
- Perform essential audit procedures required by an industry audit guide.
- 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.

- 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:

**Failure to:**
- 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.

**Obtain a client management representation letter for a review engagement.**

- Include the required language in an engagement letter for a management-use only engagement to communicate the understanding of the engagement for financial statements that are prepared for management use only, except for the failure to refer to the level of responsibility on supplementary information, which is not a significant deficiency.
<table>
<thead>
<tr>
<th>Attestation Procedures and Documentation:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Failure to:</strong></td>
</tr>
<tr>
<td>• Obtain a client management representation letter for an examination of internal control or regarding managements’ assumptions for a pro forma financial statement.</td>
</tr>
<tr>
<td>• Appropriately label pro forma financial information to distinguish it from historical financial information.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Specific Common Financial Statement Deficiencies:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
</tr>
<tr>
<td>• Improper classifications between current and long-term assets.</td>
</tr>
<tr>
<td>• Investments in majority owned or controlled subsidiary not consolidated.</td>
</tr>
<tr>
<td>• Cash overdrafts shown as a negative balance in the current asset section.</td>
</tr>
<tr>
<td>• Accounts receivable shown on cash basis financial statements.</td>
</tr>
<tr>
<td>• Investments in debt and equity securities not classified or measured correctly.</td>
</tr>
</tbody>
</table>

| **Statement of Income:**                     |
|   • Income tax provisions not recorded on interim financial statements. |
|   • Reporting period not clearly identified. |
|   • Significant components of income tax expense not disclosed. |

| **Liabilities:**                             |
|   • 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. |

| **Statement of Cash Flows:**                 |
|   • Cash flow statement not categorized by operating, investing and financing activities. |
- Misclassification of activities, especially between investing and financing activities.

- No disclosure of non-cash investing and financing activities.

- No disclosure of interest and taxes paid for indirect method.

- No reconciliation between net income and net cash flow from operations.

- Certain amounts in the statement of cash flows did not agree with amounts calculated from the comparative balance sheets.

- Cash flow statement not presented for each period that statement of income is presented.

**Incomplete and Missing Disclosures:**

<table>
<thead>
<tr>
<th>Practice Issues: Compilation and Review</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inadequate and Missing Disclosures:</strong></td>
</tr>
<tr>
<td><strong>Significant accounting policies, such as revenue recognition.</strong></td>
</tr>
<tr>
<td><strong>Basis of accounting other than GAAP.</strong></td>
</tr>
<tr>
<td><strong>Concentrations of credit risk.</strong></td>
</tr>
<tr>
<td><strong>Disclosures about fair value of financial instruments.</strong></td>
</tr>
<tr>
<td><strong>Disclosures about risks and uncertainties.</strong></td>
</tr>
<tr>
<td><strong>Components of receivables.</strong></td>
</tr>
<tr>
<td><strong>Components of inventory.</strong></td>
</tr>
<tr>
<td><strong>Disclosure of five-year debt maturities.</strong></td>
</tr>
<tr>
<td><strong>Related party transactions.</strong></td>
</tr>
<tr>
<td><strong>Leases.</strong></td>
</tr>
<tr>
<td><strong>Inadequate employee benefit.</strong></td>
</tr>
<tr>
<td><strong>Information about concentrations of products, services, customers, and suppliers.</strong></td>
</tr>
<tr>
<td><strong>Inadequate subsequent event disclosure of significant unrealized stock market losses.</strong></td>
</tr>
<tr>
<td><strong>Interest expense.</strong></td>
</tr>
<tr>
<td><strong>Rent expense.</strong></td>
</tr>
<tr>
<td><strong>Investments.</strong></td>
</tr>
<tr>
<td><strong>Intangible assets.</strong></td>
</tr>
<tr>
<td><strong>Details related to long-term debt.</strong></td>
</tr>
<tr>
<td><strong>Preferred stock redemption requirements.</strong></td>
</tr>
<tr>
<td><strong>Details related to the components of capital stock.</strong></td>
</tr>
<tr>
<td><strong>Details related to components of retained earnings.</strong></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Restricted loan covenants.</th>
<th>Restricted loan covenants.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation and amortization.</td>
<td>Depreciation and amortization.</td>
</tr>
<tr>
<td>Cash equivalents.</td>
<td>Cash equivalents.</td>
</tr>
<tr>
<td>Accrued compensation expense.</td>
<td>Accrued compensation expense.</td>
</tr>
<tr>
<td>Advertising expense.</td>
<td>Advertising expense.</td>
</tr>
<tr>
<td>Income tax expense.</td>
<td>Income tax expense.</td>
</tr>
<tr>
<td>Terms and conditions of a commitment.</td>
<td>Terms and conditions of a commitment.</td>
</tr>
<tr>
<td>Details relating to pension plans.</td>
<td>Details relating to pension plans.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Common Functional Area Deficiencies - Engagement</strong></th>
</tr>
</thead>
</table>

**Engagement performance:**

**Failure to:**

- Perform an adequate review of working papers and/or the accountant's/auditor's report and accompanying financial statements by the practitioner-in-charge of the engagement prior to the issuance of the auditor's/accountant's report.
- Perform pre-issuance review of engagement working papers and/or reports and accompanying financial statements by an independent party not associated with the engagement as required by firm policy.
- Utilize a disclosure and reporting checklist as required by firm policy.

- Consult professional literature or with a source outside the firm on reporting for a specialized industry, which resulted in the issuance of an incorrect audit report, and/or financial statement disclosure or presentation.
- Use accounting/auditing practice aids developed by third party providers as required by firm policy, which resulted in engagement deficiencies.
- Use engagement letters for accounting/auditing engagements as required by firm policy.
**Personnel management:**
- Failure of professional staff to take adequate CPE in accounting and auditing related subjects or specialized industries, which resulted in disclosure, reporting, and documentation deficiencies on engagements selected for review.

**Monitoring:**
Failure to:
- Adequately implement the firm’s monitoring policies and procedures.
- Document the firm’s compliance with policies and procedures for its system of quality control as required by AICPA Quality Control Standards.
- Perform an annual inspection, including the functional elements of quality control, as required by firm policy.
- Extend monitoring policies and procedures to non-audit services such as compilation and/or review engagements.

### Common Deficiencies Unique to Specialized Industries

<table>
<thead>
<tr>
<th>Engagements subject to government auditing standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Missing reports for internal control or compliance.</strong></td>
</tr>
<tr>
<td><strong>Missing proper A-133 reports.</strong></td>
</tr>
<tr>
<td><strong>Required compliance testing not performed.</strong></td>
</tr>
<tr>
<td><strong>Compliance and control tests not adequately designed.</strong></td>
</tr>
<tr>
<td><strong>Inadequate or outdated reference materials used.</strong></td>
</tr>
<tr>
<td><strong>Report on financial statements does not refer to reports on controls and compliance.</strong></td>
</tr>
<tr>
<td><strong>Yellow Book CPE requirements not met.</strong></td>
</tr>
<tr>
<td><strong>Improper accounting for a certain fund.</strong></td>
</tr>
<tr>
<td><strong>Failure to restrict the use of the accountant’s report to the proper governmental agency.</strong></td>
</tr>
</tbody>
</table>

### Not-for-profit organizations

- Identify a voluntary health and welfare organization.
- Present a statement of cash flows.
- Inadequate format, titles and presentation of financial statements.
- 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.

### Employee benefit plans

- Inadequate testing of participant data and investments.
- Inadequate or missing disclosures related to participant directed investment programs.
- Incomplete description of the plan and its provisions.
- Failure to properly report on a DOL limited-scope audit.
Practice Issues: Compilation and Review

<table>
<thead>
<tr>
<th>Investments and participant data.</th>
<th>Improper use of the limited scope exemption because the financial institution did not qualify for the exemption.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Failure to understand testing requirements on a limited-scope engagement.</td>
<td>• Failure to properly report on the supplementary schedules for ERISA and the DOL.</td>
</tr>
<tr>
<td>• Inadequate consideration of prohibited transactions.</td>
<td></td>
</tr>
</tbody>
</table>

---

**OCBOA financial statements**

<table>
<thead>
<tr>
<th>Failure to state the basis of accounting and that the basis is other than GAAP.</th>
<th>Inadequate description of the basis of accounting and how it differs from GAAP.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Failure to appropriately modify the accountant’s report to reflect financial statement titles that are appropriate for OCBOA.</td>
<td></td>
</tr>
</tbody>
</table>

---

**G. GAAP HIERARCHY: COMPIlATION AND REVIEW**

Although there are different reporting standards for compilation, review and audit engagements, **GAAP is the same for all 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 and_ identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy).

The objective of ASC 105 is to establish the _FASB Accounting Standards Codification™_ (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of GAAP financial statements. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.
The ASC 105 FASB Codification has the following attributes:

- The Codification simplifies user access to all authoritative GAAP by reorganizing GAAP into approximately 90 accounting topics.
- Relevant portions of SEC and SEC Staff Interpretations have been included for reference only for public companies.
- Updates to the Codification issued after the effective date of ASC 105 will serve only to update the Codification.
- At the effective date of ASC 105, all nongrandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed nonauthoritative and no longer updated.

ASC 105 establishes a new U.S. GAAP which is now split into two levels:

- Authoritative GAAP Guidance:
- Non-authoritative GAAP Guidance

| Evolution of FASB No. 162 Hierarchy into New ASC 105 (formerly FASB No. 168) GAAP |
|-----------------------------------------------|-----------------------------------------------|
| Category under Previous FASB No. 162 Hierarchy | NEW U.S. GAAP (ASC 105) | Authoritative GAAP Guidance | Non-authoritative GAAP Guidance |
| 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.

