Guide and Update to Compilations, Reviews, and Preparations

CRU4/24/V1

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Introduction to Financial Statement Preparation, Compilation, and Review Engagements

Introduction to Financial Statement Preparation, Compilation, and Review Engagements

Learning objectives

After completing this course, you should be familiar with:

- The concepts that provide a basic framework for performing and reporting on financial statement preparation, compilation, and review engagements;
- The changes implemented with Statements on Standards for Accounting and Review Services No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, as well as changes brought by SSARS No. 22, *Compilation of Pro Forma Financial Information* (AR-C section 120), and SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services – 2016* and SSARS No. 24, *Omnibus Statement on Standards for Accounting and Review Services – 2018*;
- Changes to the SSARS guidance with the recent issuance of SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*; and
- SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services.*

I. Introduction

It has been a very busy 10 years with regard to the issuance of new guidance related to Accounting and Review Services engagements. First, Statements on Standards for Accounting and Review Services No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification* (SSARS No. 21) was issued by the Accounting and Review Services Committee (ARSC) of the American Institute of Certified Public Accountants (AICPA) and is now effective. Further, the ARSC also issued two new SSARS, SSARS No. 22, *Compilation of Pro-Forma Financial Information* (AR-C section 120), which replaced the guidance found in SSARS No. 14 on this topic and conforms this guidance to that for other compilation engagements found in AR-C 80, and, in October 2016, SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services – 2016* (SSARS No. 23). SSARS No. 23 addressed two basic topics. First, SSARS No. 23 conforms to the existing guidance in SSARS No. 21 to incorporate preparation and compilation of prospective financial information engagements under the SSARS. This change was necessary due to the elimination of such engagements from the scope of Statements of Standards for Attestation Engagements (SSAE) No. 18, issued in 2016. Second, SSARS No. 23 updated certain guidance related to the accountant's responsibilities related to financial statements that contain supplemental information as well as other minor changes to guidance found in SSARS No. 21.

Next, in October 2018, the ARSC issued SSARS No. 24, *Omnibus Update – 2018*. SSARS No. 24 added a new section to the codification on the services governed by the ARSC as well as to make changes to the existing guidance in AR-C section 60 and AR-C section 90. These changes had an effective date for compilations and reviews of financial statements for periods ending on or after June 15, 2019.

In February 2020, in an effort to conform U.S. accounting and review services standards with international standards, the ARSC issued SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions* (SSARS No. 25). Broadly, SSARS No. 25 converges the AR-C 90 guidance on financial statement review engagements with International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements,* and minimalizes differences with the auditing standards regarding concepts that are consistent regardless of the level of service performed on the financial statements. SSARS No. 25 was effective for SSARS engagements for periods ending on or after December 31, 2021.

Finally, SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*, was issued in June 2022. SSARS No. 26 enhances concepts related to quality management for engagements performed in accordance with SSARSs. The amendments related to quality management are effective for engagements with periods ending on or after December 15, 2025. SSARS No. 26 also includes an amendment to section AR-C 90 guidance, removing the requirement that an accountant must obtain a signed engagement letter **prior** to the start of the review engagement. This amendment aligns AR-C 90 with engagement letter guidance found in AR-C 70, AR-C 80, and AR-C 120. This amendment was effective as of the issuance of SSARS No. 26 in June 2022.

Together, these five new SSARS, along with the other recodified standards issued by the Auditing Standards Board (ASB), represent the completion of the AICPA's simplification initiative, which has seen a virtual rewrite of its professional standards for accounting and auditing services over the past decade.

We will review the changes made by SSARS Nos. 22-26 later in the course.

As a reminder, SSARS No. 21 superseded virtually all existing AR Sections in the AICPA *Professional Standards*.

SSARS No. 21 comprises four sections:

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

In addition, accountants performing engagements under SSARS No. 21 need to comply with firm quality control standards which are found in Statements of Standards on Quality Control (SQCS) No. 8 and codified in QC Section No. 10 (QC Section 10) of the AICPA codification of its professional standards. These standards supplement the requirements found in SSARS No. 21 and deal with the systems of effective quality controls that firms, including individual practitioners, must adhere to when performing engagements under all the professional standards of the AICPA that govern accounting and auditing services. While we often take compliance with such standards for granted, these standards nonetheless form the backbone against which the engagement level quality standards rest. We will review the quality control standards found in QC Section 10 in our course as well.

Note that SAS No. 146, SSARS No. 26, SQMS No.1, and SQMS No. 2 were issued in 2022. These updates are collectively referred to as the "quality management standards." These new standards were issued to improve engagement quality based on the results of peer reviews and regulatory research. The new guidance will replace the current guidance on quality management in QC Section 10. This group of quality management standards will be effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2025. We'll discuss the main provisions of the new guidance later in the course.

With such a large amount of change in the standards for accounting and review services occurring at one time, accountants must have a firm understanding of the requirements of these new and proposed standards so they can appropriately guide their clients through this new environment as well as perform their engagements in conformity with the new requirements.

While not providing the assurance of an audit, financial statement preparation, compilation, and review engagements can be a real alternative, particularly for smaller, non-public entities, that meet both the entity's needs and the needs of the external users of their financial statements.

Preparing, compiling, and reviewing financial statements can also provide an opportunity for a CPA to expand his or her practice by offering these types of services to current clients looking to "downsize" from an audit, as well as potential future clients. If the benefits (and limitations) of these types of engagements meet a client's needs, and are acceptable to the users of the financial statements, such engagements can prove to be a win-win for all involved. Also, do not forget about the cost aspect of compiling or reviewing financial statements either, which by their general nature can be less expensive to prepare and report on than audited financial statements.

Before we look at the specifics of SSARS Nos. 21-26, let us look at how financial statement users dictate the scope of services provided by accountants as well as the path that led to the ARSC's recodification project.

II. A framework for performing preparation, compilation, and review engagements

Users request financial statements for a variety of reasons. This range of need drives the continuum of services which accountants can offer to their clients, from those offering no assurance to those offering reasonable assurance concerning the financial statement's conformity with generally accepted accounting principles or another basis of accounting. Additionally, financial statement users may want financial statements that peer into the future or those that give effect to a significant proposed transaction, such as an acquisition, divestiture, or debt or equity issuance. The range of services governed by the SSARS guidance helps the accountant match the level of assurance, if any, provided by each type of engagement with that required by the user of the financial statements. To understand this matching process, we need a basic understanding of the objectives and components of these types of engagements, which should then help us to properly discharge our professional responsibilities in these areas.

A. Objectives of preparation, compilation, and review engagements

The objectives of preparation, compilation, and review engagements are significantly different. First and foremost, a financial statement preparation or a compilation engagement is not an assurance engagement, whereas a review is. Prior to SSARS No. 21, this difference drove whether an accountant issued a report on the financial statements, but under SSARS No. 21, as we will see later in this course, an accountant now issues a report on compiled financial statements. However, understanding the difference in the level of assurance provided is critical in determining which level of service meets the needs of the financial statement users.

AR-C section 70 introduced the concept of financial statement preparation, be they historical or prospective, as a non-attest service that provides no assurance. The preparation of financial statements is a service that accountants have traditionally provided, with the product offering defined in AR-C section 70 being similar in scope to the “management use only” compilation service provided under SSARS No. 19. Its objective is for the accountant to merely prepare the financial statements in accordance with the selected financial reporting framework. Similarly, the preparation of pro forma financial information is a non-attest service as well.

The objective of a compilation is really to simply assist management in presenting historical or prospective financial information in the form of financial statements. As stated previously, a compilation is not an assurance engagement so the accountant does not provide any assurance that the financial statements are not materially misstated. Nor does a compilation or a financial statement preparation engagement, for that matter, involve obtaining an understanding of the entity’s internal control system, assessing the risk of fraud, or performing any procedures like those performed in a review engagement. Similarly, an accountant can be engaged to compile pro forma financial statements as well. In such instances, the accountant would apply the guidance in AR-C section 80 as well as that in AR-C section 120.

The objective of a review engagement on the other hand, is to obtain “limited” assurance that the financial statements are not materially misstated. This limited assurance is obtained by performing review procedures that provide review evidence to support the conclusion that no material adjustments have to be made to the financial statements in order for them to conform to the applicable financial reporting framework (chosen by management) used to prepare the statements, for example, U.S. GAAP or a “special purpose framework” (OCBOA).

Preparation/Compilation → Review

No Assurance → Limited Assurance

Although the term “limited” in limited assurance is not specifically defined in the compilation and review standards, it is certainly not meant to be the “high” level assurance contemplated in an audit. Note that an accountant cannot perform a review on prospective financial statements. Review engagements on pro forma financial statements would be addressed by the AICPA’s attestation standards.

Like a compilation or preparation engagement, a review does not involve obtaining an understanding of the entity’s internal control system or assessing the risk of fraud. However, in a review engagement the practitioner performs certain procedures (analytics and inquiries) in order to obtain review evidence to support the limited assurance conclusion. An interactive decision tree has been created to assist practitioners responsible for preparing financial statements in determining whether AR-C Section 70A is applicable or not (accessible at https://www.aicpa-cima.com/resources/download/is-ar-c-section-70-applicable-yes-or-no).

Question to ponder:

How successfully have you or your firm implemented the changes that were brought about by SSARS No. 21?

B. Quality control and ethics

In addition to complying with the technical requirements in the SSARSs, the practitioner and the practitioner's firm are also responsible for establishing quality control policies and procedures that provide reasonable assurance for complying with SSARSs in performing and reporting on compilation and review engagements. (See Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control – Redrafted*.) As mentioned previously, SQCS No. 8 will be superseded by SQMS No. 1, SQMS No. 2, and SSARS No. 26 for engagements with 2025 calendar year-ends. These new quality management standards will be discussed later in this course.

Do not forget that the accountant is also required to maintain objectivity and integrity when performing compilation and review engagements in accordance with the AICPA Code of Professional Conduct.

C. Components of preparation, compilation, and review engagements

The following basic components make up the structure that is used when performing preparations, compilations, and reviews and reporting on compilation and review engagements:

1. The players – Management, the CPA, and the intended users of the financial Statements;
2. The applicable financial reporting framework (accounting principles used), for example, U.S. GAAP or a special purpose framework (OCBOA);
3. The financial statements;
4. For a review engagement – Review procedures and review evidence; and
5. A written compilation or review report.

1. The players

Preparation of financial statements, compilation, and review engagements involve three interactive groups – management, the CPA, and the intended users of the financial statements. In a nutshell:

- Management's role in the process includes taking responsibility for the preparation and fair presentation of the financial statements as well as designing, implementing, and maintaining internal control.
- The CPA's responsibility is to prepare, compile, or review the financial statements in accordance with SSARSs, which require that he or she have the necessary knowledge and competence to perform the engagement.
- The intended users of the financial statements have the responsibility to understand the limitations of compiled or reviewed financial statements.

2. The applicable financial reporting framework

The applicable financial reporting framework is an important component in preparation, compilation, and review engagements. It comprises the accounting principles and policies (which are the responsibility of management) that determine the form and content of the financial statements. Examples of financial reporting frameworks include U.S. GAAP and special purpose frameworks (SPFs) such as the cash and income tax bases of accounting.

3. The financial statements

Preparation, compilation, and review engagements generally cover what we traditionally think of when we say, "financial statements," that is, a complete set of statements – a balance sheet, an income statement, a statement of retained earnings, a statement of cash flows, and the related notes to the financial statements. However, in some cases, a "complete set of financial statements" may only cover an individual financial statement. It all depends on the requirements of the applicable financial reporting framework that management has chosen. For example, under the pure cash basis of accounting, an SPF, the entity typically only prepares a "Statement of Cash Receipts and Cash Disbursements" as shown in the following illustration for a small local homeowner's association.

Moose Lake Homeowners Association
Statements of Cash Receipts and Cash Disbursements
Year Ended December 31

	20X2	**20X1**
Cash Receipts		
HOA Assessments	$8,000	$8,000
Cash Disbursements		
Lighting	400	400
Landscaping Fees	6,500	6,200
Insurance, Liability	735	640
Total Cash Disbursements	7,635	7,240
Increase in Cash	365	760
Beginning Cash Balance	760	0
Ending Cash Balance	$1,125	$760

See Notes to the Financial Statements.

Moose Lake Homeowners Association
Notes to the Financial Statements

Note 1 – Summary of Significant Accounting Policies

Nature of Operations

Moose Lake Homeowners Association (HOA) was incorporated on January 1, 20X3, and is responsible for maintaining the common areas within the Moose Lake subdivision in Wasilla, Alaska.

Basis of Accounting

The HOA prepares its financial statements using the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). The cash basis of accounting differs from GAAP primarily because revenues are recognized when received rather than when earned and expenses are recorded when paid rather than when incurred. The only asset is cash; liabilities and noncash transactions are not recognized in the financial statements.

Income Taxes and Uncertain Tax Positions

The Club is exempt from federal and state income taxes under Internal Revenue Code Section 501(c)(7). Accordingly, no provision for income taxes has been made in the financial statements. Federal and state income tax returns for the years 20X3 to date are subject to examination by taxing authorities.

Subsequent Events

Management has evaluated subsequent events through February 8, 20X5, which is the date the financial statements were available to be issued.

Note 2 – Commitments

The HOA has entered into an agreement with Bear Claw Landscaping, Inc. under which Bear Claw will maintain all of the common areas within Moose Lake. The agreement is subject to renewal annually beginning on January 1st of each year. The current agreement ends on December 31, 20X5. Fees for landscaping services paid to Bear Claw during 20X4 and 20X3 totaled $6,500 and $6,200, respectively.

4. Review procedures and review evidence

As we said previously, a compilation is not an assurance engagement, which means it is not required to perform procedures meant to gather evidence that is used as a basis for providing any level of assurance that the financial statements are not materially misstated.

On the other hand, a review is an assurance engagement, the objective of which is to provide “limited” assurance that the financial statements are not materially misstated.

In order to provide limited assurance, it is required to perform review procedures which result in review evidence upon which to base a conclusion (notice we did not say “opinion” here) as to whether the financial statements are materially misstated. The specific review procedures planned and performed (nature, timing, and extent) are a matter of professional judgment, but should be tailored to the engagement based on knowledge of the client and the industry in which it operates, as well as to the threshold of materiality that will be set under SSARS No. 25. Generally, performing analytical procedures and inquiries will provide the review evidence needed to obtain limited assurance that the financial statements do not require material modifications to conform with the applicable financial reporting framework (again, chosen by management and their responsibility).

5. Written compilation or review report

Unless the accountant withdraws from the engagement, the accountant is required to issue a written report on compilation or review work (unless in a compilation the accountant is simply “associated” with financial statements not expected to be used by a third party).

Do not forget that compilation engagements can be performed when independence is impaired as long as the impairment is disclosed in the compilation report. An accountant can choose to include the reason(s) why they are not independent, but the accountant is not required to do so. For example, a practitioner could use either of the following types of language:

a. I am not independent with respect to Company X; or

b. I am not independent with respect to Company X as of and for the year ended December 31, 20X1, because I performed certain accounting services that impaired my independence.

If performing a review engagement, the practitioner must be independent of the client.

D. What about materiality?

Generally, materiality is considered in context to the applicable financial reporting framework and the intended users of the financial statements. Misstatements, including omissions from the financial statements, are considered to be material in circumstances when they reasonably could be expected to influence the decisions made by users of the financial statements, either individually or in the aggregate.

1. Context of particular engagement and circumstances

Materiality judgments should be made in relation to the specific facts and circumstances of each engagement. Judgments could be affected by either the size or nature of the misstatements, or both. These judgments will be material to users of financial statements as a group. The accountant’s considerations involve professional judgment.

2. Needs of users as a group

It is reasonably assumed that financial statement users will conform to the following criteria:

- Have reasonable knowledge of business and economic activities and accounting;
- Have a willingness to study the information presented with a reasonable amount of diligence;
- Understand that financial statements are prepared and presented considering materiality;
- Recognize inherent uncertainties associated with amounts included, especially when those amounts are being measured using estimates, judgment, and the consideration of future events; and
- Make reasonable decisions on the basis of information in the statements.

Remember, under SSARS No. 25, the accountant will now need to explicitly determine a materiality threshold on review engagements and design procedures in light of that materiality threshold. We will review the practical impact of this new requirement when we discuss AR-C Section 90 engagements later in the course.

E. Basic characteristics of preparation and compilation engagements

Requirements for engagement to prepare financial statements are fairly basic. However, as compilations and reviews are attestation services, their requirements are more substantial.

Even though compilation engagements do not require the accountant to perform the types of procedures required to perform in a review engagement, the accountant still needs to establish an understanding with the client regarding the services to be performed and document that understanding in a written engagement letter with the client.

An understanding of the industry in which the client operates, the client's business, and the accounting principles and practices used by the client are also required.

- Understanding the industry in which the client operates means that the accountant understands the accounting principles and practices generally used in that industry, which then allows the compilation of financial statements appropriate to that particular industry.
- Understanding a client's business includes how it is organized and operates, and the nature of its assets, liabilities, revenues, and expenses, which is generally conducted by working directly with the client or similar clients in the same industry. Understanding the business may also help recognize errors or other issues to be corrected.
- Understanding the accounting principles and practices used by the client in preparing its financial statements should assist in recognizing any unusual accounting practices the client might be using relative to the industry norms.

An overall review of the prepared or compiled financial statements should also be conducted to make sure there are no obvious errors (typos, math, application of accounting principles, inadequate disclosures) in them before submitting them to a client. The objective of this "final read" is basically to make sure the accountant does not associate themselves with misleading financial statements, which is an ethics violation. If the accountant concludes that the financial statements are in fact misleading (for whatever reason), the accountant should withdraw from the engagement.

1. U.S. GAAP

If management has chosen U.S. GAAP as the applicable financial reporting framework to use in a compilation engagement, this is the same U.S. GAAP used in review and audit engagements. How U.S. GAAP is applied is not a function of the level of assurance provided in a particular engagement. This is important to remember because if there are U.S. GAAP departures in the compiled financial statements, the compilation report is modified accordingly.

Additionally, pro forma and prospective financial information should be prepared on the same basis of accounting as the underlying historical financial statements to which they relate.

2. Documentation of a financial statement preparation or compilation engagement

The accountant is required to prepare adequate documentation of the work performed. This documentation should support the statement in the compilation report that the engagement was in accordance with SSARSs.

We will review these documentation requirements when we review these types of engagements in greater depth in later chapters.

F. Basic characteristics of a review engagement

A review engagement is significantly different than a compilation engagement. First and foremost, a review is an assurance engagement, a compilation is not. Assurance in a review engagement really means providing "limited" assurance that the financial statements are not materially misstated. A CPA is able to provide limited assurance based on review evidence obtained by performing analytical procedures, inquiries, and other review procedures deemed necessary utilizing professional judgment.

Another significant difference between a compilation and a review is that in performing a review engagement the practitioner is required to obtain written representations from management for all of the periods covered in the review report. The specific representations are a matter of professional judgment and of course will depend on the particular engagement circumstances. However, they should include any representations management made to the practitioner, explicitly or implicitly, during the engagement.

Similar to a compilation, within a review engagement, the CPA does not have to obtain an understanding of the client's internal control or actively search for fraud and illegal acts (but if these items do come to the practitioner's attention, the proper people have to be informed – owner, management, etc.).

So, the basic steps in performing a review engagement include:

1. Establishing an understanding with the client regarding the services to be performed and documenting that understanding in a written engagement letter with the client.
2. Understanding the industry in which the client operates, the client's business, and the accounting principles and practices used by the client;
3. Designing and performing analytical procedures, inquiries, and other review procedures;
4. Obtaining written representations from management; and
5. Like a compilation, reading the financial statements "one last time" for obvious errors.

In addition, although a review does not involve assessing the risk of fraud, if the CPA becomes aware of any suspected fraud (or illegal acts), they should communicate it with the appropriate level of management.

1. Documentation in a review engagement

It is required that the practitioner documents the work completed on the review engagement in sufficient detail. In the case of a review engagement, this would include, for example:

- Engagement letter with the client;
- All of the review procedures performed and the results of those procedures;
- All of the review evidence obtained and its source;
- The conclusions reached in connection with all related work;
- Management's representation letter;
- If applicable, documentation of communication of any suspected fraud or illegal acts; and
- Determination of materiality, per SSARS No. 25.