2. The following chart illustrates the items that are included in the authoritative and non-authoritative GAAP guidance:
### Authoritative GAAP Guidance

1) FASB Accounting Standards Codification (FASB ASC).

### Non-authoritative GAAP Guidance:

1) GAAP that is not included as part of the new FASB Accounting Standards Codification (ASC).

Sources of non-authoritative accounting guidance and literature include:

- 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)
- Accounting textbooks, handbooks, and articles (2)

2) SEC companies: rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority.


(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.

ASC 105 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. ASC 105 (formerly FASB No. 168) is the final standard that was issued by FASB in an individual statement format.

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 ASC 105 (formerly FASB No. 168) 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:

<table>
<thead>
<tr>
<th>FASB Codification (FASB ASC)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Area</td>
</tr>
<tr>
<td>General Principles</td>
</tr>
<tr>
<td>Presentation</td>
</tr>
<tr>
<td>Financial Statement Accounts</td>
</tr>
<tr>
<td>Broad Transactions</td>
</tr>
<tr>
<td>Industry</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

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, and 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. Which of the following terms has been eliminated by the most recent AICPA peer review program:
   a) term “substandard”
   b) term “poor quality”
   c) term “standard”
   d) term “presents fairly”

3. A system review focuses on which of the following:
   a) working paper documentation
   b) management representation letter
   c) the accountant’s inquiry and analytical procedures
   d) the accounting firm’s system of quality control

4. 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

5. 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
6. If there is one or more findings, a peer reviewer may conclude that the finding(s) rise(s) 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 ASC 105 (formerly 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) an accounting textbook
   b) rules and interpretive releases of the SEC under federal securities laws
   c) pronouncements of professional associations or regulatory agencies
   d) technical practice aids
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 two.

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

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

   (See page 297 of the course material.)

2. 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 current 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 current program.

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

   (See page 297 of the course material.)

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

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

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

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

   (See page 298 of the course material.)
4. 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 current 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 current AICPA peer review program.

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

(See page 299 of the course material.)

5. **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 299 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 299 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 301 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 301 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 304 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 307 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 310 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 312 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 313 of the course material.)
H. 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:** ASC 350, *Intangibles- Goodwill and Other* (formerly FASB No. 142) requires that goodwill and indefinite lived intangibles not be amortized. Instead, an annual test for impairment on goodwill and certain other intangible assets must be made. For most smaller businesses, it is preferable to continue to amortize such intangibles and avoid performing the impairment test.

- **Consolidation of real estate leasing (variable interest) entities:** ASC 810, *Consolidation*, (formerly FIN 46R) requires a lessee operating company to consolidate a real estate lessor company if the real estate lessor is a variable interest entity and the operating company is 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 (including section 179 and bonus depreciation) as their GAAP depreciation unless the difference is not material.

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

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

1. Compile OCBOA statements (e.g., cash or income tax basis)
2. Compile GAAP financial statements with no footnotes and statement of cash flows
3. Issue management-use financial statements in accordance with SSARS No. 19:
• 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. 19 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 lists the departures from GAAP.

Example: Assume that an accountant prepares monthly financial statements for a client, and these statements consistently have certain GAAP departures such as missing accruals, allowance for bad debts, etc. The accountant may 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 accountant 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 full set of financial statements.

7. Apply options that are excluded from SSARS No. 19 for which a compilation or review report is not required:

• Provide selected monthly information requested by the client such as account balances (e.g., cash or accounts receivable) or operating information (e.g., number of meals served for the month)

• Provide a client or other third party users with a copy of the client’s tax return. An accountant is not required to report on a tax return.

8. Issue financial statements with one or more GAAP departures.

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

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

☐ Issue GAAP statements with one or more GAAP departures, or
☐ Issue 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 (ASC 350) precludes such goodwill and intangibles from being amortized and, instead, requires that an annual impairment test be performed.

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 (including the section 179 deduction and bonus 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 XYZ Company is a small manufacturing company.

Details regarding X follow:

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

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

1. *Amortization of goodwill*: X will amortize goodwill over the 15-year tax life, resulting in amortization expense of $100,000, which, net of the tax effect, is $60,000. GAAP (ASC 350 (formerly FASB No. 142)) does not permit goodwill to be amortized and, instead, requires goodwill to be tested annually for impairment.
2. **Avoid test for consolidation of real estate leasing company (ASC 810 (formerly FIN46R))**: 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.

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

**Accountant’s Compilation Report**

Board of Directors  
XYZ Company  
Nowhere, Massachusetts

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. **During our compilation, we did become aware of a departure (certain departures) from accounting principles generally accepted in the United States of America that is (are) described in the following paragraphs.**

Accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders’ equity would have increased by $60,000, net of the tax effect.
Accounting principles generally accepted in the United States of America require that the company test 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 accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America. 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, CPA
[Date] (date of completion of compilation engagement)

**Independent Accountant’s Review Report**

Board of Directors
XYZ Company
Nowhere, Massachusetts

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

Management (owners) is (are) responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.
Based on our review, with the exception of the matter(s) described in the following paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

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

As disclosed in Note 3 to the financial statements, accounting principles generally accepted in the United States of America require that the company test 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 accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

James J. Fox & Company, CPA
Date:
Independent Auditor’s Report

To the Board of Directors
Company X
Nowhere, Massachusetts

We have audited the accompanying balance sheet of XYZ Company 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 accounting principles generally accepted in the United States of America, 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 XYZ Company 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
Date:
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.

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**Independent Auditor’s Report**

To the Board of Directors
XYZ Company
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 accounting principles generally accepted in the United States of America, 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 XYZ Company as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

James J. Fox & Company
Date:
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 1, SSARS No. 19, Reporting When There Are Significant Departures From the Applicable Financial Reporting Framework, provides the following limited guidance.

**Question:** When the financial statements include significant departures from the applicable financial reporting framework (e.g., U.S. GAAP, OCBOA, etc.), may the accountant modify his standard report in accordance with AR Section 80 and 90 of SSARS No. 19 to include a statement that the financial statements are not in conformity with the applicable financial reporting framework (e.g., U.S. GAAP, OCBOA, etc.)?

**Response:** No. Including such a statement in the accountant’s compilation or review report would be tantamount to expressing an adverse opinion on the financial statements as a whole. Such an opinion can be expressed only in the context of an audit engagement. Furthermore, such a statement in a review report would confuse users because it would contradict the expression of limited assurance required by SSARS No. 19.

However, paragraphs 2.25 and 3.33 of SSARS No. 19 indicate 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 accounting principles generally accepted in the United States of America.

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:**
XYZ Company has four GAAP departures as follows:
- Amortization of goodwill
- Does not test its related party leasing company for consolidation
- Uses MACRS for depreciation
- Does not use the allowance method to record bad debts.

The accountant believes that due to the four GAAP departures, he should emphasize the matter in the review report as follows:
Sample Review Report with Multiple GAAP Departures

Independent Accountant’s Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

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

Management is responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, with the exception of the matter(s) described in the following paragraph(s), we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

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

As disclosed in Note 3 to the financial statements, accounting principles generally accepted in the United States of America require that the company test 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.
effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

As disclosed in Note 4, accounting principles generally accepted in the United States of America require that fixed assets be depreciated over their estimated useful lives. Management has informed us that the Company has recorded depreciation using the Modified Accelerated Cost Recovery System required for federal income tax purposes, which does not result in an allocation of depreciation to expense over the estimated useful lives of the fixed assets. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

As disclosed in Note 5, accounting principles generally accepted in the United States of America require that an allowance for uncollectible accounts be recorded to reflect an estimate of trade receivables that will not be realized. Management has informed us that uncollectible accounts have been recorded on the direct writeoff method. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

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 accounting principles generally accepted in the United States of America.

James J. Fox & Company, CPA
Date:

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.

Using income tax basis accrual financial statements is another option for avoiding traditional GAAP financial statements, and is discussed separately within this course.

I. DESIGNING EFFECTIVE ENGAGEMENT LETTERS

In order to mitigate the effects of litigation against CPAs and auditors, more and more CPA firms are including protective language in their engagement letters. The engagement letter is the contract between the client and the auditor and should clearly reflect the understanding and responsibilities of both parties. SAS No. 83, Establishing
an Understanding With The Client, 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 accountant must weigh the benefits of having a strong engagement letter with those of alienating the client.

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

Here are a few misnomers as to why CPAs have not obtained 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 write-up 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. 19 states the following with respect to a compilation or review engagement:

"The accountant should establish an understanding with management regarding the services to be performed for compilation engagements and should document the understanding through a written communication with management."

Prior to the issuance of SSARS No. 19, the SSARSs, as well as auditing standards, stated that obtaining an engagement letter for a compilation, review or audit engagement was “preferable” but not required. That option changed for audits with the issuance of SAS No. 108, *Planning and Supervision*, which requires that an auditor establish an understanding with the client in the form of a written communication such as an engagement letter. Finally, SSARS No. 19 followed SAS No. 108 by now requiring an accountant to establish an understanding with management regarding the services to be
performed for compilation and review engagements. That understanding must be through a written communication with management. SSARS No. 19 is effective for years ending on or after December 15, 2010.

Although in SSARS No. 19, the term “written communication” with management can be in a form other than an engagement letter, the reality is that an accountant should insist on obtaining a signed engagement letter from a client in a compilation, review or audit engagement.

SSARS No. 19 provides an updated sample of an engagement letter for both compilation and review engagements. Although that sample letter includes all of the required minimum elements identified in SSARS No. 19, it does not include several other clauses that the author believes may be important to assist the accountant in clarifying key issues of dispute commonly found in litigation.

SSARS No. 19 states that an engagement should include, as a minimum, the following elements:

- The objectives of the engagement
- Management’s responsibilities
- Accountant’s responsibilities
- Limitations of the engagement

Although these elements represent the minimum requirements to satisfy SSARS No. 19, rarely are they sufficient enough to convey the terms and conditions of both parties and to protect the accountant in litigation.

**What clauses should be included in any engagement letter?**

The following chart identifies some of the clauses that should be included in engagement letters beyond the standard provisions found in the SSARS No. 19 engagement letter. The chart is segregated into three categories of provisions for engagement letters:

- Required clauses that should be in every engagement letter
- Highly recommended provisions
- Recommended but difficult to obtain
Language to Include in Engagement Letters

### Provisions to Include in an Engagement Letter Beyond Those Required by SSARS No. 19

<table>
<thead>
<tr>
<th>Required- should be in every letter</th>
<th>Highly recommended provisions</th>
<th>Recommended but difficult to obtain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethics Interpretation 101-3 language for nonattest services*</td>
<td>Ownership of records and confidentiality of information</td>
<td>Use of report by third parties and limits on reproduction of report</td>
</tr>
<tr>
<td></td>
<td>Record retention policy</td>
<td>Limit on amount of damages in litigation and time to sue</td>
</tr>
<tr>
<td></td>
<td>Mediation clause</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Indemnification arising from management misrepresentations</td>
<td></td>
</tr>
</tbody>
</table>

* Interpretation 101-3 language is required if the accountant is going to perform nonattest services such as write-up, tax return preparation, etc.

### ILLUSTRATIVE ENGAGEMENT LETTERS

The following are non-authoritative engagement letters for compilation, review and write-up services engagements, most of which are based on the nonauthoritative engagement letters published in SSARS No. 19.

In addition to language required by SSARS No. 19, the author has included several suggested paragraphs that may assist the accountant in protecting himself or herself against potential litigation. Of course, an accountant may wish to consult with his or her malpractice insurance provider prior to adopting an engagement letter format.

Following are clauses that an accountant may consider inserting into the engagement letter.

**Required:**
1. Ethics Interpretation 101-3: Nonattest services language

**Highly recommended:**
1. Ownership of records and confidentiality of information
2. Record retention policy
3. Mediation clause
4. Indemnification arising from management misrepresentations.

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17 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.
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 of damages in litigation and time to sue.

a. Required language:

1. Ethics Interpretation 101-3 Language- Nonattest Services

Ethics 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._

Interpretation 101-3 language is only required if an accountant is performing nonattest services in addition to his or her review or compilation engagement. Rarely is an accountant not involved in some form of nonattest services while also performing a compilation or review engagement. For example, it is rare for an accountant not to perform some type of tax services for his or her client, or perform some bookkeeping services that include proposing adjusting entries to the client. The result is that the author believes this Interpretation 101-3 language should be included in every compilation or review engagement letter as a standard provision even though SSARS No. 19 has not included it in its standard letter.
b. Highly recommended clauses:

1. Ownership of Records and Confidentiality of Information:

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

Sample language:

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 accountant. Mediation acts as an intermediate step before litigation during which there is the possibility that both parties can agree to terms before going the costly route of litigation. Also, mediation is not binding on either party.
**Sample language:**

“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 attorneys 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 direct claim against the accountant. This clause probably should not be used in those states that practice the privity standard where, by its inclusion, a third party could claim it had a contract with the accountant. Opinions on whether known third parties should be named in the engagement letter differ among malpractice insurance companies.

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

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 of damages and time to sue

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

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. 19.
Sample Engagement Letter: Review

Mr. John Smith  
President  
XYZ Company  
100 Main Street  
Nowhere, MA 02110

Dear Mr. Smith:

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

We will perform the following services:

We will review the financial statements of XYZ Company as of December 31, 20XX, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

f. Providing us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A review includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review is substantially less in scope that an audit, the objective of which is the expression of an opinion regarding the financial
statements as a whole. A review does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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.

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

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.

REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:

[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.

[**HIGHLY RECOMMENDED PROVISIONS**]

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

1. Our firm, as well as other accounting firms, 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.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

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

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

[Indemnification for Management Misrepresentations]
If we incur legal fees as a result of our reliance on any false representations by you, you agree to reimburse us for all of our legal fees and related costs of defense.
[HIGHESTLY RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]

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

[Use of Report by Third Parties and Limits on Reproduction of the Report]
We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the 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.

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

__________________________
James J. Fox & Company, CPA

Acknowledged:
XYZ Company

__________________________    _____________
President                                      Date
Sample Engagement Letter: Compilation

Mr. John Smith
President
XYZ Company
100 Main Street
Nowhere, MA 02110

Dear Mr. Smith:

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

We will perform the following services:

We will compile, from information you provide, the annual [and interim, if applicable] financial statements of XYZ Company as of December 31, 20XX, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

1. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

2. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

3. Preventing and detecting fraud.

4. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

5. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

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; testing 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); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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 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.

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 compilation engagement, 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 engagement. 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 compilation engagement 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 PROVISIONS FOR COMPILATION ENGAGEMENT:**

*Insert additional language if CPA is not independent:*

> We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

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

If management elects to omit substantially all disclosures and the statement of cash flows from the financial statements, we will include an additional paragraph that will read as follows:
Management has elected to omit the statement of cash flows and substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

**REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:**

**[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.

**[HIGHLY RECOMMENDED PROVISIONS]**

**[Ownership of Records]**

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

1. Our firm, as well as other accounting firms, 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.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.
[Record Retention Policy]
It is our policy to keep workpapers related to this engagement for seven years. When your records are returned to you, it is your responsibility to retain and protect your records for possible use, including potential examination by any government or regulatory agencies.

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

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

[RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]

[Limit on Amount of Damages and Time to Sue]
There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our 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 review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.

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

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

You further agree that you will not reproduce our report for any reason without obtaining our written consent.
We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

__________________________________
James J. Fox & Company, CPA

Acknowledged:
XYZ Company

President

Date

Sample Engagement Letter: Compilation
Not Intended for Third Party Use
[Management-Use Financial Statements]

President
XYZ Company
100 Main Street
Nowhere, MA 02110

Dear Mr. Smith:

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

We will perform the following services:

We will compile, from information you provide, the [monthly, quarterly, or other frequency] financial statements of XYZ Company for the year 20XX.

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

1. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].
2. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

3. Preventing and detecting fraud.

4. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

5. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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; testing 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); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. 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 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.

[ADDITIONAL LANGUAGE FOR MANAGEMENT-USE ONLY FINANCIAL STATEMENTS]

The financial statements will not be accompanied by a report and are for management’s use only and are not to be used by a third party.

Material departures from accounting principles generally accepted in the United States of America (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.
Should you require financial statements for third-party use, we would be pleased to discuss with you the requested level of service. Such an engagement would be considered separate and not deemed to be part of the services described in this engagement letter.

We estimate that our fees for the above services will be approximately $XXX for our compilation engagement, 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 engagement. 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 compilation engagement 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.

**REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:**

[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.
[HIGHLY RECOMMENDED PROVISIONS]

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

1. Our firm, as well as other accounting firms, 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.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

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

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

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

[RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]

[Limit on Amount of Damages and Time to Sue]
There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our review fees. In order to induce us to accept this engagement, you hereby agree that our liability for any negligence, errors or omissions committed by us will be limited to XX times the amount of our review fees. Further, you agree that any suit or counterclaim based on this engagement must be initiated within 24 months after the performance of our services.
[Use of Report by Third Parties and Limits on Reproduction of the Report]
Not applicable

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

__________________________________
James J. Fox & Company, CPA

Acknowledged:
XYZ Company

President
Date

Observation: If an accountant is obtaining an engagement letter from a client in connection with management-use only financial statements, certain clauses applicable to a traditional compilation engagement are not needed. For example, the suggested clause that limits use of the report by third parties and limits on reproduction of the report is not applicable because there is no report. Similarly, the accountant may choose to limit some of the other clauses because there is less engagement risk given the fact that a report will not be issued to third parties.

Sample Engagement Letter: Monthly Bookkeeping and Compilation

Mr. John Smith
President
XYZ Company
100 Main Street
Nowhere, MA 02110

Dear Mr. Smith:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and 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 Company, and related statements of income and retained earnings for the month then ended, and annual financial statements for the year ended December 31, 20XX, and issue an accountant’s report thereon in
accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

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; testing 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); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

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. 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 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.

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 compilation engagement, 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 engagement. 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 compilation engagement 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 PROVISIONS FOR COMPILATION ENGAGEMENT:**

**Insert additional language if CPA is not independent:**

We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

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

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

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

**REQUIRED PROVISION IF NONATTEST SERVICES ARE TO BE PERFORMED:**

**[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.
[HIGHLY RECOMMENDED PROVISIONS]

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

1. Our firm, as well as other accounting firms, 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.

2. We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

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

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

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

[RECOMMENDED BUT DIFFICULT TO OBTAIN PROVISIONS]

[Limit on Amount of Damages and Time to Sue]
There is the risk that potential errors and fraud can occur that can result in damages that may be several times the amount of our 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.
[Use of Report by Third Parties and Limits on Reproduction of the Report]

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

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

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

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

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

__________________________________
James J. Fox & Company, CPA

Acknowledged:

XYZ Company

_______________________
President

_______________________
Date
J. 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.
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 ASC 350 (formerly FASB No. 142) 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 ASC 740 (formerly FASB No. 109) 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. Which of the following provisions should be in every engagement letter:
   a) limit on amount of damages in litigation and time to sue
   b) management’s responsibility
   c) record retention policy
   d) ownership of records and confidentiality of information

5. 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
6. 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 322 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 324 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 329 of the course material.)
4. A: Incorrect. This provision is highly recommended, but difficult to obtain, and therefore is not in every engagement letter.