III. Top SSARS No. 21 implementation issues

SSARS No. 21 has been effective since 2015. It brought significant change to the accounting and review services realm. It is not surprising that there have been many issues with accountants implementing the guidance on their engagements. Addressing some of these is part of the reason for issuance of SSARS No. 23 and SSARS No. 25. The following are some frequently cited issues practitioners have faced in the past related to SSARS No. 21. The guidance on each of these topics has been addressed in this course.

A. Applicability of SSARS No. 21

While one of the reasons for the introduction of the preparation of financial statements scope of service (AR-C section 70) was to help better define the services which are under the guidance in the SSARS, confusion still exists, especially between bookkeeping services and those covered under AR-C No. 70. While AR-C section 70 states that there is a difference between preparing financial statements, a service covered by AR-C section 70, and bookkeeping services, it is still a matter of professional judgment. AR-C section 70 lists common services which would be covered by the standard and those which would not. Accountants should apply professional judgment and consult the applicable professional standards when making the determination of whether SSARS No. 21 applies or not. Also, the accountant should discuss the scope of work with the client so they are in agreement with the deliverable, including the reporting requirements associated with each level of service.

B. "Lack of Assurance" statement on prepared financial statements

The accountant is required to add a disclaimer to the prepared financial statements if management does not agree to put a statement that states that no assurance is provided on each page of the prepared financial statements in an engagement performed under the guidance of AR-C section 70. As both the preparation service and this statement are new requirements under SSARS No. 21, it is important that the accountant discuss this requirement with the client, particularly with a focus on the needs of external stakeholders and users of the financial statements. An alternative could be a higher level of service, such as a compilation. Also, as added under SSARS No. 23, the accountant should consider whether to withdraw from the engagement if management does not agree to such a statement. It is important to maintain professional skepticism when having such conversations, to understand management's rationale for its decision.

C. Use of prescribed forms in AR-C sections 70 and 80 engagements

AR-C sections 70 and 80 do allow the accountant to prepare or compile financial statements on prescribed forms, as may be required by certain regulatory or legal requirements. When this is the case, the accountant should understand the financial reporting framework under which the financial information will be prepared and modify the engagement letter and other engagement documentation accordingly as well as assure an understanding of the framework themselves to assure that the financial statements comply with the reporting requirements.

D. Use of engagement letters in SSARS No. 21 engagements

Written engagement letters that are signed by both parties are required for all services provided under SSARS No. 21. This requirement was recently reinforced by amendments to AR-C sections 70, 80, and 90 by SSARS No. 23. As this requirement was new for compilation and preparation engagements under SSARS No. 21, accountants need to explain the requirement to clients and ensure that they accept nothing less than a letter that is signed by both parties to the engagement. It is important to take the time to discuss any potentially confusing terms and to ensure that management thoroughly understands the scope of services, its responsibilities, and the deliverables from the accountant.

E. Documentation requirements in SSARS No. 21 engagements

While in some instances SSARS No. 21 reduces the documentation requirements for covered engagements, practitioners should realize that these are only the minimum standards and that the accountant should use professional judgment when determining the appropriate type of documentation that is retained to support the work performed and report issued. In many instances, this will result in much more being documented than the minimum required, including significant consultations or professional judgments made throughout the engagement. Also, note that with regard to AR-C section 90, the new standard actually added several required elements of documentation, including the requirement to agree the financial statements to the underlying accounting records.

F. Independence requirements on SSARS No. 21 engagements

Given the level of assurance and attestation that is provided by the various services covered by SSARS No. 21, it may be difficult for accountants to remember their independence requirements with regard to such engagements. As a refresher, the accountant is required to be independent for review engagements performed under AR-C section 90 and does not even need to assess independence in the non-attest services covered by AR-C section 70 for preparation engagements. This includes engagements to prepare pro forma information. In the attest but non-assurance compilation engagements performed under AR-C section 80, the accountant must assess independence and modify the report when not independent. However, lack of independence does not preclude the accountant from accepting and reporting on the engagement. Additionally, when performing non-attest services for an attest client, the accountant should remember to consider the cumulative effect of all such services on overall independence. The accountant should consult Section 1.295 of the AICPA's *Code of Professional Conduct* for further details.

G. Peer review

Firms and individual accountants whose only engagements consist of preparation of financial statement engagements under AR-C section 70 are not required to participate in a peer review program but may choose to do so. However, firms performing other services under the SSARS are required to enroll in a peer review program, with preparation of financial engagements subject to review if the accountant or firm has an engagement level review performed while preparation engagements can be excluded from those selected for system level reviews.

Question to ponder:

What are the major quality issues your firm faces when performing SSARS engagements?

AR-C 60: General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services

AR-C 60: General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services

Learning objective

After completing this chapter, you should be familiar with:
- The general principles for engagements performed in accordance with SSARS AR-C section 60.

I. Introduction

AR-C section 60 provides general principles for engagements performed in accordance with SSARSs and is intended to help accountants better understand their professional responsibilities when performing these engagements. An accountant engaged to perform a compilation, review, or prepare financial statements is required to adhere to the requirements in AR-C section 60 as well as the requirements in the appropriate engagement section (AR-C section 70, 80, or 90).

Additionally, an accountant may have other regulatory or legal responsibilities that must be followed while performing an engagement. These may differ from those found in AR-C section 60. AR-C section 60 does not supersede these other responsibilities and the accountant should take due care to sufficiently understand all such responsibilities related to the engagement.

AR-C section 60 includes requirements and guidance on the following general principles:
- Ethical requirements.
- Professional judgment.
- Conduct of the engagement in accordance with the SSARSs.
- Engagement level quality control.
- Acceptance and continuance of client relationships and engagements.

In applying this guidance, it is important to remember that the financial statements remain the responsibility of management. The SSARSs place responsibilities on the accountant, not the entity, and in no way override legal or regulatory requirements of the entity.

While AR-C section 60 applies for engagements performed under the SSARS, all firms that perform accounting and auditing services should implement an effective system of quality control. The standards that govern such a system are found in SQCS No. 8, codified as QC Section 10. Practitioners should also begin preparing for the new quality management standards that will be in effect for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2025. The new standards, SQMS 1, SQMS 2, SAS 146, and SSARS 26 will be discussed in detail later in this chapter.

To understand the differences between AR-C section 60 and the QC standards, it is best to see AR-C section 60 as those principles that should exist at the engagement level while the QC standards are those implemented by the firm and apply across the entire entity. While clearly related, they address different aspects of quality control. As AR-C section 60 assumes that a firm has implemented a strong system of quality control, its requirements must be read in the context of a strong understanding of what QC Section 10 requires. We will also review the requirements of an accountant or firm under QC Section 10 in this chapter.

A. Determining the appropriate financial reporting framework

The preparation and fair presentation of financial statements require the identification of the applicable financial reporting framework. This selection is based on an understanding of the applicable rules and regulations that govern the entity and its financial statements. The entity's financial statements should be prepared in accordance with the selected financial reporting framework and also include a description of the framework under which the financial statements were prepared. SSARS No. 24 enhanced the guidance in that a departure from the fair presentation framework could be necessary to achieve fair presentation, but this is a rare occurrence.

Management must exercise judgment in selecting and applying accounting policies that reflect the financial reporting framework and when making estimates in support of that framework.

The framework selected may be a general purpose one (i.e., U.S. GAAP) or a special purpose framework. The framework selected often consists of financial accounting standards issued by an authorized or respective body (i.e., FASB *Accounting Standard Codifications* or the IASB's *International Financial Reporting Standards*) or those reflecting legal or regulatory requirements. Additionally, other sources may provide guidance on how to apply the framework. When conflict exists between the requirements of the framework and the guidance provided by these other sources, such as published interpretations, industry practice, and other accounting literature, the source with the highest authority prevails.

The applicable framework also determines what constitutes a complete set of financial statements. The applicable framework may determine that a single financial statement and notes constitute a complete set of financial statements.

Lastly, the financial statements may be for a year, or a period longer or shorter than a year. However, it is generally not appropriate to present financial statements for a period that is longer or shorter than a year compared with those for the annual period.

II. The requirements of QC No. 10

QC No. 10, issued as SQCS No. 8 and effective in January 1, 2012, addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. It should be read in conjunction with the AICPA's *Code of Professional Conduct* and other relevant ethical requirements. The standard is applicable to all audit and attestation engagements performed by CPA firms but not government audit organizations. The nature and extent of the policies and procedures developed by firms in order to comply with QC No. 10 will vary based on the size and other operating characteristics of the firm. However, the policies and procedures employed should ensure the documentation of both the policies as well as evidence of each element of the system actually being performed.

The professional standards required by the QC No. 10 can be divided into two categories:

- **Unconditional requirements** – Standards the accountant must comply with on all engagements, when the requirement is relevant.
- **Presumptively mandatory requirements** – Standards the accountant must comply with, when relevant. However, an accountant may, in rare circumstances, depart from a presumptively mandatory requirement, provided that the firm documents the justification for the departure and how the alternative policies or procedures established or performed were sufficient to achieve the objectives of the presumptively mandatory requirements.

SSARS using the word "must" indicate unconditional requirements while SSARS using the word "should" indicate a presumptively mandatory requirement.

Further, the QC standards contain explanatory or application guidance in addition to the above required procedures. This guidance, which uses the words "may," "might," and "could" provides further explanation of the requirements and guidance for carrying them out, including examples.

A. Objective of a system of quality control

A firm should establish a system of quality control to provide it reasonable assurance concerning the following:

- The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- Reports issued by the firm are appropriate in the circumstances.

A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

It is not enough for a firm to just have a system of quality controls; the controls must also be effectively communicated to all the appropriate personnel in a firm. The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve;
- The message that each individual has a personal responsibility for quality; and
- A requirement for each individual to be familiar with and to comply with these policies and procedures.

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Under QC No. 10, a firm must establish and maintain a system of internal controls. The system should include policies and procedures that address the following:

- Leadership responsibilities for quality within the firm [which QC No. 10 calls ("tone at the top")].
- Relevant ethical requirements.
- Acceptance and continuance of client relationships and specific engagements.
- Human resources.
- Engagement performance.
- Monitoring.

The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

While deficiencies may exist in one or several of these elements, nonetheless the system of quality control as a whole may still be effective in achieving the overall objectives of the quality control system.

The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.

- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

The development of an effective firm-wide system of quality control is not a “one size fits all” approach. Firms should consider their size, types of clients and engagements, and other relevant information when they are designing their systems of quality control. Clearly the system for a global accounting firm would be different than that of a smaller or medium-sized firm. The key is that the system developed meets the objectives of an effective system of quality control.

B. Leadership responsibilities for quality within the firm (the “tone at the top”)

QC No. 10 places the ultimate responsibility for the establishment and maintenance of the firm’s system of quality control with the firm’s leadership, its managing partner, board of managing partners, CEO, or equivalent. The firm should ensure that this person, or the person(s) so designated have sufficient and appropriate experience and ability, as well as the necessary authority to assume the role.

The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm’s leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm’s system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm’s quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm’s business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm’s overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Specifically, the firm’s policies and procedures should address the following ethical requirements with regards to independence.

The firm’s policies and procedures should provide reasonable assurance that all applicable personnel maintain independence when it is required on the engagement. These requirements should be communicated to firm personnel and the firm should identify and evaluate circumstances and relationships that create threats to independence, taking appropriate actions to safeguard independence when necessary.

The firm should also establish policies to notify it when independence is breached so it can take appropriate actions. Lastly, the firm should institute policies to ensure an at least annual written confirmation of independence from all firm personnel who are required to be independent and it should establish policies and procedures to ensure appropriate rotation of engagement personnel on audit and attestation engagements, as appropriate or required.

C. Acceptance and continuance procedures

At the forefront of all engagement quality issues are procedures that ensure a firm is associated with clients of acceptable integrity. QC No. 10 requires that firms establish policies and procedures for acceptance and continuance that provide the firm with reasonable assurance that the firm will accept or continue client relationships only when it is competent to perform the engagement and has the capabilities to do so. Also, the firm should be able to comply with legal and relevant ethical requirements and has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.

These procedures should consider the following factors as part of the firm's acceptance and continuance of clients:

- Firm personnel have knowledge of relevant industries or subject matters or the ability to effectively gain the necessary knowledge.
- Firm personnel have experience with relevant regulatory or reporting requirements or the ability to effectively gain the necessary competencies.
- The firm has sufficient personnel with the necessary competence and capabilities.
- Specialists are available, if needed.
- Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available.
- The firm is able to complete the engagement within the reporting deadlines.

Further, in assessing the integrity of the client, the firm should consider the following:

- The identity and business reputation of the client's principal owners, key management, and those charged with governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management, and those changed with governance toward such matters as internal control or aggressive interpretation of accounting standards.
- Indications of an inappropriate scope limitation.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

These procedures should consider potential conflicts of interest, and should document all issues noted and their resolution, and should also be present in the decision to continue a relationship with a client. The procedures should also consider professional and legal responsibilities that may apply, including any requirements to report to regulatory authorities and withdrawing from the engagement, if necessary.

D. Human resource policies

Quality engagement starts with the quality of the people performing the work. QC No. 10 acknowledges that by requiring a firm to establish policies and procedures that are designed to provide it with reasonable assurance that it has sufficient personnel with competence, capabilities, and commitments to ethical principles necessary to perform the engagements in accordance with professional standards and applicable legal and regulatory requirements and enable the firm to issue reports that are appropriate in the circumstances.

These policies should include the recruitment and hiring of personnel, performance evaluation, compensation and advancement, determining competencies and capabilities, professional development, and estimation of personnel needs.

These requirements extend to the assignment of engagement teams, particularly with regard to selection of the engagement partner and communication of the responsibilities of the partner on the engagement. While, in most cases, the partners will have gained such experience through their performance of engagements, in some cases, the partners must gain the relevant experience in other manners, such as industry, governmental, and academic positions. This experience must be supplemented, as needed, by CPE and consultation. Broadly, the competencies required of partners generally consist of the following:

- Understanding the role of a system of quality control and the *Code of Professional Conduct*.
- Understanding of the service to be performed.
- Technical proficiency.
- Familiarity with the industry.
- Professional judgment.
- Understanding the organization's IT systems.

E. Engagement performance

Even with the right team, it still needs to execute on the engagement strategy. QC No. 10 requires a firm to establish policies and procedures that provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements. Also, these policies and procedures should ensure that the report issued by the firm is appropriate, given the circumstances. These policies should address the topics of consistency in the quality of the performance of the engagement, appropriate supervision of staff as well as adequate review of staff, ensuring that experienced engagement team members, including the partner, review the work performed by other engagement team members.

Additionally, the firm should establish policies and procedures for consultation on difficult or contentious issues, as necessary, as well as engage adequate engagement quality control review. This entails the appointment of an engagement quality review partner, as appropriate and with sufficient experience and skills, whose review should consist of the following:

- Discussion of significant findings and issues with the engagement partner.
- Reading the financial statements or other subject matter information and the proposed report.
- Review of selected engagement documentation related to significant judgments that the engagement team made and the related conclusions that it reached,
- An evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate

This review should be performed before the report is released and should be appropriately documented, including the identification of any differences of opinion between the quality control partner and engagement partner, and their resolution.

Lastly, the firm should establish overall engagement documentation requirements that address the assembly of the final engagement files, their custody, confidentiality and retrievability, as well as retention.

F. Monitoring of quality

In addition to engagement level quality control procedures, firms should establish policies and procedures that provide reasonable assurance that its system of quality controls is relevant, adequate, and operating effectively. These should include an on-going consideration of these policies and procedures, including inspection procedures of its engagements and reports issued as well as having the responsibility for this process assigned to a partner or others with sufficient experience and authority to assume the responsibility.

The review, while acknowledging the inherent limitations of such a system of internal controls, should nonetheless evaluate the system, identify and communicate identified deficiencies, and assure adequate remedying of any identified deficiencies. Particular attention should be given to those identified deficiencies which are deemed to be of a systemic, repetitive, or other another significant nature as these may indicate issues with the design of the firm's system of quality control that require remediation.

Additionally, the policies and procedures should include a consideration of steps to take when the monitoring review identifies an issued report that may not be appropriate. These include determining whether further action is necessary to comply with professional requirements and when to obtain legal advice.

The results of this monitoring review should be communicated to engagement partners and other appropriate individuals within the firm on at least an annual basis and also include a process whereby it receives and addresses complaints received concerning the quality of its work.

G. Documentation of quality control policies and procedures

The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Documentation of a firm's quality control policies and procedures takes critical importance in the peer review process. When performing a system review as part of the peer review process, the reviewer will assess the firm's system of quality control, and its adherence to it. While flexibility is to be expected, the system must still be designed to achieve the program's objectives and operate as designed.

Question to ponder:

What policies or controls does your firm have in place to ensure its compliance with QC No. 10?
How would you rate the effectiveness of these controls?

III. AICPA's Quality Management Project

A. Quality management exposure draft

In May 2022, the ASB voted to issue Statement on Quality Management Standards 1 and 2 (SQMS 1 and SQMS 2, respectively), SSARS No. 26, and SAS 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* (SAS 146). In March 2023, SQMS 3 was issued to revise the language in QM Section 10, *A Firm's System of Quality Management* to conform with SAS 149 related to group audits. The strategy is to converge with the IAASB's new suite of standards with similar names. In comments letters related to the draft SQMS 1 and 2, SSARS 26, and SAS 146, larger firm respondents tended to support the standards with some revisions, most notably concerns about the clarity of the standard's risk assessment process (SQMS 1). Various issues were raised regarding the likelihood of firms interpreting and therefore implementing this standard in various ways which could possibly cause peer review issues. In addition, they felt that some of the provisions could have unintended consequences of increasing complexity beyond what the ASB intended.

Smaller firms and state societies had issues primarily with what is termed the "self-inspection" prohibition in the monitoring and remediation section of the standard. The feeling was that this would cause smaller firms unnecessary expenses that could not be passed along to their clients.

There were fewer issues with SQMS 2, although smaller firms had issues with the cooling-off period where the engagement partner cannot serve as the quality review partner for two years.

Lastly, the effective dates of these new standards were pushed until 2025 in order to provide more time for firms to consider how the provisions would be implemented and to implement them. The effective dates are:

Standard	Effective Date
SQMS 1, *System of Quality Management*	Systems of quality management would be required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management would be required to be performed within one year following December 15, 2025.
SQMS 2, *Engagement Quality Reviews*	Effective for: • Audits or reviews of financial statements for periods beginning on or after December 15, 2025; and • Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025. An engagement in the firm's accounting and auditing practice begins when an engagement letter or other agreement to perform attest services is signed, or when the firm begins to perform the engagement, whichever is earlier.
SQMS 3, *Amendments to QM Sections 10, "A Firm's System of Quality Management", and 20, "Engagement Quality Reviews"*	Revises the language of QM Section 10 to conform with SAS 149 and also provides clarity between the definition of a resource and an information source. Effective concurrently with firms' implementation of SQMS 1 and 2, for: • Audits or reviews of financial statements for periods beginning on or after December 15, 2025; and • Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025.
SAS 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards (SAS 146)*	Engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025.
SSARS 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*	Engagements conducted in accordance with Statements on Standards for Accounting and Review Services for periods beginning on or after December 15, 2025.

Although the effective dates were delayed, firms and practitioners should consider beginning implementation. This is especially true for SQMS 1, which focuses on the firm's system of quality management. The main changes to QC 10, AU-C 220, and AR-C sections 60, 70, 80, and 90, the current standards, are discussed below.

Suite of quality management standards

Instead of one standard, the ASB created two main quality management standards, one statement on auditing standard, and one SSARS. The ASB believes that separating the topic of quality management from engagement quality reviews helps to underscore the importance of the engagement quality review when deemed appropriate by a firm. The separation of the standard also clarifies that an engagement quality review can be a response to quality risks for any engagement type, not just audits. The separation provides a way to differentiate the requirements for the eligibility of the engagement quality reviewer and the performance and documentation of the review.

Another way to look at the integrated standards is that SQMS 1 addresses the firm's responsibility for establishing a system of quality management, including the new quality management approach. An engagement quality review, more fully discussed in SQMS 2, is one possible response to address quality risks. Although the performance of an engagement quality review is undertaken at the engagement level, it is a response that is implemented by the engagement quality reviewer on behalf of the firm. SQMS 1 requires that the firm determine when an engagement quality review is an appropriate response to quality risks. SQMS 2 contains implementation requirements such as policies and procedures to ensure the quality of engagement quality reviewers and performance of engagement quality reviews.