B: Correct. SSARS No. 19 states that one of the elements that should be in every engagement letter is management’s responsibility.

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 335 of the course material.)

5. A: Correct. Most attorneys 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 page 338 of the course material.)

6. 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 page 359 of the course material.)
K. 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 an accountant 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 accountant with respect to that client? At a simpler level, an accountant 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 an accountant is precluded from issuing a review or audit report on the financial statements of any entity to which he or she is not independent. SSARS No. 19 carves out a special exception for an accountant 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.*”

Prior to the issuance of SSARS No. 19, an accountant was not permitted to disclose the reason for the lack of independence. Now, SSARS No. 19 permits an accountant 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 an accountant 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 with specific changes made including 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 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,
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.
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)**

<table>
<thead>
<tr>
<th>Client name: ____________________</th>
<th>Year end of attest engagement: ____________________</th>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Type of attest engagement:</th>
</tr>
</thead>
<tbody>
<tr>
<td>____ Review ____ Audit ____ Attestation- SSAE No. 10 ____ Compilation with no disclaimer for lack of independence</td>
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</table>

<table>
<thead>
<tr>
<th>Type of nonattest services to be performed:</th>
</tr>
</thead>
<tbody>
<tr>
<td>____ Bookkeeping</td>
</tr>
<tr>
<td>____ Payroll tax prep/other disbursements</td>
</tr>
<tr>
<td>____ Benefit plan services</td>
</tr>
<tr>
<td>____ Investment advisory/management</td>
</tr>
<tr>
<td>____ Corporate finance/consulting/advisory</td>
</tr>
<tr>
<td>____ Tax return preparation</td>
</tr>
<tr>
<td>____ Appraisal, valuation or actuarial services</td>
</tr>
<tr>
<td>____ Business risk consulting</td>
</tr>
<tr>
<td>____ Information systems</td>
</tr>
<tr>
<td>____ Other: ____________________</td>
</tr>
</tbody>
</table>

**Comments: nonattest services:**

<table>
<thead>
<tr>
<th>1. Is the client aware of the objectives of the engagement?</th>
<th>Yes</th>
<th>No</th>
<th>Comments</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>2. Does the client understand the type of nonattest services the accountant is about to perform?</th>
<th>Yes</th>
<th>No</th>
<th>Comments</th>
</tr>
</thead>
</table>

<table>
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<tr>
<th>3. Has client accepted responsibility for the nonattest services including:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Has management agreed to continue to make all management decisions and perform all management functions?</td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------</td>
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</table>
### Practice Issues: Compilation and Review

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<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>b. Has management designated an individual who possesses suitable skill, knowledge, and/or experience, (preferably someone within senior management), to oversee the nonattest services?</strong></td>
<td></td>
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<td></td>
<td>Name: ________________________</td>
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<tr>
<td><strong>c. Has management agreed to evaluate the adequacy and results of the nonattest services performed?</strong></td>
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<tr>
<td><strong>d. Does management accept responsibility for the results of the nonattest services?</strong></td>
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<tr>
<td><strong>e. Does management take responsibility to establish and maintain internal controls, including monitoring ongoing activities, over the subject matter of the nonattest engagement?</strong></td>
<td></td>
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</tr>
<tr>
<td><strong>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?</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>5. If applicable, has management been informed of any limitations of the engagement and their impact on the nonattest engagement?</strong></td>
<td></td>
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<tr>
<td><strong>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?</strong></td>
<td></td>
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</tr>
<tr>
<td><strong>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?</strong></td>
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</tr>
</tbody>
</table>

**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

Following are excerpts from the most recent version of Interpretation 101-3, 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
- 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, within 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.\(^{18}\) However, such an option is not available for review and audit engagements.

**Observation:** The author notes that, as a matter of policy, some firms disclaim independence in all of their compilation reports to ensure that they do not violate the documentation requirements of Interpretation 101-3. By disclaiming independence, such firms avoid having to spend additional time to document under the Interpretation with the

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\(^{18}\) A failure to prepare the required documentation does not impair independence but does violate AICPA ethics Rule 202, Compliance with Standards.
sole risk that a client or third party might challenge the lack of independence. As a practical point, few third parties or clients 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.

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,$^{19}$ 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
• 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.

<table>
<thead>
<tr>
<th>TYPE OF OTHER SERVICE</th>
<th>INDEPENDENCE WOULD NOT BE IMPAIRED</th>
<th>INDEPENDENCE WOULD BE IMPAIRED</th>
</tr>
</thead>
</table>
| Bookkeeping           | • 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. | • 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. |

$^{19}$ 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.
<table>
<thead>
<tr>
<th>Non-tax Disbursement</th>
<th>Benefit Plan Administration&lt;sup&gt;21&lt;/sup&gt;</th>
</tr>
</thead>
</table>
| • 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.  
  <sup>20</sup> | • 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.  
• 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.  

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<sup>20</sup> Footnote 20 removed.

<sup>21</sup> 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.
| Investment Advisory & Management | • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client’s desired rate of return, risk tolerance, etc.  
• Perform record keeping and reporting of client’s portfolio balances including providing a comparative analysis of the client’s 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. | • 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. |
| --- | --- | --- |
| Corporate Finance Consulting or Advisory | • 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. | • 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. |
<p>| Appraisal, Valuation or Actuarial | • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would not be material to the financial statements, and the appraisal, valuation, or actuarial service does not involve a ... | • Appraisal, valuation, or actuarial service where the results, individually or in the aggregate, would be material to the financial statements, and the ... |</p>
<table>
<thead>
<tr>
<th><strong>Practice Issues: Compilation and Review</strong></th>
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<tbody>
<tr>
<td><strong>significant degree of subjectivity such as an actuarial valuation of a client's pension or postemployment benefit liabilities.</strong></td>
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<tr>
<td><strong>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.</strong></td>
</tr>
<tr>
<td><strong>appraisal, valuation, or actuarial service involves a significant degree of subjectivity such as those in connection with employee stock ownership plans, business combinations, or appraisals of assets or liabilities.</strong></td>
</tr>
<tr>
<td><strong>Executive or Employee Search</strong></td>
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<tr>
<td><strong>Recommend a position description or candidate specifications.</strong></td>
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<tr>
<td><strong>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).</strong></td>
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<tr>
<td><strong>Participate in employee hiring or compensation discussions in an advisory capacity.</strong></td>
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<tr>
<td><strong>Commit the client to employee compensation or benefits arrangements.</strong></td>
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<tr>
<td><strong>Hire or terminate client employees.</strong></td>
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<tr>
<td><strong>Business Risk Consulting</strong></td>
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<tr>
<td><strong>Provide assistance in assessing the client’s business risks and control processes.</strong></td>
</tr>
<tr>
<td><strong>Recommend a plan for making improvements to a client’s control processes and assist in implementing these improvements.</strong></td>
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<tr>
<td><strong>Make or approve business risk decisions.</strong></td>
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<tr>
<td><strong>Present business risk considerations to the Board or others on behalf of management.</strong></td>
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<tr>
<td><strong>Information Systems Design, Installation &amp; Integration</strong></td>
</tr>
<tr>
<td><strong>Install or integrate a client’s financial information system, that was not designed or developed by the member (e.g., an off-the-shelf accounting package).</strong></td>
</tr>
<tr>
<td><strong>Assist in setting up the client’s chart of accounts and financial statement format with respect to the client’s financial information system.</strong></td>
</tr>
<tr>
<td><strong>Design, develop, install, or integrate a client’s information system that is unrelated to the client’s financial statements or accounting records.</strong></td>
</tr>
<tr>
<td><strong>Provide training and instruction to client employees on an information and control system.</strong></td>
</tr>
<tr>
<td><strong>Design or develop a client’s financial information system.</strong></td>
</tr>
<tr>
<td><strong>Make other than insignificant modifications to source code underlying a client’s existing financial information system.</strong></td>
</tr>
<tr>
<td><strong>Supervise client personnel in the daily operation of a client’s information system.</strong></td>
</tr>
<tr>
<td><strong>Operate a client's local area network (LAN) system.</strong></td>
</tr>
</tbody>
</table>

Source: Interpretation 101-3 (revised), as modified by the Author.
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
- 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, and 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.]

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

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

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.

Practice Issues: Compilation and Review
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
- 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
- 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 20X6 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

- 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
   - 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

<table>
<thead>
<tr>
<th>Propose and/or post standard, adjusting, or correcting journal entries <em>not during</em> an audit, review or compilation engagement, or in a separate engagement.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpretation 101-3 applies</td>
</tr>
</tbody>
</table>

### Entries part of the attest engagement not subject to 101-3

<table>
<thead>
<tr>
<th>Propose and/or post standard, adjusting, or correcting journal entries <em>during</em> an audit, review or compilation engagement.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpretation 101-3 does not apply Interpretation 101-C applies</td>
</tr>
</tbody>
</table>

1. **Accountant may not be a member of management:**
   - The accountant may not perform management functions or make management decisions as they relate to the bookkeeping services
   - 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.

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 a competent employee,* 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
   - 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.

### Interpretation 101-C applies

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 tax and 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.\(^{23}\)
- 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:

\(^{23}\) 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.
• 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 accountant should establish and document in writing his or her understanding with the client with respect to:

   • Objectives of the nonattest tax engagement.
   • Nonattest tax services to be performed.
   • Client’s acceptance of its responsibilities.
   • Member’s responsibilities.
   • Any limitations of the engagement.

Observation: In most instances, a client does not have an individual who has an expertise in taxation. Consequently, how could a person be designated to possess the skill, knowledge, and experience to oversee the accountant’s preparation of tax returns? In general, in complying with 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 control over the client’s funds and the individual designated by the client to oversee the tax services:

   • Reviews and approves the tax return and related tax payment, and
   • If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.