SSARS 26 takes the quality principles down to the engagement level for preparations, compilations, and reviews. It discusses how the engagement partner uses the firm's system and manages quality at the engagement level. SSARS 26 clarifies that the engagement partner has overall responsibility for managing and achieving quality, including creating the appropriate environment for the team focused on ethics, values, and professional skepticism that contributes to a quality engagement. The engagement partner is ultimately responsible and accountable for compliance with the requirements of the new SSARS.

The five standards that make up the Quality Management suite are:

- Statement on Quality Management Standards 1, *A Firm's System of Quality Management*;
- Statement on Quality Management Standards 2, *Engagement Quality Reviews*;
- Statement on Quality Management Standards 3, *Amendments to QM Sections 10, "A Firm's System of Quality Management", and 20, "Engagement Quality Reviews"*;
- Statement on Auditing Standards No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*; and
- Statement on Standards for Accounting and Review Services No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*.

While using the IAASB standard as a base, the ASB and the ARSC also incorporated elements into the new standards to be responsive to issues related to engagement quality, as noted by peer reviewers and other regulators. The major issues are:

- Risks to audit quality correlated with audits, reviews, and attestation engagements performed by engagement partners who perform a low volume of such engagements.
- A need to improve firm governance and leadership and the culture and tone at the top of the firm.
- Consistency issues in the performance of engagements and a lack of focus on planning.
- Overreliance on intellectual resources, such as third-party quality control materials, which are not sufficiently tailored to the nature and circumstances of the firm.
- Challenges experienced by smaller firms in applying the standards.

The IAASB cited certain other challenges such as over-reliance on firm networks, increasing the robustness of engagement quality reviews, and emerging trends, such as ways of communicating with stakeholders.

1. SQMS 1, Firm's System of Quality Management

<u>Approaching quality management from a risk management standpoint</u>

The standard emphasizes an integrated and iterative approach that focuses on assessing risk and continuous improvement. The new approach requires a firm to customize its system of quality management rather than tailor a sample document from the firm's practice aids or other sources. This is currently the norm in many firms. The firm would customize the design, implementation, and operation of its quality management system based on the risks that may have impacted engagement quality in the past as well as the nature and complexity of the firm itself. The integrated approach is intended to cause firms to focus on the quality management system as a whole rather than focus on the required components as stand-alone elements. The new standard was written to be less prescriptive so that it could be easily scalable.

The new system of quality management as set forth in proposed SQMS 1 is designed to meet two objectives:

1. The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements and conduct engagements in accordance with such standards and requirements.
2. Engagement reports issued by the firm are appropriate in the circumstances.

The quality management system is required to address the following eight components:

1. The firm's risk assessment process (new).
2. Governance and leadership (adapted from the leadership responsibilities for quality within the firm component in QC section 10).
3. Relevant ethical requirements (same name as component in QC section 10).
4. Acceptance and continuance of client relationships and specific engagements (same name as component in QC section 10).
5. Engagement performance (same name as component in QC section 10).
6. Resources (adapted from the human resources component in QC section 10).
7. Information and communication (new).
8. The monitoring and remediation process (adapted from the monitoring component in QC section 10).

The eight components are designed to be integrated throughout the system as illustrated below. A discussion of the main changes follows.

The components of the system of quality

Component 1: Risk assessment process – This component is new and is designed to cause firm leadership to assume responsibility for the establishment of quality objectives in each component with the exception of monitoring and remediation. Firms are also required to establish additional quality objectives when needed based on the nature of the firm and its engagements. The second step to the risk assessment process is to identify risks to the achievement of the objectives (quality risks). To do this the firm considers how risks arise and how often they are likely to occur and how long the risk would take to have an effect on quality and whether the firm would, in that period of time, be able to respond and

mitigate the quality risk. Based on the assessment, the firm would initiate a response. The standard specifies certain responses, but these will not be sufficient for the firm to address all of its quality risks.

Component 2: Governance and leadership – The firm is required to assign ultimate responsibility and accountability for the system of quality management to the firm's CEO, managing partner (or equivalent) or, if appropriate, managing board of partners (or equivalent). In addition, the firm is required to assign the following to designated individuals:

- Operational responsibility for the system of quality management; and
- Operational responsibility for specific aspects of the system of quality management, including compliance with independence requirements and the monitoring and remediation process.

Component 6: Resources – The current standard addresses human resources. The proposed standard expands that to address:

- Technological resources; for example, engagement tools or IT applications used by the firm for independence monitoring;
- Intellectual resources; for example, the firm's methodology, guidance, templates, or tools; and
- Human resources, which may include people outside the firm used in engagements, including co-engagement quality (EQ) reviewers who are external to the firm.

The new standard also covers the use of resources from service providers such as methodologies, IT applications, or people the firm uses in engagements and provides guidance to determine that those resources are appropriate for the intended use by the firm.

Component 7: Information and communication – The current quality standard, QC 10, does not address the need for information and communication across the system and with engagement teams. The ASB feels this is very important to ensure an effective quality management system and effective engagement performance. SQMS 1 includes a component designed to provide guidance on this two-way mechanism to supply a continuous flow of information and communication. The standard requires the firm to implement an information system that contains processes to identify, capture, process, and maintain information. The standard is scalable, acknowledging that less complex firms with fewer personnel and direct involvement of leadership may accomplish the objective with less rigorous or detailed policies and procedures. The standard addresses both internal and external communication.

Component 8: Monitoring and remediation process – QC 10 focused on engagement-level monitoring. Proposed SQMS 1 focuses on monitoring activities, broadening the focus to the entire system of quality management. The objective of this change is for the firm to be more proactive, thereby providing a better basis for management to evaluate the system of quality management. In designing the system, leadership considers the nature, timing, and extent of monitoring activities. These are primarily driven by:

- How the system is designed.
- Nature and circumstances of the firm and the engagements it performs.
- The extent of changes to the system.
- The results of previous monitoring activities or external inspections.

The standard includes a requirement to inspect completed engagements and for engagement partners to be inspected on a cyclical basis. (Note that the standard permits monitoring activities to include inspection of in-process engagements.) The firm uses its own inspection criteria to identify the engagements to inspect, the frequency, and which partners will be selected. The standard contains requirement for evaluating findings and evaluating deficiencies identified.

Improvements were made to QC 10 to address remediation, including how firm leadership is assured that the remediation has been implemented and the actions taken are effective.

Evaluating the system of quality management

The individuals assigned ultimate responsibility and accountability for the system of quality management should evaluate the system of quality management at least annually.

2. SQMS 2, Engagement Quality Review

This standard discusses the role of engagement quality reviewers and the characteristics of those individuals necessary to fill the role as well as the individuals who will assist the reviewer. It deals with the authority, competence, and capabilities required to fill the role and highlights the need to include enough time to perform the engagement quality review.

The engagement quality reviewer is responsible for the performance of the engagement quality review, including ensuring that the work of individuals assisting in the review is appropriate. The standard imposes limitations on engagement quality reviewer so that a person who was once the partner does not fill that role for two years.

The standard calls for the engagement quality review, when performed, to be completed along with the approval by the engagement quality reviewer for release prior to the dating of the report.

IV. Applying the principles of AR-C section 60

In addition to the requirements of QC No. 10, firms performing engagements under SSARS No. 21 need to comply with AR-C section 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*. The following is a discussion of these requirements.

A. Key definitions

AR-C section 60 contains many key definitions related to all SSARS engagements. Many are self-explanatory. The following are several of these key definitions:

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

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

- **Designated accounting standard setter** – A body designated by the Council of the AICPA to promulgate accounting principles generally accepted in the United States of America pursuant to the Code's "Compliance With Standards Rule."
- **Fair presentation framework** – A financial reporting framework that requires compliance with the requirements of the framework and acknowledges both of the following:
  - Explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; and
  - Explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be only in rare circumstances.

  The financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgments of the above is not a fair presentation framework.
- **General purpose financial statements** – Financial statements prepared in accordance with a general purpose framework, which is defined as a financial reporting framework designed to meet the common financial statement needs of a wide range of users. U.S. GAAP financial statements would be an example of general purpose financial statements.
- **Special purpose financial statements** – Those prepared in accordance with a special purpose framework. A special purpose framework is one other than GAAP and includes the following:
  - Cash basis.
  - Tax basis.
  - Regulatory basis.
  - Contractual basis.
  - Other basis.

B. Ethical requirements

An accountant on a SSARS engagement should comply with all relevant ethical requirements. These requirements are those contained in the AICPA *Professional Code of Conduct* (the "Code") as well as the rules of the respective state boards of accountancy and regulatory bodies. The Code establishes fundamental principles of professional ethics in the following areas:

- Accountant responsibilities;
- The public interest;
- Integrity;
- Objectivity and independence;
- Due care; and
- Scope and nature of services.

As previously discussed, QC No. 10, *A Firm's System of Quality Control*, provides guidance on the necessary policies and procedures necessary to comply with the relevant ethical requirements of a SSARS engagement.

C. Professional judgment

Additionally, the accountant should exercise professional judgment in performing the SSARS engagement. Such judgment is necessary to effectively apply relevant knowledge and experience to the facts and circumstances experienced on the engagements.

The accountant's training, knowledge, and experience should help develop the necessary competencies to make reasonable judgments and decisions when performing the SSARS engagement. Consultation with those internal and external to the firm is often required to reach these decisions.

Professional judgment is based on the facts and circumstances known by the accountant throughout the engagement, including that obtained from prior period engagements, and from the accountant's understanding of the entity and its environment and should be applied throughout the entire engagement.

This judgment can be evaluated based on whether the judgment represents competent application of the SSARS and other appropriate guidance and its application should be documented. However, in all instances, such judgment should be supported by the applicable facts and circumstances of the engagement and, with regard to a review engagement, the evidence obtained.

Other guidance includes preparation, compilation, and review publications and consists of the following:

- AICPA preparation, compilation, and review publications not defined as interpretive publications, such as its *Preparation, Compilation, and Review Engagements Guide*.
- AICPA's annual alert addressing engagements performed in accordance with the SSARS.
- Articles addressing preparation, compilation, and review engagements in the *Journal of Accountancy* and other professional journals.
- Continuing professional education programs and other instruction materials.
- Textbooks; guidebooks; programs for preparation, compilation, and review engagements.
- Checklists.
- Other publications addressing preparation, compilation, and review engagements for state CPA societies, other organizations, and individuals.

D. Conducting the engagement in accordance with the SSARS

An accountant should perform all review, compilation, and financial statement preparation engagements in accordance with the SSARS, except as detailed in section 90 (i.e., quarterly reviews for public companies). This means applying all relevant AR-C sections, including explanatory materials. Additionally, the accountant should not present an engagement as having been performed in accordance with the SSARS unless all relevant AR-C sections have been complied with.

Similar to the Quality Control standards, all AR-C sections are considered relevant unless considered conditional by the standard and the condition does not exist. The professional standards required by the SSARS can be divided into two categories:

- **Unconditional requirements** – Standards the accountant must comply with on <u>all</u> engagements, when the requirement is relevant.
- **Presumptively mandatory requirements** – Standards the accountant must comply with, except when the specific circumstances of an engagement would result in the procedure being ineffective in achieving the intent of the requirement. This is expected to be a rare occurrence and would result in the accountant applying alternative procedures to achieve

the objective of the requirement. The rationale for the departure, revised procedures, and their results should be adequately documented by the engagement team.

SSARS using the word “must” indicate unconditional requirements while SSARS using the word “should” indicate a presumptively mandatory requirement.

AR-C section 60 contains a mandatory requirement for the accountant to document the justification for a departure from a relevant presumptively mandatory requirement and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of the requirement.

As stated earlier, the ARSC is designated to issue the standards by which accountants perform review, compilation, and preparation services. The ARSC does this by issuing the SSARS, which are the authoritative guidance on the delivery of these services. SSARS do not override other legal or regulatory requirements relevant to an engagement. When such laws differ from the requirements of the SSARS, an engagement performed in accordance with those laws and regulations is not performed in compliance with the SSARS.

Additionally, the accountant may be required to conduct a financial statement preparation, compilation, review, or other appropriate engagement, in accordance with the SSARS and other standards, such as international standards on such engagements. In these instances, the accountant should perform additional procedures in order to conform with the requirements of these other standards. Similarly, the SSARS are relevant for engagements related to governmental entities, though other rules and regulations may apply. The requirements of these other rules are not covered by the SSARS.

In determining the relevant standards to follow in conducting an engagement in conformity with the SSARS, an accountant should also look to the introductory, application, or other explanatory materials such as appendixes found in the SSARS to govern actions taken. This additional guidance can be helpful in providing explanations and examples to help implement the provisions of the SSARS. While not imposing a requirement, this guidance can help the accountant carry out the requirements of the applicable SSARS. The AR-C 60 Exhibit lists appropriate other preparation, compilation, and review publications that the accountant can reference to enhance this understanding. The accountant should use professional judgment in determining how to utilize this additional guidance.

E. Engagement level quality control

Engagement level quality control ensures that the engagement partner is accountable for the delivery of the engagement in accordance with the SSARS. Specifically, the engagement partner must have the necessary competence and capabilities to perform the engagement and appropriate competence in financial reporting.

The engagement partner is the chief responsible party in assuring effective engagement level quality control and is ultimately responsible for the following:

- The overall quality of the engagement, including consideration of independence requirements;
- The direction, supervision, planning, and performance of the engagement in accordance with professional standards;
- The appropriateness of the accountant’s report;

- Assuring the engagement is performed in accordance with the firm's quality control standards, including assuring appropriate engagement acceptance procedures were performed and that the team has appropriate competence and capabilities to perform the engagement; and
- The sufficiency of the documentation retained to support the accountant's report.

When assigning the engagement team, the engagement partner may consider the following:

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

The concept of quality for which the engagement partner is responsible extends to the following:

- Performing work that complies with professional, legal, and regulatory requirements;
- Complying with the firm's quality control policies and procedures;
- Report issuance, and
- The team's ability to raise concerns in the absence of fear of reprisal.

Unless information exists to suggest otherwise, in fulfilling this role, the engagement partner and team can rely on the firm's system of quality control to assure its compliance with firm policies and procedures. Further, a deficiency in the firm's quality control processes does not necessarily mean that the engagement was not performed in accordance with professional standards.

The engagement partner should continue to be alert for potential ethical challenges throughout the engagement, such as independence breeches. Additionally, the firm should have a system of monitoring to ensure that the firm's quality control policies and procedures are relevant and operating effectively.

Lastly, if information comes to light after the initial acceptance process that challenges the conclusion reached, the engagement partner should communicate that to the appropriate firm personnel so they may take appropriate action. Also, the engagement partner should stay alert for potential noncompliance by engagement team members of ethical requirements. If the engagement partner becomes aware of potential noncompliance with these standards, the engagement partner, in consultation with others in the firm, should determine the appropriate action.

F. Acceptance and continuance activities

In addition to those requirements found in QC No. 10, the accountant and firm's client acceptance and continuance activities are a critical element of the general principles. AR-C section 60, paragraphs .24-25 establish the elements of effective acceptance and continuance (A&C) procedures.

Specifically, the accountant should not accept an engagement to be performed in accordance with the SSARS in the following circumstances:

- The accountant has reason to believe that relevant ethical requirements will not be satisfied.
- The accountant's preliminary understanding of the engagement indicates that the necessary information needed for the engagement is not likely to be available or is unreliable.
- The accountant has doubts about management's integrity which is likely to affect engagement performance.

As part of the accountant's A&C procedures, the accountant should determine if the financial reporting framework selected by management is appropriate.

Lastly, the accountant should, through the engagement letter, get management's agreement as to its responsibility for the following with regard to the engagement:

- Selection of the financial reporting framework, based on the purpose of the financial statements and applicable laws and regulations;
- The design, implementation, and maintenance of a system of internal control related to financial reporting;
- Preventing and detecting fraud;
- The entity's compliance with applicable laws and regulations;
- The completeness and accuracy of records, documents, and explanations provided by it that support the preparation of the financial statements; and
- Providing access to all necessary information and people required by the accountant to perform the engagement.

However, it may be necessary to discuss these requirements with less sophisticated clients prior to issuance of the engagement letter to assist with their understanding of these items. As the form of information required by the accountant to complete the engagement may take many forms, discussion of these items can be particularly helpful prior to engagement acceptance. Such discussions allow the accountant to assume that client management has a sufficient understanding of its responsibilities in regard to this information.

Unless otherwise required by law or regulation, any doubt with regard to the management's integrity to a degree that it is likely to affect the performance of the engagement should result in the accountant's declining the engagement.

Additionally, the acceptance and continuance process should continue throughout the engagement, including an ongoing assessment of independence. Further, it is customary for the accountant to assist management with what is necessary to finalize the financial statements. These efforts should not impact the ongoing assessment of engagement continuance but situations when incomplete or insufficient accounting records prevent the accountant from performing required procedures could trigger the accountant to withdrawal from the engagement.

G. Assessing and determining the applicability of the financial reporting framework

An applicable financial reporting framework provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements. The criteria used by the accountant to evaluate or measure the subject matter, including, when relevant, a basis for presentation and disclosure, are also provided by the financial reporting framework. These criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements, and the accountant does not have suitable criteria for an engagement in accordance with SSARSs. In many cases, the accountant may presume that the applicable financial reporting framework is acceptable.

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

- The nature of the entity (for example, whether it is a business enterprise, a governmental entity, or a not-for-profit organization).
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users).
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement).
- Whether law or regulation prescribes the applicable financial reporting.

Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements. General purpose frameworks are generally accounting principles promulgated by a body designated by the Council of the AICPA to establish such principles. Such financial reporting standards often are identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

In some cases, the financial statements will be prepared in accordance with a special purpose framework. For example, law or regulation may prescribe the financial reporting framework to be used in the preparation of financial statements for certain types of entities. Such financial statements are referred to as special purpose financial statements.

The accountant is required to obtain the agreement of management on management's responsibilities in relation to the financial statements as a condition precedent to accepting the engagement. In smaller entities, management may not be well-informed about what those responsibilities are, including those arising in applicable law or regulation. In order to obtain management's agreement on an informed basis, the accountant may find it necessary to discuss those responsibilities with management in advance of seeking management's agreement on its responsibilities.

The financial statements are those of the entity. This section does not impose responsibilities on management and those charged with governance, nor does it override laws and regulations that govern their respective responsibilities. However, an engagement performed in accordance with SSARSs is conducted on the premise that management, and those charged with governance, as appropriate, have acknowledged certain responsibilities that are fundamental to the conduct of the engagement. The accountant's engagement does not relieve management and those charged with governance of their responsibilities.

As part of its responsibility for the preparation of the financial statements, management is required to exercise judgment in making accounting estimates that are reasonable in the circumstances and to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

Because of the significance of the preconditions for undertaking an engagement in accordance with SSARSs, the accountant is required, in accordance with this section, to obtain management's agreement that it understands its responsibilities before accepting a SSARSs engagement. The accountant may obtain management's agreement either orally or in writing. However, management's agreement is subsequently recorded within the written engagement letter.

If management, and those charged with governance, where appropriate, do not or will not acknowledge their responsibilities in relation to the financial statements, it is not appropriate to accept the engagement.

Lastly, although the accountant may accept responsibility for the design, implementation, and maintenance of internal control, accepting such responsibility would impair the accountant's independence. Therefore, if an accountant accepts such responsibility, the accountant would be precluded from performing a review of the financial statements.

The accountant is entitled to rely on management to provide all relevant information for the engagement. The form of the information provided by management for the purpose of the engagement will vary in different engagement circumstances. In broad terms, it will comprise records, documents, explanations, and other information relevant to the preparation of the financial statements in accordance with the financial reporting framework adopted by management. The information provided may include, for example, information about management's assumptions, intentions, or plans underlying development of accounting estimates needed to prepare the financial statements in accordance with the applicable financial reporting framework.

V. Accepting preparation, compilation, and review engagements

As we saw in our earlier discussion of AR-C section 60, the process for accepting preparation, compilation, and review engagements is an important element in any professional accounting practice providing these types of services. In this section, we will do a deeper dive on some of the best practices concerning the acceptance and continuance process.

This process is comprised of two basic sets of procedures: (1) those related to the evaluation of an engagement, and (2) those related to the prospective client. Evaluating engagements relates to the overall procedures in place at the firm level which consider matters such as quality control standards and independence. Evaluating prospective clients relates to matters such as client integrity, the services to be performed, and the intended users of the financial statements.

A. CCC – It all begins with quality control

Quality control standards, requirements, and guidance for CPAs have long been established by various standard-setting bodies (as well as by federal law for issuers). One of the most important elements of a system of quality control is the acceptance of client engagements, which centers around the practitioner's three "Cs":

1. Competence to perform the engagement;
2. Compliance with legal and relevant ethical requirements; and
3. Consideration of client integrity.

B. Competence

The initial step in the engagement acceptance process is to assess the competence to undertake a compilation or review engagement for a new or continuing client.

Competence in its most basic form is simply the ability of an individual to perform a job properly. In this case, competence would refer to the ability to perform a compilation or review according to the standards based on professional knowledge, skills, and experience.

Even if the practitioner has never performed a preparation, compilation, or review engagement, competence can be developed in a number of different ways, including, for example, continuing professional education (like this course) and on-the-job training by more experienced staff.

If preparation, compilation, or review engagements are new to the practitioner, it is not necessary to already have the knowledge required to perform such engagements prior to accepting them. Rather, the practitioner only needs to have the ability to effectively gain the necessary knowledge prior to engagement performance. Likewise, even if additional studying or asking assistance of others is needed while performing an engagement, this does not typically indicate a lack of competence; it is just a normal part of performing professional services.

C. Compliance with legal and relevant ethical requirements

A practitioner also needs to review the specific requirements of the engagement to make sure they understand, and are comfortable with, any regulatory or reporting requirements involved in the engagement. For example, if the engagement will be using a "special purpose framework" (OCBOA) such as the income tax basis of accounting, the accountant has to understand the relevant Internal Revenue Code requirements applicable to the engagement.

It is also important to consider any ethical issues that might come into play for the engagement. The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which includes objectivity and independence. Independence requirements are of course set forth in The Independence Rule (and its related interpretations and rulings), as well as in the rules of state boards of accountancy and applicable regulatory agencies.

D. Consideration of client integrity

The practitioner is also tasked with assessing the client's integrity. It is probably safe to say that today's practice environment is tougher than it has ever been. The risks associated with even the simplest of engagements have changed dramatically over the past several years. With this in mind, a CPA must be aware of the need to perform a thorough evaluation of a prospective client relationship and engagement.

To help in this respect, one might use the old time-tested "who, what, and why" approach by considering matters such as the following before formally accepting an engagement:

1. ***Who*** the business owners are, their reputation, and whether they might be involved in any type of criminal activity (Tony Soprano?);
2. ***What*** business the client is in and its business practices; and
3. ***Why*** the business is hiring the practitioner.

A practitioner could gather this information in a multitude of ways, including:

- Talking with other CPAs, lawyers, or consultants, who are currently, or have previously, provided professional services to the client (in accordance with relevant ethical requirements, of course); and
- Conducting background searches on the client, its management, and business operations.

VI. The client acceptance process

In a nutshell, the preceding quality control matters are intended to help protect practitioners from both themselves (lacking the competence to perform an engagement or not understanding the legal and ethical issues surrounding an engagement), as well as unscrupulous clients.

The following steps are meant to represent a basic framework of the client acceptance process. As always, practitioners should exercise professional judgment in determining the applicability of each of these steps to the acceptance process of a specific engagement.

A. Interview the prospective client

Meeting and speaking directly with a prospective new client provides the practitioner the chance to get a good feel for business owner (management) and the company. Further, the prospective client's most recent financial statements should be read prior to the interview so they can be fully discussed. Other matters to also discuss should include:

- The business itself – how it got started, how it is organized, and any internal issues that might be going on now or in the past year or two;
- The type of engagement – compilation or review;
- Any limitations the client insists on regarding the engagement;
- How the client establishes its accounting policies and any recent changes to them;
- Whether the client is a party to any current or threatened legal proceedings; and
- Any potential conflicts of interest between the accountant and the prospective client.

B. Assess the client's commitment to the appropriate application of the applicable financial reporting framework

Given the variety of financial reporting frameworks available today other than U.S. GAAP, for example, IFRS, IFRS for SMEs, and special purpose frameworks (OCBOAs), the practitioner should assess the prospective client's commitment to the appropriate application of the particular framework being used to prepare the financial statements. In this context, discussing the client's significant accounting policies should help to better understand if the policies are appropriate given the circumstances. If the policies are not appropriate, and the client is not willing to change their approach, the practitioner should not accept the engagement.

C. Assess the client's commitment to implementing and maintaining effective internal control

Even though it is not required to obtain an understanding of the entity's internal control when performing a compilation or review engagement, a prospective client's attitude toward internal control over financial reporting is an important factor to consider in any engagement acceptance process. The practitioner should discuss the various elements of internal control – control environment; risk assessment; information and communication systems; control activities; and monitoring, with the prospective client to at least get a feel for their attitude and commitment to these areas.

SSARS No. 24 clarified the guidance to note that an accountant can be responsible for the design, implementation, and maintenance of an entity's internal control. However, an accountant who takes on these responsibilities for a client will have their independence impaired. This would prevent the accountant from conducting a review engagement for the client.

D. Assess the client's financial viability

Next, the financial viability of a prospective client should be considered. Simply reading the prior reviewed or audited financial statements, income tax returns, and any documents filed with regulatory agencies can help more fully understand the client's financial position. Accepting engagements with clients in dire financial straits could expose the practitioner to all kinds of litigation if the client fails, regardless of the quality of the professional services provided.

E. Communicate with the predecessor accountant

Like our brief discussion of internal control above, even though it is not required to communicate with the predecessor accountant when engaged to perform a compilation or review, it is a best practice to do so anyway. Communicating with the predecessor accountant (with the prospective client's permission of course) can be a very good way to not only investigate the integrity of a prospective new client, but to also gain valuable insight into the potential engagement itself. For example, understanding the level of sophistication of a prospective client's accounting system and personnel from an "outsider's perspective in the know" could be an important factor to consider in the client acceptance process.

The practitioner should request the prospective client to authorize the predecessor accountant to respond fully to inquiries regarding matters that will assist in determining whether to accept the engagement. If the client refuses or limits the response, the client's reasoning should be understood and considered in deciding whether to accept the engagement.

In determining whether to accept an engagement, the following matters should be discussed with the predecessor accountant:

- The prospective client's integrity;
- Any disagreements or professional concerns they have regarding the potential client's business practices or accounting policies and procedures;
- Any actual or potential fraud, illegal acts, and internal control related matters; and
- The reasons why the potential client is switching accountants.

Additional inquiries should include the potential client's system of internal control, current or threatened legal matters, and any going concern issues.

As for the predecessor's workpapers, that review (again, not required but a best practice) typically occurs after engagement has been accepted.

F. Review independence and objectivity

As we touched upon above, independence and objectivity play a key role in determining whether to accept a new client engagement. The practitioner considers things such as any financial interests (or "covered persons") in the client, as well as any employment or business relationships that could affect independence and objectivity. Before accepting a new client engagement, it is important to make sure that all independence and objectivity requirements with respect to the client are met. The practitioner should also ensure that accepting the engagement does not create any conflicts of interest with respect to existing engagements.

Do not forget that a compilation engagement can be performed when independence is impaired as long as such impairment is disclosed in the compilation report.

G. Consider other issues

The following issues can create additional risk in an engagement and should be considered before deciding whether to accept the engagement:

- *Scope Restrictions* – An accountant should consider avoiding engagements where the client limits the scope of the work without valid business reasons for doing so.
- *Business and Industry* – If a prospective client operates a risky business, say for example, hauling nuclear waste, or operates in a risky business environment, such as off-shore drilling, the accountant should consider this in the client acceptance process.
- *Timing Considerations* – Formally accepting a new client engagement should always be contingent upon completing the entire client acceptance process.

H. Documentation

In the end, whether or not a practitioner decides to accept or reject a new client engagement, the consideration of the engagement acceptance process should be documented. This documentation should be retained according to relevant policies and procedures.

I. Client engagement acceptance forms

When conducting the client acceptance (or continuation) process, it is a best practice to use a "Client Engagement Acceptance Form." These forms provide an excellent way to document this process and are widely available from many reputable vendors. Client engagement acceptance forms generally include the following types of matters:

- Basic information such as the entity's legal name and description, primary contacts, type of business operations, management structure, and services to be provided;
- Any communications with predecessor accountants;
- Client relationship matters such as the client's integrity and conflicts of interest; and
- A list of suggested client acceptance procedures such as interviewing the client, assessing the client's commitment to internal control, and the client's financial viability.

Question to ponder:

What are some of your firm's quality control procedures that ensure engagement quality?

AR-C 70: Performing Financial Statement Preparation Services

AR-C 70: Performing Financial Statement Preparation Services

Learning objectives

After completing this chapter, you should be familiar with:

- The requirements of AR-C section 70, *Preparation of Financial Statements*; and
- Performing preparation of financial statement engagements.

I. Introduction

AR-C section 70 applies to accountants in public practice that have been engaged by management to prepare financial statements. The accountant's objective in such an engagement is the preparation of financial statements pursuant to the financial reporting framework adopted by management. AR-C section 70 may also be applied and adapted as necessary in the circumstances to other historical or prospective financial information.

Financial statement preparation under SSARS No. 21 is a non-attest service, as opposed to compilations and reviews, which are also covered by SSARS No. 21 and which are attest services. We will explore the impact of this distinction on the accountant's independence requirements as well as the accountant's responsibilities in performing the engagement later in this chapter.

It is important to note here that merely assisting in preparing financial statements is a bookkeeping service that is not subject to AR-C section 70. The determination about whether the accountant has been engaged to prepare financial statements or merely assist in preparing financial statements is based on the services the client requests the accountant to perform and requires the accountant to apply professional judgment.

II. Why have a financial statement preparation service?

Due to technological advances in accounting and financial reporting systems, it is becoming increasingly difficult to distinguish between financial statements prepared by management and those prepared by an accountant. Accountants often assisted clients in the preparation of financial statements generated via the software used to perform bookkeeping services. The guidance in SSARS No. 19 did not apply to this service.

However, SSARS No. 19 became applicable whenever the accountant "submitted" unaudited financial statements of a nonpublic company to management or a third party. The accountant needed to apply judgment as to whether the services provided constituted a compilation engagement, to which SSARS No. 19 applied and which would require the accountant to deliver a report. This requirement could cause ambiguity as two accountants could call essentially the same service by different names, with one governed by formal standards and the other not. It is this situation that AR-C section 70 is aiming to address.

With the issuance of SSARS No. 21 – specifically, AR-C section 70, as well as changes to the AICPA Code of Professional Conduct which explicitly describe financial statement preparation services as a non-attest service for engagements covering periods beginning on or after December 15, 2015 – the ARSC achieved a better distinction between preparation and compilation services. As a result, a compilation engagement, and related accountant's report, is required when the accountant is formally "engaged" to provide that service. The specifics of a compilation engagement, and what constitutes the accountant being "engaged" to perform one, will be reviewed later in this course. Also, effective for prospective financial information prepared on or after May 1, 2017, the guidance in AR-C section 70 applies to the preparation of prospective financial information.

In addition to providing clarity with regard to when an accountant is performing a compilation, these changes necessitated the need for formal standards on how to perform a preparation of financial statements engagement, which AR-C section 70 provides.

III. So, what is a financial statement preparation engagement?

AR-C section 70 defines a preparation of financial statements engagement as a nonattest service that does not require the accountant to assess independence with regard to the entity. Additionally, the accountant does not need to verify the completeness and accuracy of the information provided by management to prepare the financial statements or gather any evidence to express an opinion or conclusion on the financial statements. In fact, the accountant does not even issue a report on the financial statements.

In applying the guidance provided by AR-C section 70, the accountant still must make a determination whether the services provided are bookkeeping services (to which AR-C section 70 does not apply) or a preparation of financial statement engagement which is subject to AR-C section 70. This determination is based on the services requested by the entity and still requires that the accountant apply professional judgment.

An online tool, created by the AICPA's Audit and Standards staff, with contributions from ARSC, has been developed to guide accounting professionals in deciding if they need to follow AR-C Section 70. This tool is particularly useful for those providing bookkeeping or accounting services that result in financial statements. The tool is interactive PDF format, where practitioners can respond to a brief set of questions to ascertain if AR-C Section 70 applies to their work. In addition, a separate flowchart is available for a quick reference of the decision-making process. The Appendix to AR-C section 70 provides the following examples of services that represent bookkeeping services and those to which AR-C section 70 applies:

Examples of Services for Which AR-C 70 Applies	Examples of Accountant Services for Which AR-C 70 Does Not Apply (Bookkeeping Services)
Preparation of financial statements prior to an audit or review by another auditor.	Preparation of financial statements when an accountant is engaged to perform an audit, review, or compilation of such financial statements.
Preparation of financial statements for an entity to be presented alongside the entity's tax return.	Preparation of financial statements with a tax return solely for submission to taxing authorities.
Preparation of personal financial statements for presentation alongside a financial plan.	Personal financial statements that are prepared for inclusion in written personal financial plans prepared by the accountant.
Preparation of single financial statements, such as a balance sheet or an income statement or financial statements with substantially all disclosures omitted.	Drafting financial statement notes.
Using the information in the general ledger to prepare financial statements outside of an accounting software system.	Entering general ledger transactions or processing payments in an accounting system (general bookkeeping).
	Financial statements prepared in conjunction with litigation services that involve pending or potential legal or regulatory proceedings.
	Financial statements prepared in conjunction with business valuation services.
	Maintaining depreciation schedules.
	Preparing or proposing certain adjustments, such as those applicable to deferred income taxes, depreciation, or leases.

AR-C section 70 can also be applied to other historical or prospective financial information, including:

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

While the guidance for the applicability of AR-C section 70 seems pretty straight forward, there are certain circumstances where applying it can be difficult. An accountant not in the practice of public accounting would not need to comply with the SSARS; this would include entity employees, etc. However, if the accountant is in public practice and prepares financial statements and is also a stockholder, partner, director, officer or employee of the entity, the accountant may either comply with the SSARS or communicate the accountant's relationship to the entity, preferably in writing.

Further, an accountant who meets the following criteria should follow the performance requirements of AR-C section 70:

- Practices public accounting;
- Provides an entity with controllership or other management services that involve the submission of financial statements; and
- Is not a stockholder, partner, director, officer, or employee of the entity.

In either instance, the accountant must use judgment in determining whether he or she is engaged to prepare financial statements or merely assist management with preparing the financial statements. When in doubt as to the applicability of AR-C section 70, it is good to take a good read of the standard and consult others, as needed.

A. What are the requirements of a financial statement preparation engagement?

As with all engagements subject to SSARS No. 21, the accountant should perform appropriate client acceptance or continuance procedures, as applicable. These procedures were detailed in Chapter 2 of this course.

The following is a discussion of additional requirements of a preparation of financial statements engagement.

1. Signed engagement letter

The accountant should not accept an engagement to prepare financial statements unless he or she has agreed to the terms of the engagement with management and recorded those terms in an engagement letter (or other suitable form of written agreement), which has been signed by both the accountant or the accountant's firm and management. The requirement for both parties to sign the engagement letter has been made explicit in amendments found in SSARS No. 23 and is effective immediately. In practice, this should not represent a change but is merely a clarification of the existing requirement.

Per AR-C section 70, the following elements should be included in the engagement letter:

- The objective of the engagement.
- The responsibilities of management, as defined in AR-C section 60, paragraph .25c (see Chapter 2 and example letter that follows).
- The agreement of management that each page of the financial statements will include a statement indicating that no assurance is provided on the financial statements or that the accountant will be required to issue a disclaimer that makes clear that no assurance is provided on the financial statements.
- The responsibilities of the accountant.
- The limitations of the engagement to prepare financial statements.
- Identification of the applicable financial reporting framework for the preparation of financial statements.
- Whether the financial statements are to contain any known departure(s) from the applicable financial reporting framework (including inadequate disclosures) or omit substantially all the disclosures required by the applicable financial reporting framework.

Best practice related to the engagement letter is for the accountant to review the contents of the engagement letter with client management and/or those changed with governance of the entity to assure that the appropriate entity personnel thoroughly understand the scope of services provided, that the accountant is providing no assurance on the financial statements, and the mutual roles and responsibilities of the accountant and the entity.

The following is an example engagement letter for preparing financial statements in accordance with U.S. GAAP. The engagement letter can be modified to address preparation of any historical, pro forma, or prospective financial information.

Example Engagement Letter

Note 1: This engagement letter would be appropriate to prepare financial statements in accordance with GAAP or a special purpose framework, modified appropriately where noted for the appropriate applicable financial reporting framework and titles of financial information to be prepared.

To [Appropriate representative of management, including considering relevant jurisdictions]:

You have requested that we prepare the financial statements of [Entity], which comprise the balance sheet as of December 31, 20XX, and the related statements of income, and changes in stockholders' equity, and cash flows for the year then ended and the related notes to the financial statements. This letter confirms our acceptance and our understanding of this engagement to prepare the financial statements.

Note 2: If the engagement is to prepare the financial statements omitting the statement of cash flows and substantially all disclosures required by the applicable financial reporting framework, the introductory paragraph would be modified to appropriate circumstances, such as the following:

You have requested that we prepare the financial statements of [Entity], which comprise the balance sheet as of December 31, 20XX, and the related statements of income and changes in stockholders' equity. These financial statements will not include a statement of cash flows related notes to the financial statements as required by accounting principles generally accepted in the United States of America. This letter confirms our acceptance and our understanding of this engagement to prepare the financial statements.

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

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

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

Management Responsibilities

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

- The prevention and detection of fraud.
- To ensure that the entity complies with the laws and regulations applicable to its activities.
- The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide us for the engagement to prepare financial statements.
- To provide us with:
  - (a) Documentation and other related information that is relevant to the preparation and presentation of the financial statements;
  - (b) Additional information that may be requested for the purpose of the preparation of the financial statements; and
  - (c) Unrestricted access to persons within [Entity] to whom we determine necessary to communicate.

Option A: The financial statements will not be accompanied by a report. However, you agree that the financial statements will clearly indicate that no CPA provides any assurance on them.

Option B: If accountant expects to issue a disclaimer, this would be used instead of Option A.
As part of our engagement, we will issue a disclaimer that will state that the financial statements were not subjected to an audit review or compilation engagement by us and accordingly, we do not express and opinion, a conclusion, nor provide any assurance on them.

Other Relevant Information

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

Optional: Include information regarding fee arrangements, timing, reporting deadlines, staffing, etc.

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

Regards –

SIGNATURE OF ACCOUNTANT OR ACCOUNTANT'S FIRM

Acknowledged and agreed on behalf of [Client]:

SIGNATURE OF CLIENT

NAME AND TITLE

DATE

Note 3: The following matters should be considered when drafting the engagement letter:

- The addressee and reference to other matters should be appropriate to the circumstances.
- Amend references such as you, us, we, etc., as appropriate.
- The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.
- The accountant may be engaged to prepare financial statements in accordance with a prescribed format. The applicable financial reporting framework could be described as applicable throughout the engagement letter as "the format prescribed by [developer of the format of the financial statements] and in accordance with accounting principles generally accepted in the United States of America."
- The accountant may be engaged to prepare one or more specified elements, accounts, or items of a financial statement (for example, schedule of accounts receivable or schedule of depreciation). The scope of the engagement described in the introductory accountant responsibility and management responsibility paragraphs should be modified appropriately.
- If the accountant is being engaged to prepare financial statements in conjunction with an attest service (such as a compilation, review, or audit), then use the engagement letter and requirements of the attest service.

The wording to this standard letter should be modified, as necessary, for the following:

- The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services;
- The accountant may be engaged to prepare financial statements in accordance with a prescribed format. The applicable financial reporting framework could be described as applicable throughout the engagement letter as "the format prescribed by (developer of the format of the financial statements) and in accordance with accounting principles generally accepted in the United States of America;"
- The accountant may be engaged to prepare one or more specified elements, accounts, or items of a financial statement (for example, schedule of accounts receivable or schedule of depreciation). The scope of the engagement described in the introductory accountant responsibility, and management responsibility paragraphs should be modified appropriately; and
- If the accountant is being engaged to prepare financial statements in conjunction with an attest service (such as a compilation, review, or audit), then use the engagement letter and requirements of the attest service.