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.

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24 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.
c. Authorized representation of a client in administrative proceedings before a taxing authority would not impair independence provided the accountant obtains client agreement prior to committing the client to a specific resolution with the taxing authority.

1) Representing a client in a court or in a public hearing to resolve a tax dispute would impair an accountant’s independence.

What is the definition of a tax return 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 control over the client’s funds and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment, and
- If required for filing, the designated individual signs the tax return prior to the accountant transmitting the return to the taxing authority.

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.

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25 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.
Example 2: Same facts as Example 1 except that the following actions occur:

- Joe prepares the federal and state tax returns.
- Joe sends a copy of the returns to Mary, who is Company X’s controller and the individual designated by X to oversee the tax services. Mary reviews and approves the tax returns.
- Company X (Mary) signs a Form 8879 authorization for e-filing and returns it to Joe.
- Joe files the tax returns and related tax payments electronically with each taxing authority.
- Joe does not have custody or control over the client’s funds.

Conclusion: Joe has not 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
• 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
- 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. 19 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, can the accountant 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 impairment 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:

| **Business Combinations (ASC 805)** | Requires that fair value be used in allocating the purchase price to net assets in a business combination |
| **Intangibles- Goodwill and Other (ASC 350)** | Requires that fair value be used in performing an annual test of impairment of goodwill and other intangible assets |
| **Property, Plant and Equipment (ASC 360)** | Requires that fair value be used to test the impairment of long-lived assets if certain criteria are met |
| **Consolidation (ASC 810)** | Requires that fair value be used to determine whether an entity is a variable interest entity (VIE) that should be consolidated |
| **Guarantees (ASC 460)** | 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:

a. The results of the service, individually or in the aggregate, *would be material to the financial statements*, and

b. The service requires a *significant degree of subjectivity*.

This means that an accountant cannot be involved in a valuation if that valuation involves an element(s) that will be material to the financial statements, and the valuation has a significant degree of subjectivity.

**Note:** In discussions with the AICPA Ethics Division staff, the author determined that the staff is taking a general position that a valuation performed by an accountant for a client in connection with the requirements of ASC 805 (formerly FASB No. 141R), ASC 350 (formerly FASB No. 142), or ASC 810 (formerly 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 ASC 350 (formerly FASB No. 142). Because X does not have expertise in valuation, X asks its outside accountant to compute the entity’s fair value for purposes of performing the goodwill test. The accountant did the fair value test for the client. Goodwill is material to the financial statements.

**Conclusion:** The accountant is not independent with respect to X. The reason is two-fold:

An accountant *may not* perform appraisal, valuation and actuarial services for an attest client if two factors exist:

a. The results of the service, individually or in the aggregate, *would be material to the financial statements*, and

b. The service requires a *significant degree of subjectivity*.

Both of these factors have been met.
Observation: The independence issue related to valuation has come to the forefront due to the issuance of ASC 810 (formerly FIN 46R). Specifically, ASC 810 deals with the consolidation of variable interest entities (VIEs) and can result in a related party real estate lessor being consolidated into an operating company lessee.

More particularly, under certain tests, ASC 810 requires that a valuation be done of the fair value of the real estate leasing entity. Depending on the results of that valuation, the entity might be categorized as a VIE and, thus, consolidated into the operating company.

Because of the complexity in valuing the real estate lessor, many small businesses will look to their accountants to perform an informal valuation to test under ASC 810.

It appears that if an accountant does perform a valuation under ASC 810, the accountant impairs his or her independence because:

a. The results of the valuation would be material to the financial statements as they would result in the consolidation of another entity, and

b. The service requires a significant degree of subjectivity.

One possible solution

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

• 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 an amendment to Interpretation 101-3 was to address the independence issues related to the performance of forensic accounting services for an attest client.
Forensic accounting services are defined as non-attest services that involve the application of special skills in accounting, auditing, finance, quantitative methods, and certain areas of law, research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Forensic accounting services consist of:
- Litigation services, and
- Investigative services.

**Rules for litigation services:**

Litigation services consist of accountant services in the capacity as an expert or consultant and involve providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties.

Litigation services are segregated into:
- Expert witness services,
- Litigation consulting services, and
- Other services related to litigation.

Following is a table that summarizes the rules of independence as they relate to the three litigation services previously noted.

<table>
<thead>
<tr>
<th>Type of litigation service</th>
<th>Impact on independence</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expert witness services:</td>
<td>Independence is impaired</td>
<td>Large group exception:</td>
</tr>
<tr>
<td>Accountant is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the accountant’s expertise, rather than his or her direct knowledge of the disputed facts or events.</td>
<td>Expert witness services create the appearance that the accountant is an advocate for and promoting a client’s position. If the accountant conditionally or unconditionally agrees to provide expert witness testimony for a client, independence would be impaired.</td>
<td>Independence is <em>not impaired</em> 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:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>a. The attest clients constitute less than 20 percent of the members of the group, the voting interests of the group, and the claim,</td>
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<tr>
<td></td>
<td></td>
<td>b. No attest client within the group is designated as a “lead” plaintiff or defendant of the group, and</td>
</tr>
</tbody>
</table>
c. No attest client has the sole decision-making power to select or approve the expert witness.  

**Fact witness services**\(^{26}\): Answering questions while testifying as a fact witness would not impair independence.

**Litigation consulting services**:  
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 **not impaired** 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 would be impaired.

**Other litigation services**:  
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 is **impaired** as these services create the appearance that the accountant is not independent.  

Independence is **not impaired** 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.

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**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 non-attest 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.

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\(^{26}\) 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.
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 an accountant to be asked to serve as a trustee for a client or as an executor of a client’s estate. The client is alive and well and the trust does not become activated until the client dies. An example may be a trust that will hold the common stock of a company that the member presently audits or reviews, but again, not until the owner dies. There may also be an irrevocable insurance trust that owns an insurance policy that will be used to fund estate taxes. Or, the accountant will be an executor or co-executor of the owner’s estate. How do these situations affect independence? Is the fact that the accountant will become a trustee or executor impair his or her independence now?

Interpretation 101-1 states that independence is impaired if the accountant:

“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 an accountant has been named as an executor or trustee in a client’s will does not affect his or her independence now. The key is whether the accountant was independent during the year being audited or reviewed and the period up to the date the report is issued. The fundamental problem lies in the risk that a client may die in the middle of a year, and immediately the accountant is named as executor or trustee. At that point, independence is impaired and the accountant and his or her firm are precluded from performing the engagement. Let’s look at a few examples that illustrate these important points:

Example 1: An accountant is the sole trustee of a trust that holds all of the voting stock of Company C. As the trustee, the accountant is actively involved in all management functions.

Conclusion: The accountant 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: An accountant is a named trustee of a trust that will hold 100% of the common stock of Company B upon the death of Harry, the 100% shareholder. Presently, the trust has no assets and Harry, not the accountant, provides all of the management of Company B. The accountant reviews the financial statements of Company B for the year ended December 31, 20X1 and issues his review report on March 1, 20X2. Harry is alive and kicking for the entire period.

Conclusion: The accountant is independent provided he is not a trustee during the period January 1, 20X1 through March 1, 20X2. The fact that the accountant will become a trustee upon a certain event occurring (e.g., death of Harry) is not an issue in this case. Because the accountant was not a trustee during the period of the financial statements, the engagement period or at the date that the review report was issued, independence is not impaired.
Example 3: Same facts as Example 2, except that Harry dies on October 1, 20X1 and the accountant is named as the trustee of the trust that now holds 100% of the common stock of Company B.

Conclusion: Too bad for the accountant. Effective October 1, 20X1, he is not independent with respect to Company B, and therefore, taints the entire financial statement period. Thus, he is precluded from issuing a review report for the year ended December 31, 20X1. He could issue a compilation report and include a disclaimer for lack of independence.

Example 4: Same facts as Example 3, except that the accountant is one of four trustees and the trust only owns 10% of the common stock of the company.

Conclusion: The accountant is still not independent because the trust has a direct financial interest in Company B. Interpretation 101-1 provides a materiality threshold only for indirect financial interests, not direct interests. The fact that the accountant is a trustee means that he is deemed part of management, which impairs independence.

Example 5: Bill is the co-trustee of an insurance trust set up for a client who is deceased. The son of the deceased client is now the 100% shareholder of Company X, which is an audit client of Bill and one of the beneficiaries of the insurance trust.

Conclusion: The fact that Bill is a trustee of an insurance trust does not impair his independence with respect to Company X. The insurance trust has no direct or indirect investment in the common stock of Company X. The fact that the son happens to be both a beneficiary of the trust and a 100% shareholder of Company X has no effect on Bill’s independence with respect to X.

Example 6: Same facts as Example 5, except that Bill is a co-trustee of the insurance trust. The trust has no direct or indirect investment in the common stock of Company X. The other trustee is the son of the deceased client who is also the 100% shareholder of Company X, an audit client.

Conclusion: Oddly enough, independence is not impaired. The trust does not have a direct or indirect financial interest in Company X. Further, the fact that the son is both the co-trustee and 100% shareholder of Company X has no bearing on Bill’s independence with respect to Company X.

Observation: The author included Example 6 to illustrate a common scenario in practice. It is typical for an accountant to be named as a co-trustee with a family member. The client trusts (no pun intended) the accountant, but not enough to control the family affairs outright. The key point to remember is that the trust must have a direct or material indirect investment in the client in order to impair independence with respect to the client. The mere fact that there is commonality of control between the trust and the client with the same family member in both roles, is not important. We are not dealing with rules of attribution and related party issues as customarily used in tax law and accounting. The ethics rules are separate and distinct from other areas that may deal with attribution differently. There is further discussion made in this chapter about attribution with respect to spouses and close relatives 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 has become a chronic problem among accounting firms. Firms are barraged with unpaid fees from good clients that have encountered short-term cash flow problems. The result is the firms are being placed in a very difficult position of having impaired independence with a large percentage of clients. The solution is not an easy one. A purist might suggest that an accountant give up an audit or review engagement for a long-term client who is unable to fully pay the prior year’s audit or review fees before issuance of the audit or review report. However, there are a few possible options for the accountant to comply with the independence ruling and still keep the client.

1. Option one is for the accountant to delay issuance of the report until the bill is paid. That is, the field work and all other work related to the engagement could be completed but the report could be held by the accountant until the bill is paid. Of course, this may require cooperation with the third party (e.g., bank, etc.) who may insist on receiving the report on a timely basis.

2. Another option is to drop the engagement level to the issuance of a compilation report with a disclaimer for lack of independence. Although SSARS No. 19 permits (but does not require) disclosure of the reason for lack of independence (e.g., unpaid fees) in the accountant’s compilation report, few clients would want to disclose this fact as it suggests that the client has cash flow problems.

3. As a last resort, the accountant could forgive a portion or all of the unpaid fees and, perhaps, make up the difference in later engagements. If the accountant does forgive a portion or all of the unpaid fees, he or she should not make an agreement to recover the fees in a later engagement. Such an arrangement could be construed to be the equivalent of a de facto 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 arms 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 arms 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 (ASC 840).

Member Performs Services for Common Interest Realty Association

**Question:** A member or his/her firm is associated with, or a member of, a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Is the member or his/her firm’s independence impaired with respect to the CIRA?

**Response:** Yes. However, there is an exception whereby independence is not considered impaired if all of the following conditions are met:

- The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
- The member or his/her firm’s annual assessment is not material to either the accountant or his/her firm or the CIRA’s operating budgeted assessments.
- The liquidation of the CIRA or the sale of common assets would not result in a distribution to the accountant or his/her firm.
- Creditors of the CIRA would not have recourse to the accountant or CPA’s firm if the CIRA became insolvent.
- The accountant 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 accountant 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.

12. Recent Ethics and Independence Rulings and Interpretations

In 2010, the Professional Ethics Executive Committee (PEEC) of the AICPA adopted revised Ethics interpretations and rulings as follows:

a. Ethics Interpretation No. 101-1, “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client”

b. Ethics Interpretation No. 101-1, “Application of the Independence Rules to a Covered Member’s Immediate Family”

c. Ethics Ruling No. 107 of ET Section 101, “Independence Participation in Employee Benefit Plan Sponsored by Client”

d. Ethics Interpretation No. 101-15, “Retirement, Savings, Compensation, or Similar Plans”

Before reading the following changes, the reader should be familiar with Rule 101, Independence, of the AICPA Code of Professional Conduct.

Rule 101 states:

A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

Ethics Interpretation No. 101-1: Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client

A firm’s independence would be impaired if a covered member who was formerly\(^\text{27}\) (a) employed by a client or (b) associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit sharing trust of the client:

a. fails to disassociate himself or herself from the client prior to becoming a covered member. Disassociation includes the following:
   i. Ceasing to participate in all employee health and welfare plans sponsored by the client, unless the client is legally required to allow the covered member to participate in the plan (for example, Consolidated Omnibus Budget Reconciliation Act (COBRA)) and the covered member pays 100 percent of his or her portion of the cost of participation on a current basis.

\(^{27}\) This provision applies once the individual has terminated his or her relationship with the client and is no longer employed by, or otherwise associated with, the client. See Interpretation No. 101-1(C) (par. .02) for matters involving a partner or professional employee who is simultaneously employed by, or otherwise associated with, the client and the firm.
ii. Ceasing to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the client’s defined benefit plans, defined contribution plans, share-based compensation arrangements, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. When the covered member does not participate on the attest engagement team or is not in a position to influence the attest engagement, he or she is not required to liquidate or transfer any vested benefits if such an action is not permitted under the terms of the plan or if a penalty significant to the benefits is imposed upon such liquidation or transfer.

iii. Disposing of any direct or material indirect financial interests in the client.

iv. Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation No. 101-5 (par. .07).

v. Assessing other relationships with the client to determine if such relationships create threats to independence that would require the application of safeguards to reduce the threats to an acceptable level.

b. participates on the attest engagement team or is an individual in a position to influence the attest engagement for the client when the attest engagement covers any period that includes his or her former employment or association with that client.

Effective Date: The revisions to the section “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client” of Interpretation No. 101-1 will be effective on June 1, 2011. Early application is permitted.

Ethics Interpretation No. 101- 1: Application of the Independence Rules to a Covered Member’s Immediate Family

A covered member’s immediate family is subject to Rule 101 and its interpretations and rulings. When materiality of a financial interest is identified as a factor affecting independence in these interpretations and rulings, the immediate family member and the covered member’s interests should be combined.

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28 As defined in the Financial Accounting Standards Board Accounting Standards Codification glossary under the term share-based payment arrangements.

29 When the member is a former employee of a governmental unit that is one of the sponsors of an employee benefit plan, the member may continue to participate in the governmental plan if his or her current employer is also one of the sponsors of the plan. In such circumstances, a covered member’s participation in the plan will not impair independence, provided that the plan is offered to all employees in comparable employment positions and the covered member has no influence or control over the investment strategy, benefits, or other management activities associated with the plan and is required to continue his or her participation in the plan as a condition of employment. See Ethics Ruling No. 107 (ET section 191.214–.215) for further information.

30 A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed, or market losses that may be incurred, as a result of the liquidation or transfer.
The following exceptions address situations in which independence will not be considered impaired. Notwithstanding the following exceptions, the independence requirement in Interpretation No. 101-1(B) applies.

**a. Permitted Employment**

An individual in a covered member’s immediate family may be employed by an attest client in a position other than a key position.

**b. Employee Benefit Plans Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans**

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a plan that is an attest client or that is sponsored by an attest client, other than a client’s share-based compensation arrangement or nonqualified deferred compensation plan, provided that:

1. The plan is offered to all employees in comparable employment positions;
2. The immediate family member does not serve in a position of governance (for example, board of trustees) for the plan; and
3. The immediate family member does not have the ability to supervise or participate in the plan’s investment decisions or in the selection of the investment options that will be made available to plan participants.

An immediate family member of a covered member may hold a direct or material indirect financial interest in an attest client through participation in a plan,31 provided that:

1. The covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement;
2. Such investment is an unavoidable consequence32 of such participation; and
3. In the event that a plan option to invest in a nonattest client becomes available, the immediate family member selects such option and disposes of any direct or material indirect financial interests in the attest client as soon as practicable but no later than 30 days after such option becomes available.33

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31 Excluding share-based compensation arrangements and nonqualified deferred compensation plans.

32 *Unavoidable consequence* means that the immediate family member has no investment options available for selection, including money market or invested cash options, other than in an attest client.

33 When legal or other similar restrictions exist on a person’s right to dispose of a financial interest at a particular time, the person need not dispose of the interest until the restrictions have lapsed. For example, a person does not have to dispose of a financial interest in an attest client if doing so would violate an employer’s policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not fall within this exception.
c. Share-Based Compensation Arrangements

Share-Based Compensation Arrangements Resulting in Beneficial Financial Interests in Attest Clients

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement, such as an employee stock ownership plan (ESOP), that results in his or her holding a beneficial financial interest in an attest client, provided that:

1. The covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement.
2. The immediate family member does not serve as a trustee for the share-based compensation arrangement and does not have the ability to supervise or participate in the selection of the investment options, if any, that are available to participants.
3. When the beneficial financial interests are distributed or the immediate family member has the right to dispose of the shares, the immediate family member:
   a) Disposes of the shares as soon as practicable but no later than 30 days after he or she has the right to dispose of the shares, or
   b) Exercises his or her put option to require the employer to repurchase the beneficial financial interests as soon as permitted by the terms of the share-based compensation arrangement. Any repurchase obligation due to the immediate family member arising from exercise of the put option that is outstanding for more than 30 days would need to be immaterial to the covered member during the payout period.
4. Benefits payable from the share-based compensation arrangement to the immediate family member upon termination of employment, whether through retirement, death, disability, or voluntary or involuntary termination, are funded by investment options other than the employer’s financial interests, and any unfunded benefits payable are immaterial to the covered member at all times during the payout period.

Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement resulting in a right to acquire shares in an attest client, such as an employee stock option plan or restricted stock rights plan, provided that:

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34 See Interpretation No. 101-15 (par. .17) for an explanation of when a financial interest is beneficially owned.
35 Footnote deleted.
36 See Interpretation No. 101-15 (par. .17) for guidance on stock option plans.
1. The covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement, and

2. The immediate family member exercises or forfeits these rights once he or she is vested and the closing market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days (market period). The exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period. In addition, if the immediate family member exercises his or her right to acquire the shares, he or she should dispose of the shares as soon as practicable but no later than 30 days after the exercise date. If the employer repurchases the shares, any employer repurchase obligation due to the immediate family member that is outstanding for more than 30 days would need to be immaterial to the covered member during the payout period.

Share-Based Compensation Arrangements Based Upon Stock Appreciation

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement based on the appreciation of an attest client’s underlying shares, provided that:

1. The share-based compensation arrangement (for example, a stock appreciation or phantom stock plan) does not provide for the issuance of rights to acquire the employer’s financial interests.