2. Obtaining an understanding of the entity's financial reporting framework

As part of the engagement planning process, the accountant must develop an understanding of the financial reporting framework to be used in the preparation of the financial statements. Lack of experience with this framework does not prevent the accountant from accepting the engagement. However, the accountant must acquire this understanding, which can be obtained from a variety of resources, including AICPA guides, industry publications, reviewing the financial statements of other entities in the industry, formal or informal training, or by referencing others who are knowledgeable about the industry.
Without such knowledge, the accountant has not fulfilled the professional responsibilities with regard to the engagement. The accountant is also required to develop an understanding of significant accounting policies related to the preparation of the financial statements.

3. Preparation of the financial statements

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

As mentioned previously, each page, generally at the bottom of the financial statements, should include the statement that no assurance is provided, this statement is intended to avoid any misunderstanding by the user of the financial statements as to the accountant's involvement with the financial statements. The statement is made at management's discretion and the name of the accountant or firm is not required to be presented. Examples of this statement are as follows:

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

The accountant should assure that whatever words are used are not misleading.

If the statement is not included on each page, the following is an example of the wording of the disclaimer that the accountant should add:

> *The accompanying financial statements of ABC Company as of and for the year ended December 31, 201X, were not subjected to an audit, review, or compilation engagement by me (us) and I (we) do not express an opinion, a conclusion, nor provide any assurance on them.*
>
> *Signature of accounting firm or accountant, as appropriate*
>
> *Accountant's city and state (which may be on firm's letterhead)*
>
> *Date*

Another alternative if the disclaimer is not provided is for the accountant to perform a compilation engagement, in accordance with AR-C section 80, or another scope of service, such as a review or audit.

Also, the accountant should consider withdrawing from the engagement if management does not agree to add the "no assurance is provided" to each page of the financial statements. If withdrawing from the engagement, the accountant must inform management of the reasons for withdrawing.

Note that there is no formal accountant's report issued in an engagement performed under AR-C section 70.

B. Other financial statement preparation considerations

When preparing financial statements in accordance with a special purpose framework, the accountant should include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements. A description of the special purpose framework is usually placed next to or under the title of the financial statements (for example "statement of assets and liabilities–modified cash basis"). However, the description may be placed elsewhere in the financial statements. Additionally, entities may need to report to regulatory or other bodies on certain prescribed forms and the entity may engage the accountant to prepare or assist with the preparation of the proscribed forms. These forms may call for departures from the requirements in the applicable financial reporting framework. For example, the proscribed form may specify a measurement principle not in accordance with the applicable framework or fails to request certain disclosures or presentation typically required. Such a format, in a standard preprinted form, is presumed to meet the reporting requirements of the body. Examples of such reports are those used by trade associations, credit agencies, banks, and other governmental or regulatory bodies. Such statements may also need to be prepared under a special purpose framework, such as cash, tax, contractual, or regulatory basis financial statements. AR-C section 70 allows for the preparation of such financial statements by an accountant. Reports should state the basis of accounting on which the financial statements were prepared, such as in accordance with the requirements of a contract or a regulation.

During the preparation of financial statements, the accountant may provide assistance to management with significant judgments used in the preparation of the financial statements. For example, the accountant may advise management on alternative accounting policies that are significant to the financial statements or help management with significant judgments regarding material accounting estimates. If the accountant assists management with significant judgments regarding amounts or disclosures to be reflected in the financial statements, the accountant should discuss the judgments with management so management understands the significant judgments reflected in the financial statements and accepts responsibility for those judgments. The accountant's documentation in connection with a financial statement preparation engagement may include documentation regarding significant consultations or significant professional judgments made throughout the engagement.

If the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, used in the preparation of the financial statement are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information. If management fails to provide such additional or corrected information, the accountant should disclose a material misstatement or misstatements in the financial statements in accordance with paragraph .18 or withdraw from the engagement and inform management of the reasons for withdrawing.

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

Lastly, when the preparation engagement relates to prospective financial information, a summary of significant assumptions is deemed essential to the user's understanding of the prospective financial information. Accordingly, effective for prospective financial information prepared on or after May 1, 2017, the accountant should not prepare prospective financial information that excludes disclosure of the summary of significant assumptions. Also, effective the same date, the accountant should not prepare a financial projection that excludes either an identification of the hypothetical assumptions or a description of the limitations on the usefulness of the presentation.

To help the accountant and the client with the preparation of prospective financial information, the AICPA has published the following Guide, *Prospective Financial Information*, which provides comprehensive guidance regarding prospective financial information. Specifically, Chapter 6, *Preparation Guidelines*; Chapter 7, *Reasonably Objective Basis*; Chapter 8, *Presentation Guidelines*; and Chapter 9, *Illustrative*

Prospective Financial Statements, establish the guidelines for preparation and presentation of financial forecasts and projections. The guide also provides suitable criteria for the preparation and presentation of prospective financial information as well as information on the types and uses of financial projections and forecasts. Note that the accountant is not prohibited for preparing prospective financial information that is prepared and presented in accordance with other suitable criteria.

1. Omitting substantially all disclosures required

If the accountant prepares financial statements that omit substantially all disclosures required by the applicable financial reporting framework, the accountant should disclose such omission either in the financial statements or in an accompanying disclaimer. This includes disclosures concerning substantial doubt about going concern.

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

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

Financial statements may be misleading; for example, if the applicable financial reporting framework includes the premise that the financial statements are prepared on the going concern basis and undisclosed doubt exist regarding the entity's ability to continue as a going concern. If the accountant becomes aware that uncertainties exist regarding the entity's ability to continue as a going concern, the accountant may suggest additional disclosures concerning the entity's ability to continue as a going concern in order to avoid the financial statements being misleading. However, disclosure of items, such as an uncertainty, is not required in financial statements in which substantially all the disclosures required by the applicable financial reporting framework are omitted.

The accountant may prepare financial statements that include disclosures about only a few matters in the notes to the financial statements. Such disclosures may be labeled "Selected Information–Substantially All Disclosures Required by [*the applicable financial reporting framework*] Are Not Included."

2. Documentation for a preparation of financial statements engagement

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

a. The engagement letter (or other suitable form of written documentation) with management; and
b. A copy of the financial statements that the accountant prepared.

If, in rare circumstances, the accountant judges it necessary to depart from a relevant presumptively mandatory requirement, the accountant must document the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of that requirement.

Additionally, documentation may include evidence of significant consultations or professional judgments made throughout the engagement as well as communications, whether written or oral, made to management concerning fraud or illegal acts that the accountant came across in the performance of the engagement.

Lastly, the accountant is not required to obtain a management representation letter at the completion of the financial statement preparation engagement.

C. Inclusion of preparation engagements in the scope of peer review

In 2015, the AICPA Peer Review Board (Board) in approved guidance that would not require firms that only perform financial statement preparation engagements in accordance with AR-C section 70 to be or remain enrolled in an approved peer review program. However, if such a firm remains enrolled or elects to enroll, then it would be required to undergo a peer review.

For a system review, preparation engagements would not be required to be selected but if the firm had an engagement review, then preparation engagements would be selected in certain instances. The goal of the Board was to facilitate firm compliance with state board of accountancy licensing requirements and mitigate issues with regard to mobility that might arise if preparation engagements were not subject to peer review in some capacity.

The changes also included revisions to Interpretation 6-3 to clarify that a firm that only performs management use only compilations with no report and is not required to enroll in the AICPA Peer Review Program would be required to undergo a peer review if it elects to enroll in the Peer Review Program.

Question to ponder:

What challenges have you faced in determining whether your engagements are covered by the SSARS or not?

IV. Practice exercises

Use the following brief exercises to review what you have learned about performing and reporting on compilation engagements discussed above. A suggested solution appears at the end of the chapter material.

Determine if AR-C section 70 would apply in the following scenarios

1. The engagement calls for the accountant to prepare financial statements in accordance with U.S. GAAP from the trial balance generated from the client's financial reporting system.

2. Under the supervision of the client, the accountant prepares adjusting and closing journal entries and posts them into the client's general ledger system.

3. Monthly, the accountant groups the accounts as they appear in the client's trial balance into account groupings, provides headings to these groupings, and delivers this package to the client's management.

4. As part of its procedures for the audit of the entity's financial statements, which the accountant performs, the accountant prepares an unaudited set of financial statements.

5. The accountant prepares financial statements on a cash basis of presentation.

V. Practice exercises – Suggested solutions

Determine if AR-C section 70 would apply in the following scenarios

1. The engagement calls for the accountant to prepare financial statements in accordance with U.S. GAAP from the trial balance generated from the client's financial reporting system.

   As the accountant is preparing financial statements in accordance with U.S. GAAP from the trial balance, AR-C section 70 would apply.

2. Under the supervision of the client, the accountant prepares adjusting and closing journal entries and posts them into the client's general ledger system.

   An accountant's preparation of adjusting and closing journal entries and posting them into the client's general ledger system would be considered bookkeeping services and AR-C section 70 would not apply.

3. Monthly, the accountant groups the accounts as they appear in the client's trial balance into account groupings, provides headings to these groupings, and delivers this package to the client's management.

   In this scenario, since the accountant is modifying the output from the financial systems and formatting it into financial statements, AR-C section 70 would apply.

4. As part of its procedures for the audit of the entity's financial statements, which the accountant performs, the accountant prepares an unaudited set of financial statements.

   As the financial statements are being prepared as part of an audit of those financial statements, AR-C section 70 would not apply.

5. The accountant prepares financial statements on a cash basis of presentation.

   AR-C section 70 would apply. The financial reporting framework used to prepare the financial statements does not dictate whether the SSARS apply but rather the level of service.

AR-C 80: Performing and Reporting on Compilation Engagements

AR-C 80: Performing and Reporting on Compilation Engagements

Learning objective

After completing this chapter, you should be familiar with:
- Performing and reporting on compilation engagements.

I. Introduction

This chapter will review all the requirements related to compilation engagements. SSARS No. 21 codified the compilation requirements within AR-C section 80. As a reminder, a compilation engagement provides no assurance that the financial statements are not materially misstated; however, it is an attestation engagement. This will be discussed in further detail later in this chapter.

The following is a review of a few major changes related to compilation engagements implemented by SSARS No. 21. As a reminder, SSARS No. 21 has been effective for approximately eight years.

The biggest change regarding compilation engagements was with the “trigger” for when the accountant is required to perform the engagement. Under AR-C section 80 guidance, which was codified by SSARS No. 21:
- The accountant now performs a compilation when engaged – not when the accountant prepares and presents financial statements.
- The “management use only” compilation services were eliminated (such a nonreporting, nonattest service would be a preparation engagement).

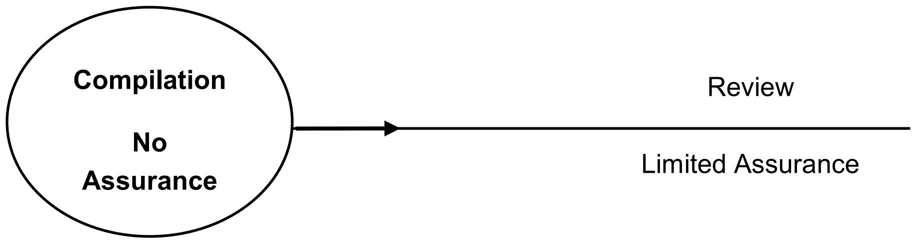
Another big change was the format of the accountant’s compilation report itself:
- AR-C section 80 shortened the “standard” compilation report to just one paragraph, which is meant to better differentiate it from assurance reports (review and audit reports).
- SSARS No. 19’s standard compilation report was three paragraphs.

Minimum documentation requirements were also changed:
- AR-C section 80 documentation requirements include the engagement letter, a copy of the financial statements, and a copy of the accountant’s report.
- SSARS No. 19 documentation also explicitly included any findings or issues that, in the accountant’s judgment, are significant, and communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention.

Additionally, stepping down from an audit or review is currently addressed in the guidance relevant to those services and not included in AR-C section 80. Also, AR-C section 80 is silent as to discretionary emphasis-of-matter paragraph in a report (i.e., going concern uncertainty, subsequent events, etc.)

The guidance on performing compilation engagements was also impacted by the issuance of SSARS Nos. 22 and 23. We will discuss the changes in standards for compilation engagements on pro forma financial information in a later chapter of the course.

Compilations are significantly different than review engagements in terms of both their performance requirements and reporting. One can think of it as a continuum moving from no assurance to a level of limited assurance.



AR-C section 80 applies when the accountant is engaged to perform a compilation engagement and may also be applied and adapted as necessary in the circumstances to other historical or prospective financial information.

The accountant's objective in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with the provisions of AR-C section 80. However, the accountant does not undertake to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework. Although a compilation is not an assurance engagement, SSARS No. 21 makes it clear that it is an attest engagement. As a reminder, a practitioner is required to report on independence in an attest engagement. To clarify, a compilation does not require independence, but a practitioner should disclose if they are not independent of the entity within the compilation report. The accountant may also choose to disclose the reason why independence is impaired in the notes to the financial statements.

Additionally, the accountant performing a compilation engagement must follow applicable sections of the Code. Specifically, the accountant must have professional competence to perform the engagement. The accountant must exercise due professional care in performing professional services. The accountant should adequately plan and supervise the performance of the services and obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed. Therefore, if the accountant believes that the client's information is incorrect, incomplete, or otherwise unsatisfactory, the accountant should attempt to obtain additional or revised information. The financial statements must be in appropriate form, and free from obvious material errors [e.g., math or clerical mistakes, misapplication of generally accepted accounting principles (GAAP) or other comprehensive basis of accounting, or inadequate disclosures]. If the client is unable to provide additional or revised information, the accountant should appropriately alter the compilation report or withdraw from the engagement.

We will look at examples of the report modification and sample disclosure later in this chapter.

II. Compiling financial statements

A compilation is significantly different than a review and is generally considered to be the simplest of financial statement engagements to perform and report on. A compilation is really just a CPA assisting management in presenting their information in the form of financial statements and effective May 1, 2017, in the form of pro forma financial information. And since a compilation is not an assurance engagement, no assurance type procedures need to be performed. Also, when a practitioner performs and reports on a compilation engagement, they do not have to obtain an understanding of internal control or actively search for fraud and illegal acts (however, if fraud or illegal acts are discovered, the proper people must be informed – owner, management, etc.).

However, with the issuance of AR-C section 70, confusion could arise between the scope of service that comprises a compilation as opposed to that which constitutes a preparation engagement. The following compares and contrasts frequently asked questions concerning these scopes:

	Preparation	**Compilation**
When does the standard apply?	When an accountant is engaged to prepare financial statements.	When an accountant is engaged to perform a compilation.
Is an engagement letter required?	Yes	Yes
Is the accountant required to determine if they are independent of the client?	No	Yes
If the accountant is not independent, is that fact required to be disclosed?	N/A	Yes
Does the engagement require a report?	No	Yes
May the financial statements go to users outside of management?	Yes	Yes
May the financial statements omit notes?	Yes	Yes

III. Performing a compilation engagement

Performing a compilation basically involves assisting management in taking their data and putting it in the form of financial statements. Because a compilation is not an assurance service, the accountant is not required to verify the accuracy or completeness of the information provided by management or otherwise gather information to express an opinion or a conclusion on the financial statements. Further, a practitioner is not required to perform any in-depth procedures on the data; however, there are certain minimum compilation procedures that should be performed. At a minimum, a practitioner should understand the industry in which the client operates, the client's business, and the accounting principles and practices used by the client.

Understanding the industry in this case means understanding the accounting principles and practices generally used in that industry. This will assist the practitioner in compiling proper financial statements common to that particular industry. Understanding a client's business includes how it is organized and operates, and the nature of its assets, liabilities, revenues, and expenses. This knowledge is typically gained through client meetings or other engagements with clients in the industry.

Understanding the accounting principles and practices used by the client in preparing its financial statements assists in recognizing any unusual accounting practices the entity is utilizing. Additionally, as with engagements performed on prospective financial information under the guidance of AR-C section 70, the accountant should refer to the AICPA Guide, *Prospective Financial Information*, for guidance on appropriate preparation and presentation of such information. A practitioner should also perform any additional procedures that are necessary in their professional judgment to ensure that they have complied with the requirements of the SSARSs.

After a practitioner has assisted management in taking their data and putting it in the form of financial statements, an overall review of the financial statements should be conducted. This helps prevent obvious errors (typos, math, application of accounting principles, inadequate disclosures) in any of the statements before submitting them to the client. The objective of this “final read” is basically to make sure the financial statements are not misleading, which is an ethics violation. If the practitioner does conclude that the financial statements are in fact misleading (for whatever reason), the practitioner should withdraw from the engagement.

The following illustration presents the compiled financial statements of a hypothetical company, Candy Baskets.com.

Candy Baskets.com, Inc.
Statement of Assets, Liabilities and Equity (FRF for SMEs basis)
December 31, 20X1

Assets	
Current Assets	
Cash	$911
Inventory	1,562
Total Current Assets	2,473
Office Furniture and Fixtures	6,346
Less: Accumulated Depreciation	(1,269)
Total Property and Equipment, Net	5,077
Total Assets	$7,550
Liabilities and Stockholder’s Equity	
Current Liabilities	
Income Tax Payable	1,125
Stockholder’s Equity	
Contributed Capital	
Common Stock – $1 par, 100 Shares Authorized	
50 Shares Issued and Outstanding	50
Retained Earnings	6,375
Total Stockholder’s Equity	6,425
Total Liabilities and Stockholders’ Equity	$7,550

See independent accountant’s compilation report and notes to the financial statements.

Candy Baskets.com, Inc.
Statement of Revenues and Expenses (FRF for SMEs basis)
For the Year Ended December 31, 20X1

Revenues	
Noncorporate Sales	$137,150
Corporate Sales	205,632
Total Revenues	342,782
Expenses	
Cost of Sales	175,282
Gross Profit	167,500
General and Administrative Expenses	160,000
Earnings Before Income Taxes	7,500
Income Tax Expense	1,125
Net Income	$6,375

See independent accountant's compilation report and notes to the financial statements.

Candy Baskets.com, Inc.
Statement of Cash Flows (FRF for SMEs basis)
For the Year Ended December 31, 20X1

Cash Flow from Operating Activities		
Net income		$6,375
Adjustments to reconcile net income to net cash		
Depreciation	$1,269	
Increase in inventory	(1,562)	
Increase in income tax payable	1,125	832
Net cash provided by operating activities		7,207
Investing Activities		
Furniture and fixtures purchased		(6,346)
Financing Activities		
Issuance of common stock		50
Net increase in cash		911
Cash January 1, 20X1		0
Cash December 31, 20X1		$911

See independent accountant's compilation report and notes to the financial statements.

Candy Baskets.com, Inc.
Notes to Financial Statements
December 31, 20X1

Note 1 – Nature of Operations

Candy Baskets.com is a leading retail website for unique candy arrangements and gourmet gift baskets.

Note 2 – Summary of Significant Accounting Policies

Basis of Financial Presentation

The accompanying financial statements have been prepared in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities* which is a special purpose framework issued by the American Institute of Certified Public Accountants and not U.S. generally accepted accounting principles.

Inventory

Inventory consists of various candy and other gift basket materials which are stated at the lower of cost or net realizable value, on a first-in, first-out basis.

Office Furniture and Fixtures

Office furniture and fixtures are carried at cost and includes expenditures for improvements which substantially increase its useful life. Office furniture and fixtures are depreciated using the straight-line method over five years with no residual values.

Maintenance and repairs are expensed as incurred. When office furniture and fixtures are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts and any profit or loss is credited or charged to income.

Use of Estimates

The preparation of the accompanying financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure 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 these estimates.

Note 3 – Office Furniture and Fixtures

	Cost	Accumulated Depreciation	Book Value
Office Furniture and Fixtures	6,346	1,269	5,077

Note 4 – Income Taxes
Income tax payable and income tax expense are the expected tax on taxable earnings for the period using the prevailing tax rates at the reporting date.

Income tax expense for the period ending December 31, 20X1, was $1,125. There were no deferred tax assets or liabilities at December 31, 20X1.

Income tax paid during 20X1 was $0.

Note 5 – Changes in Equity
The following table summarizes changes in the Company's equity accounts during 20X1.