2. The covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement.

3. The immediate family member exercises or forfeits his or her vested compensation rights if the underlying price of the employer’s shares equals or exceeds the exercise price for 10 consecutive days (market period). Exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period.

4. Any resulting compensation payable to the immediate family member that is outstanding for more than 30 days is immaterial to the covered member during the payout period.

d. Nonqualified Deferred Compensation Plan

As a result of his or her permitted employment at an attest client, an immediate family member of a covered member may participate in a nonqualified deferred compensation plan, provided that:

1. The covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement;

2. The amount of the deferred compensation payable to the immediate family member is funded through life insurance, an annuity, a trust, or similar vehicle and any unfunded portion is immaterial to the covered member; and

Footnote deleted.
3. Any funding of the deferred compensation does not include financial interests in the attest client.

Effective Date

The revisions to the “Application of the Independence Rules to a Covered Member’s Immediate Family” section of Interpretation No. 101-1 (par. .02) will be effective on June 1, 2011. Early application is permitted.

Ethics Ruling No. 107 of ET Section 101, Independence, Participation in Employee Benefit Plan Sponsored by Client

**Question:** A member participates in or receives benefits from, an employee benefit plan (plan) that is a client or is sponsored by a client. Would independence be considered to be impaired with respect to the client sponsor or the plan?

**Answer:** A covered member's participation in a plan that is a client or is sponsored by a client would impair independence with respect to the client sponsor and the plan, except when the covered member is:

- Permitted by the “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client” section of Interpretation No. 101-1 (ET section 101.02) to continue his or her participation in the plan, or

- An employee of a governmental organization that is required by law or regulation to audit a plan sponsored by a governmental unit. In such circumstances, a covered member’s participation in the plan will not impair independence, provided that the plan is offered to all employees in comparable employment positions and the covered member:
  - Is not associated with the plan in any capacity prohibited by Interpretation No. 101-1(C) (ET section 101.02);
  - Has no influence or control over the investment strategy, benefits, or other management activities associated with the plan; and
  - Is required to participate in the plan as a condition of employment.

In addition, a covered member’s independence would not be impaired if he or she receives benefits as a result of an immediate family member’s participation in a plan that is permitted by the “Application of the Independence Rules to a Covered Member’s Immediate Family” section of Interpretation No. 101-1 (ET section 101.02).

**Effective Date:** Revised May 2010, by the Professional Ethics Executive Committee.
Ethics Interpretation No. 101-15, Financial Interests, Section “Retirement, Savings, Compensation, or Similar Plans”

Background:

Interpretation 101-1 [ET section 101.02A.1] states that independence shall be considered to be impaired if, during the period of the professional engagement, a covered member had or was committed to acquire any direct or material indirect financial interest in the client. When reviewing this interpretation, the covered member should also refer to Interpretation 101-1 [ET section 101.02] for the application of rule 101 and its interpretations and rulings to the covered member's immediate family and close relatives.

Interpretation No. 101-15, Financial Relationships, provides definitions of direct and indirect financial interests and further guidance on whether various types of financial interests should be considered to be direct or indirect financial interests and provides certain limited exceptions under which a covered member could hold a direct or material indirect financial interest in an attest client without being considered to have impaired his or her independence.

Interpretation No. 101-15 is revised as follows:

Depending upon the facts and circumstances, investments held in a retirement, savings, compensation, or similar plan may be considered a covered member's direct or indirect financial interests as follows:

- Investments held by a retirement, savings, compensation, or similar plan sponsored by a covered member's firm would be considered direct financial interests of the firm.

- If a covered member or his or her immediate family member self-directs the investments in a retirement, savings, compensation, or similar plan or has the ability to supervise or participate in the plan's investment decisions, the investments held by the plan would be considered direct financial interests of the covered member. Otherwise, the underlying plan investments would be considered indirect financial interests of the covered member.

- Investments held in a defined benefit plan would not be considered financial interests of the covered member unless the covered member or his or her immediate family member is a trustee of the plan or otherwise has the ability to supervise or participate in the plan's investment decisions.

- Allocated shares held in an employee stock ownership plan (ESOP) would be considered indirect financial interests that are beneficially owned until such time as the covered member or his or her immediate family has the right to dispose of the financial interest. Once the participant has the right to dispose of the financial interest, the financial interest is considered a direct financial interest.
• Rights to acquire equity interests, restricted stock awards, or other share-based compensation arrangements are considered direct financial interests, regardless of whether such financial interests are vested or exercisable.

The following examples illustrate these concepts:

1. If a covered member or his or her immediate family member is a trustee of a retirement, savings, compensation, or similar plan or otherwise has the authority to supervise or participate in the plan’s investment decisions (including through the selection of investment managers or pooled investment vehicles), the underlying investments would be considered to be direct financial interests of the covered member.

2. If investments in a defined contribution plan are participant directed, whereby a covered member or his or her immediate family member selects his or her underlying plan investments or selects from investment alternatives offered by the plan, the underlying investments would be considered to be direct financial interests of the covered member.

3. If investments in a defined contribution plan are not participant directed and the covered member or his or her immediate family member has no authority to supervise or participate in the plan’s investment decisions, the underlying investments would be considered to be indirect financial interests of the covered member.

Effective Date: The revisions to the “Retirement, Savings, Compensation, or Similar Plans” section of Interpretation No. 101-15 are effective May 31, 2010.

L. 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

The most common approach adopted by states is the restatement approach, followed by the near-privity and then the least common being the foreseeability approach.

**Near-privity:** Under the near-privity (near-contract) standard, a third-party that does not have a contractual relationship with the accountant can still bring suit against an accountant for negligence if all three of the following conditions apply:

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:** SSARS No. 19 permits an accountant to restrict the use of compiled or reviewed financial statements. This change provides an excellent opportunity for accountants in states that have near-privity third-party defenses to limit third-party liability. For example, in his or her compilation or review report, an accountant in New York State (currently a near-privity state) could restrict the use of the compiled or reviewed financial statements to a known named third party such as a particular bank. In doing so, the accountant restricts his or her liability to that named third party.

**Restatement approach:** In those states that follow the restatement approach, accountants are responsible to third parties who fall into either one of two categories:

1. Third parties the accountant **expressly knows** will be provided with the financial report, and

2. Third parties who are members of a **limited class of persons** to whom the accountant knows the financial report will be given.

**Note:** The restatement approach requires that the accountant know the class of third party (e.g., bankers, insurance companies, etc.), but not necessarily the name of the party. This is different from the requirement of the near-privity defense where the third party must be identified.

**Example 1:** Fred, an accountant reviews a client’s financial statements and issues a review report. Fred gives the client several copies of the financial statements without knowing specifically to whom the statements will be provided. The client gives a copy of the statements to a vendor who grants credit to the client. Subsequently, the client’s business fails and the vendor sues Fred for negligence. The state of jurisdiction follows the restatement approach for responsibility to third parties.

**Conclusion:** Fred is not liable to the vendor because he did not have notice that the financial statements would be given to the creditor or to a class of third parties (e.g. vendors).

**Example 2:** Same facts as Example 1, except that during the review engagement, the client informs Fred that the statements will be issued to the vendor, names the vendor, and states that the vendor will be using the statements to grant credit to the client. 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:** 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. Luckily, at the date of publication, only two states (Mississippi and Wisconsin) follow the foreseeability approach to accountant’s liability.

M. PUBLIC PERCEPTION OF ACCOUNTANTS IN JURY TRIALS

A Gallup Poll\(^{38}\) concludes that the public image of the accounting profession has improved since its all-time low during Enron, but has not recovered to its pre-Enron level.

Specifically, in Gallup’s 2008 poll of various professions, the public was asked to rate accountants in terms of having very high or high honesty and ethic standards. From the poll, 38 percent of those polled rated accountants as having very high or high ethic standards as compared with only 31 percent right after Enron surfaced in 2002, and a pre-Enron high (2000) of 47 percent. Although the accounting profession has seen slight improvement in its image since Enron, it still is below other professions such as medical doctors (64%), funeral directors (47%), clergy (56%), and nurses (84%).

The good news is that the public rates accountants more highly than several other professionals, such as bankers (23%), journalists (25%), lawyers (18%), and at the bottom of the list- lobbyists (5%).

\(^{38}\) Gallup poll, November 2008.
In November 2009, Gallup conducted a similar poll that rated the professions but interestingly, did not include accountants in that poll. Despite the fact that accountants were not on the 2009 polling list, public perception of the other professions did not change significantly from 2008. Those professions held in high regard in 2008, such as nurses, clergy, funeral directors, and medical doctors, continued to be held in high regard in 2009. Similarly, those professions at the bottom of the list in 2008, such as bankers, journalists, lawyers, and lobbyists, made little movement upward in 2009.

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?

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<tr>
<td>Yes</td>
<td>46%</td>
<td>78%</td>
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<tr>
<td>No</td>
<td>54%</td>
<td>22%</td>
</tr>
</tbody>
</table>

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:

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<tbody>
<tr>
<td>Agree</td>
<td>34%</td>
<td>61%</td>
</tr>
<tr>
<td>Neither</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>Disagree</td>
<td>39%</td>
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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?

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<tr>
<td>Yes</td>
<td>40%</td>
<td>71%</td>
</tr>
<tr>
<td>No</td>
<td>60%</td>
<td>29%</td>
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Quality of work of small firms (when compared with the work of large firms):

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<tr>
<td>Higher</td>
<td>16%</td>
<td>36%</td>
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<tr>
<td>Same</td>
<td>46%</td>
<td>55%</td>
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<tr>
<td>Lower</td>
<td>38%</td>
<td>9%</td>
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An auditor who works closely with a company’s financial statements should easily detect any fraud:

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<tr>
<td>Strongly agree</td>
<td>45%</td>
<td></td>
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<tr>
<td>Somewhat agree</td>
<td>29%</td>
<td></td>
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<tr>
<td>Neutral</td>
<td>10%</td>
<td></td>
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<tr>
<td>Somewhat disagree</td>
<td>12%</td>
<td></td>
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<tr>
<td>Strongly disagree</td>
<td>4%</td>
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A professional accounting firm that does not catch a company’s fraud should pay a severe penalty:

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<tr>
<td>Strongly agree</td>
<td>42%</td>
<td></td>
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<tr>
<td>Somewhat agree</td>
<td>25%</td>
<td></td>
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<tr>
<td>Neutral</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Somewhat disagree</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>9%</td>
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While some accountants have done bad things, the entire accounting profession should not be condemned:

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<tbody>
<tr>
<td>Strongly agree</td>
<td>65%</td>
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<td>Somewhat agree</td>
<td>20%</td>
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<tr>
<td>Neutral</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Somewhat disagree</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>6%</td>
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</table>

Source: Camico Mutual Insurance Company

N. PROVIDING RECORDS TO A DEAD-BEAT CLIENT

Facts: Mary Jones, CPA has had XYZ Company as a client for twenty years. One day, XYZ calls Mary and tells her that XYZ is going to obtain a new CPA and asks Mary to return records in her possession. Mary is not overly disappointed with the loss of the client, but is very upset at the fact that XYZ has not paid its most recent bill due to Mary...
that remains outstanding. Mary wants to withhold the records until XYZ pays her bill in full. XYZ informs Mary that the records belong to XYZ and that Mary must return the records regardless of whether the bill is paid.

**What responsibility does an accountant have to return records to a client who has not paid his or her bill?**

Ethics Ruling 501-1: *Response to Requests by Clients and Former Clients for Records*, as revised, gives guidance on this matter.

**Terminology used in the Ruling follows:**

*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* consist of 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.

Ethics Ruling 501-1 states:

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:39

   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.

39 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.\(^{40}\)

   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:** Ethics Ruling 501-1 gives accountants leverage in dealing with clients that have not paid their bills. More specifically, an accountant may withhold most client or accountant-prepared records until the bill is paid in full. Of course, many state licensing boards may not take the AICPA’s accountant-friendly approach outlined in 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.

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\(^{40}\) 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.

**O. ETHICS INTERPRETATIONS**

**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)*, 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 three 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
   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.

**P. TECHNICAL PRACTICE AIDS**

**Determining Whether Financial Statements Have Been Prepared by the Accountant (Technical Practice Aid (TIS Section 9150))**:

**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 the 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.

**TIS Section 9150, Compilation and Review Engagements (Technical Practice Aid TPA 9150.26) The Accountant’s Responsibilities for Subsequent Events in Compilation and Review Engagements (December 2009)**

Inquiry—Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 855-10-50-1 states, “An entity shall disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the
financial statements were issued or the date the financial statements were available to
be issued.” How does the entity’s responsibility to disclose the date through which
subsequent events have been evaluated affect the accountant’s responsibilities for
subsequent events in a compilation or review engagement?

Reply—FASB ASC 855, Subsequent Events, does not change the accountant’s
responsibilities under AR section 100, Compilation and Review of Financial Statements
(AICPA, Professional Standards, vol. 2), which states that an accountant performing a
review engagement should inquire of members of management who have responsibility
for financial and accounting matters concerning events subsequent to the date of the
financial statements that could have a material effect on the financial statements. In a
compilation engagement, the accountant does not have any responsibility with respect to
subsequent events unless evidence or information comes to the accountant’s attention
that a subsequent event that has a material effect on the financial statements has
occurred. When such evidence or information comes to an accountant’s attention during
a compilation or review engagement, the accountant should request that management
consider the possible effects on the financial statements, including the adequacy of any
related disclosure. If the accountant determines that a subsequent event is not
appropriately accounted for in the financial statements or disclosed in the notes, he or
she should follow the guidance in paragraphs .56–.58 of AR section 100 regarding
departures from generally accepted accounting principles.

Because the accountant’s compilation or review report should be dated as of the
completion of the compilation or review procedures, the date of the accountant’s
compilation or review report can never be earlier than management’s subsequent event
note date.

In a review engagement, because the accountant is concerned with events occurring
through the date of the review report that may require adjustment to, or disclosure in, the
financial statements, the specific management representations relating to information
concerning subsequent events should be made as of the date of the accountant’s review
report.

In most cases, the date that management discloses as the date through which they have
evaluated subsequent events (in the notes to the financial statements and, in a review
engagement, in the management representation letter) will be the same date as the
accountant’s compilation or review report. In order to coordinate that these dates (the
note date, the representation letter date [in a review engagement], and the accountant’s
compilation or review report date) are the same, the accountant may want to discuss
these dating requirements with management in advance of beginning the compilation or
review engagement. The accountant also may want to include, in the accountant’s
understanding with the client regarding the services to be performed (engagement
letter), that management will not date the subsequent event note earlier than the date of
management’s representations (in a review engagement) and the date of the
accountant’s compilation or review report.
TIS Section 9150, Compilation and Review Engagements (Technical Practice Aid TPA 9150.27) The Accountant’s Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report

Inquiry—Paragraphs .77–.82 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), provides requirements and guidance when the accountant becomes aware that facts may have existed at the date of the accountant’s compilation or review report (or the date of submission of compiled financial statements not intended for third party use in which the accountant does not report) that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts. Paragraph .79(a) states that when the accountant has concluded that action should be taken to prevent further use of the accountant’s report or the financial statements, and the effect on the accountant's report or the financial statements of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, where applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, where applicable, referred to in the accountant's report. Generally, only the most recently-issued compiled or reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years. What does the term where applicable refer to in paragraph .79(a)?

Reply—The use of the term where applicable refers to a situation in which the accountant has not reported on compiled financial statements not intended for third party use. In the case of a review or a compilation in which the accountant has issued a report, then a revised accountant's report should be issued and the reason for the financial statement's revision usually should be described in the accountant’s revised report as well as in a note to the revised financial statements.
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 an accountant’s independence:

   a) an accountant can issue an audit report even if he or she is not independent
   b) an accountant cannot issue a compilation report without being independent
   c) an accountant can issue a review report even if he or she lacks independence
   d) an accountant 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. 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
5. 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

6. 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

7. 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

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. Joe Smith, CPA audits XYZ Company. Joe’s sister Sally is employed by XYZ. Which position held by Sally would result in Joe’s independence being impaired: Sally’s position in XYZ is:
   a) a CFO
   b) a janitor
   c) a sales person
   d) a Pilates instructor in the employee gym

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-privy
   c) restatement approach
   d) foreseeability approach

14. According to 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 Ethics Ruling 501-1, which of the following is correct as it relates to an accountant having to provide records to a client:
   a) the accountant is permitted to charge the client a special termination or break-up fee
   b) the accountant must provide the records in an electronic format
   c) the accountant is not permitted to retain copies of any records returned to the client
   d) the accountant is permitted to charge for the cost of photocopies of the records

16. Under the AICPA technical practice aid, which of the following may support a conclusion that the accountant prepared 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
1. **A:** Incorrect. The general rule is that an accountant who is not independent is precluded from issuing an audit report on the financial statements.

**B:** Incorrect. An accountant may issue a compilation report if he or she is not independent, provided he or she disclaims independence with the compilation report.

**C:** Incorrect. An accountant is not permitted to issue a review report if he or she is not independent.

**D: Correct.** When an accountant performs certain services, his or her independence may be impaired for that client, particularly when the accountant has decision making authority.

(See page 365 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 368 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 page 369 of the course material.)
4. **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 377 of the course material.)

5. 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 384 of the course material.)

6. 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 388 of the course material.)
7. 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 402 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 406 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 414 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 page 421 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 422 of the course material.)
12. **A: Correct.** Interpretation 101-1 states that Joe’s independence is not impaired if an immediate family member holds “other than a key position” in an attest client. Clearly, being a CFO of XYZ is a key position thereby impairing Joe’s independence.

B: Incorrect. Because the position of “janitor” is not a key position, Joe’s independence in XYZ is not impaired.

C: Incorrect. Mary holds an “other than key position” in XYZ as a sales person. Consequently, Joe’s independence is not impaired with respect to XYZ.

D: Incorrect. Although Interpretation 101-1 does not define a “key position,” it is unlikely that being a Pilates instructor for XYZ is a key position. The result is that Joe’s independence, with respect to XYZ, is not impaired.

(See page 430 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 436 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 do not need to be provided to the client under any provisions of this revised ruling.

(See page 443 of the course material.)
15. A: Incorrect. The Ethics Ruling does not provide that the accountant may charge the client a special termination or break-up fee.

B: Incorrect. The accountant is allowed to provide the records in any format that is usable by the client, and is not limited to an electronic format.

C: Incorrect. The Ruling states that the accountant is permitted to retain copies of any records returned to the client.

D: Correct. The Ethics Ruling allows the accountant to charge for the cost of photocopies of the records.

(See page 444 of the course material.)

16. 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 prepared them.

(See page 447 of the course material.)
Glossary

**Assurance engagement** – An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

**Attest engagement** – An engagement that requires independence, as defined in AICPA Professional Standards.

**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.

**Predecessor accountant** – An accountant who has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

**Prescribed form** – Is a standard preprinted (financial statement) form designed or adopted by the body to which it is to be submitted, such as a bank financial statement.

**Privity standard** – Accountant’s liability is limited to those third parties with whom the accountant has a contractual relationship.

**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 accountant has been made aware of any subsequent events that could affect measurements or disclosures in the financial statements.

**Successor accountant** – An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement, or an accountant who has accepted the engagement.
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