	Common Stock	Additional Paid-In Capital	Retained Earnings
Balance at January 1, 20X1	$ -	$ -	$ -
Issuance of stock	50	-	-
Net income		-	6,375
Balance at December 31, 20X1	$ 50	$ -	$ 6,375

Note 6 – Contingencies and Litigation
At the report date, Candy Baskets.com had no material unrecorded contingencies.

Note 7 – Subsequent Events
Candy Baskets.com has evaluated all subsequent events through January 18, 20X2, the date the financial statements were available to be issued.

Now, let us look at some of these requirements and procedures of a compilation in greater detail.

A. Acceptance and continuance process for a compilation

In addition to the general procedures that an accountant should undertake to determine whether to accept the first-year engagement or to continue with the engagement that we previously discussed and that are found in paragraph .25 of AR-C section 60, AR-C section 80 requires additional procedures be performed before the accountant accepts a compilation engagement.

Specifically, the accountant should obtain the agreement of management that management acknowledges and understands its responsibility for the following:

- The preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework used to prepare the entity's financial statements.

If the financial statements are prepared in accordance with a special purpose framework, this includes:

  - A description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP, the effect of which need not be quantified, and informative disclosures similar to those required by GAAP, in the case of special purpose financial statements that contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP;
  - A description of any significant interpretations of the contract on which the special purpose financial statements are prepared, in the case of financial statements prepared in accordance with a contractual basis of accounting; and
  - Additional disclosures beyond those specifically required by the framework that may be necessary for the special purpose framework to achieve fair presentation.

- To include the accountant's compilation report in any document containing financial statements that indicates that the entity's accountant has performed a compilation engagement on such financial statements unless a different understanding is reached.

If such understanding is not obtained, the accountant should not accept the proposed engagement.

This mutual understanding is best documented in a formal engagement letter that is signed by the accountant and the appropriate entity personnel.

B. Signed engagement letter

As mentioned earlier, the accountant should not accept a compilation engagement unless he or she has agreed to the terms of the engagement with management and recorded those terms in an engagement letter (or other suitable form of written agreement), which has been signed by both the accountant or the accountant's firm and management. Effective immediately, AR-C section 80 has been amended to make the requirement for a written engagement letter signed by both parties explicit. The engagement letter for a compilation is similar to those currently used in practice.

Elements that should be documented in an engagement letter include the following:

a. Objectives of the engagement.
b. Management responsibilities.
c. Accountant's responsibilities.
d. The limitations of the compilation engagement.
e. Identification of the applicable financial reporting framework.
f. The expected form and content of the accountant's compilation report and a statement saying that there may be circumstances where the report may differ from the expected form and content.

The following is an example of an engagement letter for a compilation engagement where the accountant will prepare the financial statements, including related notes, subject to the compilation engagement. The financial statements will be prepared in accordance with U.S. GAAP and will include all required disclosures. Lastly, the letter assumes that the accountant expects independence not to be impaired.

Sample Engagement Letter

Note 1: This example presumes that the accountant is also engaged to prepare the compiled financial statements. This engagement letter would be appropriate for compilations of financial statements prepared in accordance with GAAP or a special purpose framework, modified appropriately where noted for the appropriate applicable financial reporting framework and titles of financial information to be prepared.

To the appropriate representative of management of ABC Company:

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

Note 2: If the engagement is to prepare the financial statements omitting the statement of cash flows and substantially all disclosures required by the applicable financial reporting framework, the introductory paragraph would be modified to appropriate circumstances, such as the following:

You have requested that we prepare the financial statements of [Entity], which comprise the balance sheet as of December 31, 20XX and the related statements of income and changes in stockholders' equity for the year then ended and perform a compilation engagement with respect to those financial statements. These financial statements will not include a statement of cash flows and related notes to the financial statements. We are pleased to confirm our acceptance and our understanding of this compilation engagement by means of this letter.

Our Responsibilities
The objective of our engagement is to

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

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

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

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

Your Responsibilities

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

You have the following overall responsibilities that are fundamental to our undertaking the engagement in accordance with SSARSs:

a. The selection of accounting principles generally accepted in the United States of America as the financial reporting framework to be applied in the preparation of the financial statements.
b. The preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America and the inclusion of all informative disclosures that are appropriate for accounting principles generally accepted in the United States of America.
c. The design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Note 3: If the accountant decides to accept responsibility for relevant internal control, the above item may be omitted from the engagement letter. However, this would preclude the accountant from being independent for the period of professional engagement and the period covered by the prepared financial statements. In a compilation engagement, such lack of independence must be noted in the compilation report. Lack of independence may preclude the accountant to perform certain future attest services.

d. The prevention and detection of fraud.
e. To ensure that the entity complies with the laws and regulations applicable to its activities.
f. The accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, you provide to us for the engagement.
g. To provide us with:
    i. Access to all information of which you are aware is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters.
    ii. Additional information that we may request from you for the purpose of the compilation engagement.
    iii. Unrestricted access to persons within the entity of whom we determine it necessary to make inquiries.

Note 4: If the financial statements are prepared in accordance with a special purpose framework, the following additional specific management responsibility modified to the specific circumstances should be inserted.

The inclusion of all informative disclosures that is appropriate for the tax basis of accounting. This includes:

a. A description of the tax basis of accounting, including a summary of significant accounting policies, and how the tax basis of accounting differs from accounting principles generally accepted in the United States of America, the effects of which need not be quantified; and
b. Informative disclosures similar to those required by accounting principles generally accepted in the United States of America.

You are also responsible for all management decisions and responsibilities and for designating an individual with suitable skills, knowledge, and experience to oversee our preparation of your financial statements. You are responsible for evaluating the adequacy and results of the services performed and accepting responsibility for such services.

Note 5: Omit the above paragraph if the accountant is going to modify the compilation report for lack of independence.

Our Report

As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them.

Note 6: If the financial statements will be prepared omitting the statement of cash flows and substantially all disclosures required by the applicable financial reporting framework, the following paragraph should be added:

Our report will disclose that the company's 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 statement of cash flows and omitted disclosures were to be 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 will not be designed for those who are not informed about such matters.

Note 7: If the accountant lacks independence, add the following:

We [also] will disclose that we are not independent in the report.

Note 8: If the financial statements are prepared in accordance with a special purpose framework, the following additional paragraph modified to the specific circumstances should be added.

Our report will disclose that the financial statements are prepared in accordance with the income tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

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

Other Relevant Information
Our fees for these services. . . .

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

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

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

Sincerely yours,

____

[*Signature of accountant or accountant's firm*]
Acknowledged and agreed on behalf of ABC Company by:

____

[*Signed*]
[*Name and Title*]

____

[*Date*]

It is considered to be best practice to obtain an engagement letter at least annually. The engagement letter can cover multiple services, addressing both attest and nonattest services performed for the same client.

The accountant should modify the letter to reflect when the financial statements will be compiled using a basis of accounting other than U.S. GAAP, such as a tax basis, as well as when the compiled financial statements will omit a financial statement and/or substantially all the disclosures required by U.S. GAAP. Examples of this modified language can be found in Appendix A of AR-C section 70.

Lastly, the following matters should also be considered when drafting the engagement letter:

- The addressee and reference to other matters should be appropriate to the circumstances.
- Amend references such as you, us, we, etc., as appropriate.
- The accountant may include other nonattest services to be performed as part of the engagement, such as income tax preparation and bookkeeping services.
- The accountant may be engaged to prepare the compiled financial statements in accordance with a prescribed format. The applicable financial reporting framework could be described as applicable throughout the engagement letter as "the format prescribed by [developer of the format of the financial statements] and in accordance with accounting principles generally accepted in the United States of America."

- The accountant may be engaged to compile one or more specified elements, accounts, or items of a financial statement (for example, schedule of accounts receivable or schedule of depreciation). The scope of the engagement described in the introductory accountant responsibility and management responsibility paragraphs should be modified appropriately.
- If the accountant is not being engaged to prepare financial statements in conjunction with the compilation engagement, then remove all references to preparing the financial statements.

C. Compilation procedures

1. Knowledge and understanding of the entity's financial reporting framework

The accountant should obtain an understanding of the applicable financial reporting framework intended to be used in the preparation of the financial statements and the significant accounting policies adopted by management. Similar to a preparation of financial statements engagement, lack of such knowledge does not prevent the accountant from accepting the engagement. The accountant can use the wide variety of resources available to obtain this understanding.

2. Applying the "RRP" approach

The following steps summarize the key compilation procedures:

a. **Read the financial statements.** The accountant should read the financial statements in light of the accountant's understanding of the applicable financial reporting framework and the significant accounting policies adopted by management and consider whether such financial statements appear to be appropriate in form and free from obvious material misstatements. The accountant should also determine whether the headings, sections, and captions used in the financial statements are correct, and whether the financial statements are free of grammatical and arithmetical errors.
b. **Request additional or corrected information.** If, in the course of the engagement, the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, provided by management are incomplete, inaccurate, or otherwise unsatisfactory, the accountant should bring that to the attention of management and request additional or corrected information.
c. **Propose the appropriate revisions.** If the accountant becomes aware during the course of the engagement that the financial statements do not adequately refer to or describe the applicable financial reporting framework; revisions to the financial statements are required for the financial statements to be in accordance with the applicable financial reporting framework; or the financial statements are otherwise misleading, the accountant should propose the appropriate revisions to management.

While the accountant is not required to make inquiries or perform procedures to verify or collaborate any information received from management, prior engagement knowledge or such inquires and procedures may alert the accountant that the information received is incorrect or incomplete. In such instances, as per above, the accountant should request additional or corrected information.

The financial statements should describe the financial reporting framework used either in the body of the statements or the notes to the financial statements. Additionally, the financial statements should not be misleading. An example would be if the applicable financial reporting framework used assumes that the entity is a going concern while uncertainty concerning this assumption exists. When the accountant is aware of such situations, the accountant may suggest additional disclosure to address the situation in order to prevent the financial statements from being misleading. However, such disclosure is not necessary if the entity omits substantially all the disclosures required by the financial reporting framework.

The accountant should withdraw from the engagement and inform management of the reasons for withdrawing if:

- The accountant is unable to complete the engagement because management has failed to provide records, documents, explanations, or other information, including significant judgments, as requested; or
- Management does not make appropriate revisions that are proposed by the accountant or does not disclose such departures in the financial statements, and the accountant determines to not disclose such departures in the accountant's compilation report.

Lastly, note that when performing a compilation engagement on pro forma financial information, the accountant is also required to follow the guidance on such engagements found in AR-C section 120.

When performing any compilation engagement, even the simplest, it is best practice to use a checklist. There are many engagement checklists that can be purchased and tailored to specific engagements. A practitioner could also develop his own in-house version from scratch. Some practitioners simply use a standard checklist and sign-off as "N/A," not applicable for the items that do not apply to a particular client engagement. In the end, these checklists are intended to be used as a guide for determining whether professional requirements related to the performance of a compilation are satisfied. Once these requirements have been met, the following statement is included in the accountant's compilation report:

> I have compiled the accompanying… [financial statements] in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

3. Documentation of a compilation engagement

A practitioner is required to prepare adequate documentation of the work performed so it is clear what procedures were conducted, and to support the statement in the compilation report that the engagement was performed in accordance with SSARSs. The form, content, and extent of documentation depend on the circumstances of the engagement, the methodology and tools used, and the accountant's professional judgment.

Documentation of a compilation engagement should include the following:

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

There are other documentation items that the accountant should consider obtaining as part of a compilation engagement. The following are traditionally included, but not required, in compilation files:

- Checklist or memorandum describing the CPA's knowledge of the client's business and industry.
- Documentation that the CPA read the compiled financial statements.
- Support for data in the notes to the financial statements.
- Discussion of significant unusual matters encountered.
- Reasons for omissions of all, or substantially all, disclosures.
- Description of any related accounting or bookkeeping services performed.
- Reasons for a step-down from an audit or review, if applicable.

4. Management representations letter

A management representations letter is not required for a compilation engagement; however, it is best practice to get them. The specific representations are a matter of professional judgment and, of course, will depend on the particular engagement circumstances, but the letter should certainly include any representations made to the practitioner, explicitly or implicitly, during the engagement.

Using Candy Baskets.com as an example, Mr. Owner's representations to the practitioner should include:

- His acknowledgment that he is responsible for preparing and fairly presenting the financial statements in accordance with FRF for SMEs™ and that he is responsible for selecting and applying the accounting policies used by the company;
- That he believes the financial statements are fairly presented in accordance with FRF for SMEs™;
- That the financial statements are supported by the underlying accounting records and that all material transactions have been properly recorded;
- That the financial statements adequately reflect disclosures required by FRF for SMEs™;
- That he has advised the practitioner of any actions taken at any meetings that might affect the financial statements;
- That no events have occurred subsequent to December 31, 20X1, through the date of his letter that would require adjustment to or disclosure in the financial statements; and
- That he has responded fully and truthfully to all inquiries.

The following illustration is an example management representations letter for Candy Baskets.com.

Management Representations Letter

January 18, 20X2

To Comp Piler, CPA:

I am providing this letter in connection with your compilation of the annual statement of assets, liabilities and equity of Candy Baskets.com as of December 31, 20X1, and the related statements of income and cash flows for the year then ended.

I confirm that I am responsible for the fair presentation of the financial statements in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities* and the selection and application of the accounting policies used by Candy Baskets.com.

I also confirm, to the best of my knowledge and belief, as of January 18, 20X2, the following representations made to you during your compilation:

1. The financial statements referred to above are fairly presented in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities*.

2. The assertions reflected in the financial statements are supported by the underlying accounting records and data.

3. All material transactions have been properly recorded in the accounting records and included the financial statements.

4. The financial statements adequately reflect disclosures required by the *Financial Reporting Framework for Small- and Medium-Sized Entities*.

5. The general nature of Candy Baskets.com's business operations and financial transactions has been accurately described to you.

6. You have been advised of all actions taken at any meetings that might affect the financial statements.

7. No events have occurred subsequent to December 31, 20X1, through the date of this letter that would require adjustment to or disclosure in the financial statements.

8. I have responded fully and truthfully to all inquiries made to me by you during your compilation engagement.

B. Owner

President and CEO
Candy Baskets.com

IV. Reporting on a compilation engagement

Once the client's financial statements have been compiled, the practitioner issues the report on the engagement.

A. Requirements of the accountant's report under AR-C section 80

The accountant's compilation report should be in writing and include the following:

a. Include a statement that management (owners) is (are) responsible for the financial statements.
b. Identify the financial statements that have been subjected to the compilation engagement.
c. Identify the entity whose financial statements have been subjected to the compilation engagement.
d. Specify the date or period covered by the financial statements.
e. Include a statement that the accountant performed the compilation engagement in accordance with SSARSs promulgated by Accounting and Review Services Committee of the AICPA.
f. Include a statement that the accountant did not audit or review the financial statements nor was the accountant required to perform any procedures to verify the accuracy or completeness of the information provided by management and, accordingly, does not express an opinion, a conclusion, nor provide any assurance on the financial statements.
g. Include the signature of the accountant or the accountant's firm.
h. Include the city and state where the accountant practices.
i. Include the date of the report, which should be the date that the accountant has completed the procedures required by this section.

The format of the accountant's compilation report is one of the more substantial changes that occurred with the issuance of SSARS No. 21. The report was condensed to just one paragraph in order to differentiate it from the accountant's report issued on reviews engagements under AR-C section 90.

The following is an illustrative example of a compilation report.

Independent Accountant's Compilation Report

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

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

1. Reporting on compilations of prospective financial information

Similar to preparation engagements on prospective financial information, a summary of significant assumptions is essential to the user's understanding of prospective financial information. The accountant should not issue a compilation report on prospective financial information that excludes a summary of significant assumptions. Also, no compilation report should be issued on a financial projection that excludes either an identification of the hypothetical assumptions or a description of the limitations of the presentation.

Also, in addition to the elements of the compilation report discussed above, the report on prospective financial information should include the following statements:

- The forecasted or projected results may not be achieved.
- The accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

2. Restrictions on use of the accountant's compilation report

The accountant may restrict the use of the compilation report. This would be done through a separate paragraph added to the standard report.

B. Reporting when the accountant is not independent

As we saw earlier, the accountant need not be independent of the entity to issue the compilation report. However, when the accountant is not independent of the entity, this should be included in a paragraph within the compilation report. The following is an example of the paragraph:

> I am not independent with respect to XYZ Company.

The accountant may also elect to disclose a description about the reason why their independence is impaired, for example:

> I am not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I had a direct financial interest in XYZ Company.

If the accountant elects to disclose a description about the reason why independence is impaired, all such reasons should be disclosed. For example:

> I am not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I had a direct financial interest in XYZ Company; and I performed certain accounting services (the accountant may include a specific description of those services) that impaired my independence.

C. Special purpose frameworks

When compiling financial statements that use a special purpose framework, the titles of the financial statements should be modified to avoid confusion (i.e., Balance Sheet – Income Tax Basis). However, the captions within the financial statements may remain the same as U.S. GAAP. Additionally, there should be a policy note in the footnotes to the financial statements that describes the substantive differences between the special purpose framework and U.S. GAAP. However, these differences do not need to be quantified. Other disclosures should parallel those under U.S. GAAP.

Financial statements prepared in accordance with a special purpose framework need not include a summary of significant accounting policies or a description about how the special purpose framework differs from GAAP if such financial statements omit substantially all disclosures, and the omission of substantially all disclosures is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

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

a. A description of the special purpose framework.
b. A summary of significant accounting policies.
c. An adequate description about how the special purpose framework differs from GAAP (the effects of these differences do not need to be quantified).
d. Informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

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

Circumstances may exist in which a regulatory or contractual basis of accounting is based on a general purpose framework established by a designated accounting standard setter, such as GAAP, or by law or regulation, but does not comply with all the requirements of that framework. An example is a contract that requires financial statements to be prepared in accordance with most, but not all, of GAAP. If the financial statements purport to be prepared in accordance with a general purpose framework and such financial statements are materially misstated due to a departure from that framework, the accountant should follow the guidance for when reporting on a known departure from the financial reporting framework.

When it is acceptable in the circumstances of the engagement to report, in accordance with this section, on special purpose financial statements that purport to be prepared in accordance with a regulatory or contractual basis of accounting that is based on a general purpose framework, it is inappropriate for the description of the applicable financial reporting framework in the special purpose financial statements to imply that the special purpose framework includes all the requirements of, or is the same as, the financial reporting framework on which the special purpose framework is based.

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

The accountant's compilation report on financial statements prepared in accordance with a special purpose framework should include a separate paragraph that indicates that the financial statements are prepared in accordance with the applicable special purpose framework, refers to the note to the financial statements that describes the framework, if applicable, and states that the special purpose framework is a basis of accounting other than GAAP.

For special purpose financial statements prepared in accordance with a contractual basis of accounting, the separate paragraph should also state that, as a result, the financial statements may not be suitable for another purpose. Special purpose financial statements may be used for purposes other than those for which they were intended. To avoid misunderstandings, AR-C section 80 requires the accountant to include a separate paragraph in the accountant's compilation report that alerts users of the accountant's compilation report that the financial statements are prepared in accordance with a special purpose framework and that the basis of accounting is a basis of accounting other than GAAP.

Also, financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. Such special purpose financial statements may be used by users other than those for whom the financial reporting framework is designed. Despite the distribution of the financial statements, the financial statements are still considered to be special purpose financial statements for purposes of SSARSs. The reference to suitability is designed to avoid misunderstandings about the framework used to prepare the financial statements.

The following is an example of an accountant's compilation report on financial statements prepared in accordance with a special purpose framework.

Example Accountant's Compilation Report – Special Purpose Framework

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

I (we) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

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

Note that language should be added to compilation reports when the basis of accounting is not readily determinable from reading the report. This is true for tax-basis financial statements, as well as cash/modified-cash-basis financial statements; for example, "The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles."

D. Other reporting considerations

1. One financial statement or multiple financial statements

An accountant may issue a compilation report on one financial statement (e.g., the balance sheet) and not on any other financial statements. Regardless, each page of financial statements should reference the compilation report (e.g., "See Accountant's Compilation Report").

Peer review common issue:

The compilation or review report should refer to the actual financial statements included in the presentation. Occasionally CPAs fail to modify standard reports for certain statements not included in the financial statements (e.g., omission of statement of income and retained earnings).

2. Going concern uncertainty

Inadequate disclosure may be a material known departure in full disclosure financial statements. Unless adequately disclosed in the financial statement footnotes, substantial doubt about an entity's ability to continue as a going concern could be a known departure from the applicable financial reporting framework. Even financial statements prepared under a special purpose framework would require informative disclosures about material uncertainties.

If there is inadequate disclosure, the accountant should consider modifying the compilation report or withdraw from the engagement if report modification would not be adequate to emphasize the inadequacy.

Management may elect to omit substantially all disclosures, including substantial doubt about an entity's ability to continue as a going concern. The going concern uncertainty disclosure would be among other disclosures being omitted. However, the accountant should not accept an engagement to substantially omit all disclosures if the intent is to mislead financial statement users.

3. Report dating

The report should be signed and dated the date of the completion of the compilation.

4. General vs. restricted use

An accountant may either issue a report that is for general use, or one that is intended for one or more specified third parties (i.e., a restricted-use report). A restricted-use report includes a separate paragraph at the end of the report that states that the report is intended solely for the information and use of specified parties, an identification of the specified parties to whom use is restricted, and a statement that the report is not intended to be used and should not be used by anyone other than the specified users. If the subject matter is based on one of the following, the accountant should restrict the use of the report:

- Measurement or disclosure criteria contained in contractual agreements; or
- Regulatory provisions that are not in conformity with GAAP or a special purpose framework.

5. Prescribed form compilations

A prescribed form is any standard preprinted form designed or adopted by the body to which it is to be submitted. Prescribed forms include those used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. It does not include a form designed or adopted by the entity itself. If the prescribed form or related instructions call for departures from the applicable financial reporting framework, special considerations apply. The form may specify a measurement principle not in conformity with the applicable financial reporting framework or by failing to request the disclosures or presentation required by the applicable financial reporting framework. There is a presumption that the information required by a prescribed form is sufficient to meet the needs of the body to be advised of departure required. However, the prescribed form statements may be deemed a special purpose framework.

SSARS No. 21: Section 70 allows for preparation of prescribed form financial statements. However, a compilation or review of prescribed form financial statements may also be performed.

V. Other compilation issues

A. Omitting substantially all disclosures

It is not unusual for a business owner or management to ask the CPA to compile financial statements that omit substantially all of the disclosures required by the applicable financial reporting framework being used to prepare the financial statements.

Management can elect to omit substantially all of the disclosures, the statements of cash flows, and the statement of comprehensive income required by GAAP, but the compilation report must include a paragraph explaining the lack of disclosures and the incomplete statements. In addition, the accountant should not issue such a report if, in the accountant's professional judgment, such financial statements would be misleading to their users. When only a few notes are presented, the notes presented should be labeled "Selected Information – Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included." However, if more than a few required disclosures are included in the financial statements, any omitted notes should be treated as GAAP departures.

If an element of comprehensive income exists, the display of comprehensive income is required when a full set of financial statements is presented in accordance with GAAP. However, such display can be omitted when the accountant issues a compilation report with substantially all disclosures omitted if the accountant identifies the omission in his or her report. If the accountant performs a compilation and includes all disclosures other than the display of comprehensive income, that omission would be a GAAP departure. If an element of comprehensive income has not been calculated, this omission would also be a GAAP departure.

If management does elect to omit substantially all disclosures required by the financial reporting framework that it selects, the accountant should include a paragraph in his or her compilation report after the conclusion paragraph similar to the following typically found in practice today for U.S. GAAP frameworks:

> Management has elected to omit substantially all of the disclosures required by the *Financial Reporting Framework for Small- and Medium-Sized Entities*. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

If financial statements include both a balance sheet and an income statement, the statement of cash flows should be provided for each period that the income statement is provided. A failure to include the statement of cash flows should be disclosed as a departure from GAAP if the CPA compiles full-disclosure financial statements. However, if the CPA compiles financial statements in which management elects to omit substantially all disclosures, the omitted statement of cash flows can be referenced in the paragraph that reports the fact that disclosures have been omitted.

A common deficiency is the inclusion of material balances that are not appropriate for the basis of accounting being used. If the entity is applying a special purpose framework, then reporting deficiencies may arise where the line between accrual-basis accounting and modified-cash-basis accounting is blurred (e.g., inclusion of trade receivables, which is essentially using accrual-basis accounting for revenue recognition).

B. Departures from the applicable financial reporting framework

Another scenario a practitioner might encounter during compilation engagements is a departure from the applicable financial reporting framework that is material to the financial statements. This departure may be due to the inappropriate recording of a transaction or inadequate disclosure of items required by the applicable financial reporting framework selected. The following are some common departures from U.S. GAAP:

- Nonconsolidation of appropriate subsidiaries.
- Omission of significant income tax provisions.
- Omission of significant disclosures related to material defined employee benefit plans.
- Improper capitalization of start-up costs.
- Recording a capital lease as an operating lease.
- Omission of compensated absences.
- Missing required significant accounting policy notes.

In this circumstance, the practitioner should ask management to revise the financial statements to alleviate the departure. If the financial statements are not modified to correct this departure or the departure is not disclosed in the notes to the financial statements, the accountant's report should be modified to disclose the departure. Additionally, effective immediately with amendments made to AR-C section 70 by SSARS No. 23, the accountant should also consider whether the modification to the report is even adequate to disclose the departure. If the modification is deemed adequate, the departure should be disclosed in a separate paragraph of the report.

The following is an example of the paragraph that would be added to the accountant's report in this instance:

> Accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me (us) that XYZ 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.

However, the report should not say that the financial statements are not presented in accordance with the applicable financial reporting framework.

Lastly, if it is determined that modifying the report is not adequate to disclose the departure and its effect on the financial statements, the practitioner should withdraw from the engagement and not provide any additional services with respect to those financial statements.

C. Supplementary information

Many times, especially for governmental and not-for-profit entities, the financial statements will be accompanied by supplementary information such as a schedule of functional expenses or management's discussion and analysis, as shown in the following examples.

SUPPLEMENTAL SCHEDULE OF FUNCTIONAL EXPENSES

Year ended December 31, 20X1

	Program	Supporting Services		
	Grants and Related Services	Administration and General	Fundraising	Total
Expenses:				
Grants and subcontracts	$ 22,620,997	$ -	$ -	$ 22,620,997
Salaries	8,363,760	2,895,058	107,193	11,366,011
Non-staff labor	5,463,187	-	-	5,463,187
Payroll taxes and employee benefits	5,344,620	1,691,323	57,259	7,093,202
Office rent and utilities	1,867,053	380,480	10,539	2,258,072
Travel	3,768,767	364,926	2,836	4,136,529

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED DECEMBER 31, 20X1
(SEE ACCOUNTANT'S COMPILATION REPORT)

The management's discussion and analysis of the General Health District's (the "Health District") financial performance provides an overall review of the Health District's financial activities for the year ended December 31, 20X1. The intent of this discussion and analysis is to look at the Health District's financial performance as a whole; readers should also review the basic financial statements and the notes to the financial statements to enhance their understanding of the Health District's financial performance.

Financial Highlights

Key financial highlights for 20X1 are as follows:

- For 20X1 the total net cash assets of the Health District increased $87,711, which represents a 12.6 percent increase from 20X0.

Sometimes the supplementary information is required by the users of the entity's financial statements and others, it is presented for the purpose of providing additional information. AR-C section 80, as amended by SSARS No. 23, defines supplementary information as that presented outside the basic financial statements, excluding required supplementary information, which is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the financial statements subjected to the compilation engagement or separate from the financial statements subjected to the compilation engagement. Supplementary information includes additional details or explanation of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity. The supplementary information may be prepared in accordance with an applicable financial reporting framework, by regulatory or contractual requirements, in accordance with management's criteria, or in accordance with other requirements.

SSARS No. 23 made a number of other conforming changes to AR-C section 80 in order to make the reporting requirements on supplementary information consistent with that found in the amended AR-C section 90. These changes have been incorporated into the following examples.

The practitioner should disclose any responsibility they are taking with regard to supplementary information in a compilation engagement. This responsibility (if any) should be disclosed in either: (a) another matter paragraph in the accountant's compilation report; or (b) a separate report on the supplementary information.

If the accountant has compiled the basic financial statements and the supplementary information, the accountant's compilation report should refer to the supplementary information, for example:

> The accompanying [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was subject to our compilation engagement. I (we) have not audited or reviewed the supplementary information and do not express an opinion, a conclusion, or provide any assurance on such information.

If the accountant has compiled the basic financial statements but not the supplementary information, the compilation report should refer to the supplementary information as follows:

> The accompanying [*identify the supplementary information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was not subject to our compilation engagement. I (we) do not express an opinion, a conclusion, or provide any assurance on such information.

If the compiled financial statements contain required supplementary information, the accountant's report should approve appropriate language to explain the following situations:

- The required supplementary information is included and covered by the accountant's compilation engagement.
- The required supplementary information is included and is not covered by the accountant's compilation engagement.
- The required supplementary information is omitted.
- Some of the required information is missing.
- There are departures from the prescribed guidelines.
- The accountant has doubts about whether the required supplementary information is presented in accordance with the prescribed guidelines.

AR-C section 80, paragraphs .36-37 provides further guidance on reporting when required supplementary information is presented in the compiled financial statements and the accountant did not perform a compilation engagement on it as well as when the required supplementary information is omitted.

Lastly, the accountant may either issue a report that is for general use or one intended for one or more specified third parties (i.e., a restricted use report). A restricted use report contains a separate paragraph at the end of the report that states the report is intended solely for the information and use of specified parties, an identification of the specified parties to whom use is restricted, and a statement that the report is not intended to be used and should not be used by anyone other than the specified users.

If the subject matter is based on one of the following, the accountant should restrict the use of the report:

- Measure or disclosure criteria contained in a contractual agreement.
- Regulatory provisions that are not in conformity with GAAP or a special purpose framework.

VI. Common peer review feedback on AR-C section 80 engagements

A. Peer review issue #1 – Compilation engagements: Failure to prepare reports in accordance with professional standards

Reports are required to be prepared in AR-C 80. This includes both the accountant's compilation report and the reporting on supplementary information that accompanies financial statements, if any. Although commercial practice aids and AR-C 80 include sample reports with the appropriate language, peer reviewers have noted the following.

1. General reporting and disclosure issues

a. Significant departures from the financial statement formats prescribed by industry accounting and audit guides.
b. Omission of disclosures related to significant accounting policies applied (whether GAAP or special purpose framework).
c. Failure to include a summary of significant assumptions in a financial forecast or projection.
d. Failure to segregate the statement of cash flows into components: operating, investing, and financing activities. Failure to consider all noncash financing and investing activities.
e. Failure to disclose the cumulative effect of a change in accounting principle.
f. Failure to disclose significant related party transactions.
g. Omission of financial statements that are noted in the report.
h. Failure to include one or more statements of cash flows when comparative results of operations are presented in accordance with GAAP.

2. Preparation engagements

a. Failure to include, either on the face of the financial statements, or in a note, a description of the financial reporting framework when the statements have been prepared in accordance with a special purpose framework.
b. Failure to disclose a material misstatement in the financial statements when the accountant prepares financial statements that contain a known departure from the applicable financial reporting framework.

3. Compilation engagements

a. Accountants disclosed that substantially all of the disclosures were omitted when that was not the case. In some cases, this is a matter of choosing the incorrect report form. It is appropriate to prepare a compilation report without disclosures.
b. Sometimes certain disclosures are missing when substantially all other disclosures are presented. This should be treated in a compilation report like any other departure from the applicable financial reporting framework, and the nature of the departure and its effects, if known, should be disclosed.
c. Failure to disclose that compiled financial statements that omit substantially all disclosures were prepared using a special purpose framework and the basis of accounting is not readily determinable from reading the accountant's compilation report.
d. Reports do not contain the required elements. This may be because the language was not updated for the current language in the SSARS.

e. Reports do not always specify the date or period covered by the financial statements.

f. Reports do not always include a separate paragraph when supplementary information accompanies financial statements. Note that accountants can always issue a separate report on the supplementary information.

g. Reports do not always include a separate paragraph in the accountant's compilation report that includes the required elements when reporting on financial statements that omit substantially all disclosures required by the applicable financial reporting framework.

h. Lack of independence is not always cited when this is the case.

> ***Example:*** ***Accountant's Compilation Report***
>
> Management is responsible for the accompanying financial statements of Tampa Bay Cleaners, which comprise the balance sheets as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.
>
> *Granada & Bay, CPAs*
> Tampa, FL
> March 31, 20X2

When substantially all the disclosures that are required by the entity's financial reporting framework are omitted it is important that the accountant does not believe that the disclosures were omitted to intentionally mislead anticipated users of the financial statements. When the client wants to issue financial statements that omit substantially all the disclosures, the report should be modified to alert the user.

The report should include a statement that management has elected to omit substantially all disclosures including the statement of cash flows, if applicable, required by the applicable financial reporting framework. There should be a statement that says that if the omitted disclosures (and the statement of them) were included in the financial statements, they might influence the user's conclusions about the entity's financial position, results of operations, and cash flows and accordingly, the financial statements are not designed for those who are not informed about such matters.

B. Peer review issue #2 – Compilation engagements: Failure to document the agreed-upon terms of the engagement

The compilation standards in AR-C section 80 require that the accountant agree upon the terms of the compilation engagement with management or those charged with governance, as appropriate, and document the agreed-upon terms of the engagement in an engagement letter or other suitable form of written agreement between the parties. There are certain required elements that must be present in the engagement letter. Although the guidance does not specify a letter, per se, the agreement must be in writing. Most firms issue engagement letters except in certain instances where a governmental entity requires a contract. Regardless, the required elements must be included. SSARS No. 21 states that the engagement letter must be signed and returned to the accountant.

Peer reviewers have noted that accountants often fail to:

- Use the updated SSARS language. This is probably because engagement letters are often carried forward from year to year updating the fee or other current information but without going back to see what language in the SSARS has changed.
- Identify lack of independence. (Note that professional standards permit the accountant to lack independence in a compilation if it is disclosed in the accountant's report.)
- Include the expected form and content of the accountant's compilation.
- Report when the accountant's independence is impaired.
- Identify the applicable financial reporting framework for the preparation of the financial statements.

The engagement letter should contain the following:

- **Objective of the engagement** – To assist management in presenting financial information in the form of financial statements.
- **Responsibilities of management** – Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, for designing, implementing, and maintaining adequate internal controls over the financial statement process, for the prevention and detection of fraud, for identifying and ensuring the entity's compliance with laws and regulations, and for making all financial information available to the accountant.
- **Responsibilities of the accountant** – The accountant is **not** providing any type of assurance that the accountant will find material modifications to the information that is management's representation.
    - Limitations of the engagement to compile financial statements.
    - Identification of the applicable financial reporting framework for the preparation of financial statements.
    - Expected form and content of the accountant's compilation report and a statement that there may be circumstances where the report may differ from its expected form and content.
- **Professional standards** – The engagement will be performed in accordance with SSARS.
- **Differences in levels of service** – A compilation is different from an audit or review in that the accountant does not:
    - Perform inquiry, analytical or other review procedures;
    - Obtain an understanding of internal controls;
    - Assess fraud risk;
    - Test accounting records through confirmation, inspection, observation, etc.;
    - Perform any other audit procedures, such as looking at bank checks or images; or
    - Express any assurance, opinion, or other conclusion on the financial statements.

    In addition, the engagement letter should state that the engagement cannot be relied on to discover errors, fraud, or illegal acts. However, the accountant will inform the appropriate management level if any material errors, fraud, or illegal acts come to their attention, except for illegal acts that are clearly inconsequential.
- **Independence** – If the accountant lacks independence, that fact will be expressed in the report.

There could be other elements included in the engagement letter if circumstances warrant it, such as:

- Material departures from the financial reporting framework might be in the financial statements and the effects may not be disclosed.
- Substantially all disclosures have been omitted.
- Reference to supplementary information, if included.
- Management is adopting a new Private Company Counsel standard.

Note that engagement letters are now required for **all levels of service**. It is important to ensure that all required signatures are on the engagement letter. In addition, when the agreement on the terms of engagement is only with those charged with governance, the accountant is required to obtain management's agreement that it acknowledges and understands its responsibilities.

VII. Practice exercise

Use the following brief exercise to review what you have learned about performing and reporting on compilation engagements discussed above. A suggested solution appears at the end of the chapter material.

Identify and correct the deficiencies in the following compilation report.

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

Accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me (us) that XYZ Company has stated its land at appraised value.

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

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

VIII. Practice exercise – Suggested solutions

1. The report should state that management is responsible for the financial statements, not the accountant.

2. The report needs to state the financial reporting framework under which the financial statements were prepared, such as accounting principles generally accepted in the United States.

3. The SSARS are issued by the Accounting and Review Services Committee of the AICPA, not the Auditing Standards Board.

4. The report should say the accountant did not review as well as audit the financial statements.

5. The additional paragraph in the report should state the amount by which the value of the land, and shareholders' equity, would be different if the land had been valued using accounting principles generally accepted in the United States of America.

AR-C 90: Performing and Reporting on Review Engagements

AR-C 90: Performing and Reporting on Review Engagements

Learning objective

After completing this chapter, you should be familiar with:

- Performing and reporting on review engagements.

I. Introduction

AR-C section 90 addresses the accountant's responsibilities when engaged to review financial statements. This section may also be applied, as necessary in the circumstances, to engagements to review other historical financial information.

Generally, SSARS No. 21 did not make significant changes to the guidance on performing review engagements but rather clarified the guidance previously found in SSARS No. 19. These changes, where applicable, will be discussed in the appropriate section of this chapter. SSARS No. 23, SSARS No. 24, SSARS No. 25, and SSARS No. 26 all amended or clarified AR-C section 90. These updates to the guidance will also be discussed in the following sections.

SSARS No. 21 did make fairly significant changes to when the accountant should add an additional paragraph to the standard review opinion in order to emphasize such items as use of a special purpose financial reporting framework or a change in framework used. SSARS No. 21 also encourages the use of an emphasis of matter paragraph to address other situations which arose over the course of the review. We will address these specific reporting situations later in this chapter.

However, AR-C section 90 does not apply when the accountant is engaged to review interim financial information in the following scenarios:

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 in which it is expected that the current year financial statements will be audited, the engagement of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review; and
c. The entity prepares its interim financial information in accordance with the same financial reporting framework that it uses to prepare the annual financial statements.

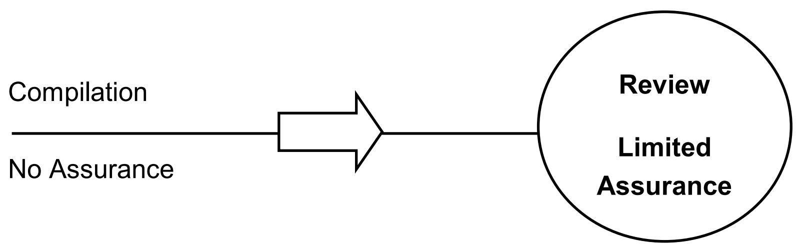
AU-C section 930, *Interim Financial Information*, provides guidance for review engagements when the above conditions are met.

First, let's define what a review engagement is under AR-C section 90. In a review of financial statements, the accountant expresses a conclusion regarding the entity's financial statements in accordance with an applicable financial reporting framework. The accountant's conclusion is based on the accountant obtaining limited assurance. The accountant's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion.

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

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

A review engagement is significantly different than a compilation engagement. First and foremost, a review is an assurance engagement, a compilation is not. Assurance in a review engagement really means providing "limited" assurance that the financial statements are not materially misstated. This assurance is obtained primarily through the performance of inquiry and analytical procedures. However, like a compilation, when you perform and report on a review engagement you do not have to obtain an understanding of the client's internal control or actively search for fraud and illegal acts (but again, if they come to your attention you have to inform the proper people – owner, management, etc.). We will now take a step to the right along the continuum moving from no assurance to a level of limited assurance.



II. Performing a review engagement

As we said, a review engagement is significantly different than a compilation. A review is an assurance engagement, which means that your review report is specifically meant to enhance the degree of confidence (to a "limited" extent) in the financial statements.

To better understand the objective of a review engagement, let's review certain key definitions.

- **Analytical procedures –** Evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
- **Experienced accountant –** An individual (whether internal or external to the firm) who has practical review experience and a reasonable understanding of:
  a. Review processes;
  b. SSARSs and applicable legal and regulatory requirements;
  c. The business environment in which the entity operates; and
  d. Review and financial reporting issues relevant to the entity's industry.

- **Inquiry –** Inquiry consists of seeking information of knowledgeable persons within or outside of the entity.
- **Pervasive –** A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements. Pervasive effects on the financial statements are those that, in the accountant's judgment:
  - Are not confined to specific elements, accounts, or items of the financial statements;
  - If so confined, represent or could represent a substantial portion of the financial statements; or
  - With regard to disclosures, are fundamental to users' understanding of the financial statements.
- **Review documentation –** The record of review procedures performed, relevant review evidence obtained, and conclusions the accountant reached (terms such as *working papers* or *workpapers* are also sometimes used).

A. Use of professional skepticism

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

While generally identified with audits, SSARS No. 25 added the concept of professional skepticism to financial statement review engagements. The accountant should plan and perform the review with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to the following, for example:

- Review evidence that contradicts other review evidence obtained;
- Information that brings into question the reliability of responses to inquiries and other information or records to be used as review evidence; and
- Circumstances that suggest the need for review procedures in addition to those required by this section.

Maintaining professional skepticism throughout the review is necessary if the accountant is, for example, reducing the risks of:

- Overlooking unusual circumstances;
- Overgeneralizing when drawing conclusions from review observations; or
- Using inappropriate assumptions in determining the nature, timing, and extent of the review procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of review evidence. This includes questioning contradictory review evidence and the reliability of responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of review evidence obtained in light of the circumstances.

Lastly, the accountant may accept records and documents as genuine unless the accountant has reason to believe the contrary. The accountant neither assumes that management is dishonest nor assumes unquestioned honesty. The accountant cannot be expected to disregard past experience of the honesty and integrity of management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the accountant of the need to maintain professional skepticism or allow the accountant to be satisfied with less than persuasive review evidence when obtaining limited assurance.

In performing a review, you gather *review evidence* by performing review procedures in order to provide you with a reasonable basis for obtaining "limited assurance" that no material modifications have to be made to the financial statements so they conform to the applicable financial reporting framework used to prepare them.

Additionally, review engagements can be performed on single financial statements, specified elements, accounts or items of financial statements, as well as supplementary information, whether required in the financial statements or added at management's discretion. Also, financial information contained in a tax return can be subject to a review engagement. The requirements of AR-C section 90 apply irrespective of the financial information on which the accountant is performing the review. However, AR-C section 90 does not apply to reviews of pro forma financial information. Such reviews are performed in accordance with the Statements on Standards for Attestation Engagements (SSAE).

B. Consideration of materiality in a review engagement

SSARS No. 25 added the requirement that the accountant explicitly determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. Further, the accountant should revise materiality for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.

The accountant's consideration of materiality is made in the context of the applicable financial reporting framework. 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 there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.
- Judgments about materiality are made in light of surrounding circumstances and affected by the size or nature of a misstatement, or a combination of both.
- Judgments about materiality involve both qualitative and quantitative considerations.
- 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 above characteristics 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.

For purposes of determining materiality, the accountant may assume that reasonable users:

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

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

Lastly, the accountant's determination of materiality for the financial statements as a whole may need to be revised during the engagement as a result of the following:

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

As the accountant is providing assurance, albeit limited assurance in the review report, the stakes are higher in review engagements. While high quality is of paramount importance in all engagements performed under SSARS No. 21, the range of users of reviewed financial statements as well as their use of the financial statements is generally wider and greater than with engagements performed under AR-C sections 70 and 80. These are all important considerations as the accountant designs procedures and evaluates the results of the procedures, in light of the established materiality threshold.

C. Review evidence and limited assurance

The concept of risk and responding to that risk is critical to the accountant's design of review procedures. Let us look at the concept of risk and how it manifests itself on AR-C section 90 engagements.

The accountant obtains limited assurance in a review engagement, though that concept was not formally defined in AR-C Section 90 prior to the issuance of SSARS No. 25.

However, International Standard on Review Engagements 2400 (Revised), *Engagements to Review Historical Financial Statements*, does define the term *Limited assurance* as follows:

Limited assurance – The level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement [i.e., an audit], as the basis for expressing a conclusion in accordance with this ISRE. The combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the financial statements.

SSARS No. 25 defines limited assurance as a level of assurance that is less than the reasonable level of assurance obtained in an audit engagement but is at an acceptable level as a basis for the conclusion expressed in an accountant's review report. Sufficient appropriate review evidence, consisting primarily of the results of the accountant's analytical procedures and inquiries, is required to obtain limited assurance to support the accountant's conclusion. Review evidence is cumulative in nature and primarily obtained from the procedures performed during the course of the review. The combination of the nature, timing, and extent of evidence-gathering procedures is limited compared to an audit engagement.

Review evidence is further defined in SSARS No. 25 as the information used by the accountant to provide a reasonable basis for obtaining limited assurance. Review evidence includes both information contained in the accounting records underlying the financial statements and other information, which primarily consists of the results of analytical procedures and inquiries. Sufficiency of review evidence is the measure of the quantity of review evidence. Appropriateness of review evidence is the measure of the quality of review evidence; that is, its relevance and reliability in providing support for the conclusions on which the accountant's review report is based.

D. Risk awareness

Although SSARS No. 19 or SSARS No. 21 does not use the term "risk assessment" or come right out and discuss risk assessment in a review engagement, they do touch upon the concept of risk when designing and performing review procedures, noting that an accountant should focus his or her review procedures on those areas where he or she believes there are increased risks of material misstatements.

In place of risk assessment, SSARS No. 19 and SSARS No. 21 include the concept of "risk awareness," noting that the results of review procedures can modify the accountant's risk awareness. For example, the response to an inquiry that a related party transaction is not disclosed may revise the accountant's awareness of risk relative to related party transactions.

Also, SSARS No. 21 notes that in addition to analytical procedures and inquiries, in certain circumstances and based on the accountant's professional judgment, the accountant may perform procedures ordinarily performed in an audit. However, in such instances the engagement remains a review and the accountant is not required to perform an audit of the financial statements.

E. Business risks

Like risk assessment, SSARS No. 21 also does not specifically use the term "business risks" in its guidance, but you should nevertheless be aware of business risks when performing a review engagement. The professional auditing literature defines *business risks* as:

Business risks – Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

In the context of a review engagement, it is a best practice to factor business risks into your engagement planning process as well as when designing and performing your review procedures.

F. Review risk

Another concept that SSARS No. 21 does not provide a specific term for but that you need to be fully aware of is "review risk." Review risk can be thought of as the risk that you might unknowingly fail to modify your review report on financial statements that are materially misstated.

We can draw the analogy here to the definition and concept of *audit risk*, which the auditing literature defines as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

III. Planning the review engagement

A. Independence

An accountant must be independent of the entity while performing the review of the financial statements in accordance with AR-C section 90. This assessment of independence should be performed initially before the accountant accepts the engagement. Further, if the accountant's independence is impaired during the engagement, the accountant should consider the options available.

The accountant should be very familiar with the AICPA *Code of Professional Conduct* (the "Code") in order to complete a detailed independence assessment. The Independence Rule and its various interpretations can be found in Section 1.200 of the Code and provides very helpful guidance in successfully navigating the sometimes complex independence landscape.

B. Client acceptance and continuance

Similar to preparation and compilation engagements, the accountant should go through a rigorous acceptance and continuance process before beginning a review engagement. The same requirements of AR-C section 60 apply for review engagements. Further, the accountant should not accept the engagement if management places a limit on the accountant's work that prevents the accountant from performing sufficient review procedures to support the review opinion.

Additionally, as a condition for accepting the review engagement, the accountant should obtain from management its acknowledgement of its responsibility for the following:

a. For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework used to prepare the entity's financial statements.

   If the financial statements are prepared in accordance with a special purpose framework, this includes:

   1. A description of the special purpose framework, including a summary of significant accounting policies, how the framework differs from GAAP (the effect of which need not be quantified), and informative disclosures similar to those required by GAAP, in the case of special purpose financial statements that contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP;

2. A description of any significant interpretations of the contract on which the special purpose financial statements are prepared, in the case of financial statements prepared in accordance with a contractual basis of accounting; and
3. Additional disclosures beyond those specifically required by the framework that may be necessary for the special purpose framework to achieve fair presentation.

b. To provide the accountant with, at the conclusion of the engagement, a letter that confirms certain representations made during the review.

c. To include the accountant's review report in any document containing financial statements that indicates that such financial statements have been reviewed by the entity's accountant unless a different understanding is reached.

With regard to acceptance and continuance of a review client relationship, if it is discovered after the engagement has been accepted that the accountant is not satisfied regarding any of the preconditions for acceptance in AR-C section 60 or in AR-C 90, the accountant should discuss the matter with management or those charged with governance and should determine the following:

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

These terms should be agreed to in an engagement letter, which is issued prior to performing the review engagement.

The accountant should not accept the review engagement if all of these conditions are not met.

Further, the SSARS do not require an accountant to communicate with a predecessor accountant prior to accepting the engagement, such communication may be valuable in obtaining enough information concerning whether to accept the new engagement. Some reasons for such inquiries could be the existence of only limited information about the client or its management, frequent changes in accountants, or unusual timing in the change of accountants. Also, under the AICPA *Code of Professional Conduct*, the successor accountant should ask the client to permit the requests for information and for the client to authorize the predecessor accountant to respond fully to these requests.

C. Agreement on engagement terms

Given the importance of the accountant maintaining independence as well as having management acknowledge its responsibilities in a review engagement, it is vital to get this agreement between the entity and the accountant in writing prior to the commencement of the engagement. The requirement for a written understanding signed by both parties was emphasized in amendments added by SSARS No. 23. Issued in June 2022, SSARS No. 26 included a technical revision that removed the requirement for an accountant to obtain a signed engagement letter prior to the start of the review engagement. This does not remove the requirement for the signed engagement letter but instead aligns the guidance with preparation engagements and compilation engagements. This revision was effective when issued.

Key items such as engagement objectives, mutual responsibilities, limitations of the review process, identification of the financial reporting framework to be used, and the form of the report that the accountant expects to issue are generally covered in review engagement letters. As these letters are already customarily used by accountants in performing review engagements, there should be no significant changes from the letters currently used when documenting this understanding with the entity under SSARS No. 21.

Further, in addition to the engagement letter, throughout the engagement, the accountant should communicate to management those items that the accountant thinks to be of significant importance in the completion of the review engagement.

D. Industry and client knowledge and understanding

When performing a review engagement, you need to understand:

a. The industry in which the client operates:
   - Which means that you understand the accounting principles and practices generally used in that industry, which then allows you to understand whether proper financial statements common to that particular industry have been prepared.

b. The client's business:
   - Understanding a client's business includes how it is organized and operates, and the nature of its assets, liabilities, revenues, and expenses, which you generally get by working directly with the client or similar clients in the same industry. The accountant should understand if there are related-party transactions or other unusual transactions between principals and management of the client or other items that would increase the risk associated with the engagement.

c. The accounting principles and practices used by the client:
   - Understanding the accounting principles and practices used by the client in preparing its financial statements should help you to recognize any unusual accounting practices they might be using relative to the industry norms.

You can see how the concept of business risks easily fits into this particular aspect of your review procedures. Do not forget, you also have to be aware of "review risk," which is unknowingly failing to modify your review report on financial statements that are materially misstated.

You then use this knowledge to design and perform analytical procedures and make inquiries, which results in review evidence upon which to base your limited assurance.

A couple of important notes here:

1. Even though the review evidence that results from performing analytical procedures and inquiries will ordinarily provide you with a reasonable basis for obtaining limited assurance, in some cases you might have to perform additional procedures if you feel, in your professional judgment, that the analytics and inquiries alone do not provide you with a firm enough basis to obtain limited assurance that the financial statements are not materially misstated. For example, if your analytics reveal that the A/R balance increased much more than expected, and management is not quite sure why, you might want to go ahead and use confirmations to gather up additional review evidence in this area.
2. Analytical procedures and inquiries are not simply "checklist" items. They should be tailored (nature and extent) based on your understanding of the industry in which the client operates, the client's business, and the accounting principles and practices used by the client. Additionally, you should also consider "review risk" in this context as well.

With a greater knowledge of the industry and the client, the accountant can formulate better inquiries of the client as well as establish better expectations for analytical procedures. The accountant should strive to understand such items as major sources of funding for the client, significant vendors and customers, as well as how both general business trends and industry unique factors impact the entity's financial results.

Also, the accountant should strive to understands such client specific topics as the entity's key products and services, including their revenue channels. Additionally, the accountant should look to obtain information about the entity's operating locations, production, distribution, and compensation systems. All of this information should then be used in the design and performance of the accountant's review procedures.

IV. Designing and performing review procedures

The accountant should design and perform analytical procedures, make inquiries, and perform other procedures, as appropriate, to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework. The nature, timing, and extent of these procedures is a matter of professional judgment and its determination is based on the accountant's understanding of the industry, knowledge of the entity, and awareness of the risk that the accountant may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated (i.e., "review risk" – akin to the concept of audit risk in the auditing literature). However, review procedures should be performed on all material items in the financial statements, including disclosures.

More procedures should be performed in those areas that have an increased risk of material misstatement.

A. Analytical procedures

Simply put, analytical procedures are used to develop and compare expectations or relationships about financial statement amounts, account balances, or other forms of financial and nonfinancial data. Developing expectations is the backbone of analytical procedures in any review engagement.

Expectations are the accountant's predictions about the results of applying analytical procedures and are based on the accountant's identification of plausible relationships that should exist between elements of the financial statements or between such elements and other information, such as industry or economic trends. They should be developed in such a way that differences between the expectation and the actual result of the analytical procedure could indicate a possible misstatement in the financial statements. The accountant would then take appropriate follow up procedures to gain an explanation for the variance.

There are a wide variety of analytical procedures which the accountant can perform to obtain the required support for the review engagement. Whichever analytical procedures the accountant selects, the procedures should identity relationships as well as individual items that appear to be unusual and that could be indicative of a material misstatement.

These analytics should include the following:

- Comparing the current financial statements with the prior period financial statements, anticipated results such as budgets or forecasts, and with relevant nonfinancial information.
- Considering plausible relationships between financial and, in some instances, non-financial data.
- Comparing ratios and indicators for the current period with expectations based on prior periods, and with those of entities in the same industry.

The accountant should consider performing these procedures on disaggregated data, especially with regard to revenue, in order to obtain greatest evidence.

While generally easy to perform, considerable thought should be placed on the design of the analytical procedures to assure that they will actually provide the assurance that the accountant desires. The selected procedures should be suitable for the level of assurance required and should be based on reliable data. Expectations should be precise enough so that the investigation of the result of the procedure would provide the accountant with the limited assurance required that the financial statements are free of material misstatement. However, the expectations do not need to be as precise as they would be if the procedures were substantive audit procedures performed as part of an audit engagement. The accountant should use professional judgment in developing these tests.

Additionally, when developing expectations or investigating differences, the accountant should be aware of any unusual or complex situations that may impact the quality of the assumption or the explanations obtained from management. Some common factors to consider are the following:

- Business combinations.
- New or complex revenue recognition methods.
- Impairment of assets.
- Disposal of a segment of a business.
- Use of derivative instruments and hedging activities.
- Adoption of new stock compensation plans or changes to existing plans.
- Significant, unusual, or infrequently occurring transactions.
- Changes in litigation or contingencies.
- Changes in major contracts with customers or suppliers.
- Application of new accounting principles.
- Changes in accounting principles or the methods of applying them.
- Accounting estimates, such as allowances for bad debts and obsolete inventories.
- Compliance with debt covenants.
- Changes in related parties or significant new related party transactions.

All of these factors could impact comparability of financial statement amounts and should be considered in developing expectations. This only further highlights the need for the accountant to have a strong understanding of the entity and its industry and use strong professional judgment.

B. Common financial statement ratios

The accountant uses professional judgment in determining which analytical procedures to perform and at which level of disaggregation to perform them. Here are common analytical procedures which are frequently performed in review engagements.

1. Gross profit margin

Gross Profit Margin = Gross Profit/Gross Sales

Gross margin measures gross profit (sales less cost of sales) as a percentage of revenue. As gross profit margin varies significantly across industries, this ratio is best employed when viewed at the entity level over a period of time (trend analysis) and/or when comparing the entity against peers.

When appropriate and if the information is available, gross profit margin can be calculated and analyzed on a disaggregated level, based on classes of products sold or distribution channels.

2. Return on investment (assets) or equity

Return on assets (ROA) and return on equity (ROE) are similar measures, which provide feedback on how well an entity converts its invested assets or equity into earnings.

ROA is calculated as follows:

Return on Investment (Assets) = Earnings After Tax/Total Assets

ROE is calculated as follows:

Return on Equity = Earnings After Tax/Stockholder's Equity

Again, ROA and ROE will vary significantly by industry. Entity trend analysis and peer group analysis are often the best basis for analyzing these ratios.

When possible, calculating these on a disaggregated basis can provide valuable feedback into how profitable various segments of an entity are. This information can provide feedback to support capital allocation decisions, as well as cost of capital determinations.

3. Liquidity ratios

Liquidity ratios provide feedback on an entity's relative ability to pay its bills and to have sufficient cash flows. Two common liquidity ratios are the current ratio and the quick ratio. Both measure liquidity, but they include different items in the calculation.

a. **Current ratio.** Current ratio is measured as follows:

Current Ratio = Current Assets/Current Liabilities

It is essentially a measure to determine whether the entity has sufficient cash or assets which can be converted into cash in the current operating cycle in order to pay its known current liabilities.

Generally, a 2-1 current ratio was deemed sufficient, but the measurement of an acceptable ratio can vary significantly by industry. Again, trend and industry analysis are often the best methods to analyze current ratio. Also, a declining current ratio is a red flag of broader liquidity issues, which could signal a going concern issue.

b. **Quick ratio.** Quick ratio is measured as follows:

Quick Ratio = (Cash + Marketable Securities + Accounts Receivable)/Current Liabilities

Quick ratio measures essentially the same conditions as current ratio, but only focuses on the most liquid of assets, cash or those assets that are convertible into cash easily or as part of the normal collections cycle.

4. Turnover ratios

Turnover ratios measure the efficiency with which an entity converts inventory and accounts receivable into cash. Better turnover ratios indicate an entity's ability to fund its cash flow needs from operations, as opposed to external sources, such as debt or equity.

Turnover ratios and related days calculations can be calculated for both accounts receivable and inventory, as follows:

a. **Accounts receivable turnover and related days sales in A/R.** A/R turnover is calculated as follows:

Receivables Turnover Ratio = Net Credit Sales/Average Accounts Receivable

Days sales in A/R is calculated as 365/ A/R turnover, as determined above. If calculated separately, days in A/R is calculated as follows:

Average Collection Period = Accounts Receivable/(Net Sales/365 Days)

A/R turns and days sales in A/R are the opposite side of the same coin and essentially measure the same characteristic: How quickly an entity can turn a credit sale into cash. Lower days sales and the related higher A/R turns represent better cash management techniques and result in the lower need to rely on external sources of financing.

A/R turns and days sales are highly dependent on the normal credit terms issued by an entity or which are common in a particular industry. Again, multi-year trend analysis and/or industry peer data are effective reference points for such ratios. If such terms vary by segment or product, such ratios should be reviewed on a disaggregated basis.

b. **Inventory turnover and related days sales in inventory.** Days sales in inventory are measured as follows:

Days Sales in Inventory = Inventory/(Net Sales/365 Days)

Inventory turnover is measured as follows, or as 365/days sales in inventory, measured as per the above.

Inventory Turnover = Cost of Goods Sold/Inventory

Inventory turn ratios measure similar variables as A/R turn ratios: The ability to turn inventory into cash. As such, the analysis of such ratios is similar to that of the A/R turnover ratios.

5. Debt and related interest coverage ratios

Debt is generally cheaper than equity and is thereby a more efficient way to fund operations. However, when an entity overleverages, its cost of borrowing increases, jeopardizing its ability to pay interest on current debt and its ability to turn over existing debt or obtain new debt.

The level of debt of a company can be measured in several ways, either as the debt ratio or the debt-to-equity ratio.

The debt ratio is measured as follows:

Debt Ratio = Total Debt/Total Assets

The debt-to-equity ratio is measured as follows:

Debt-to-Equity Ratio = Total Debt/Equity

Acceptable debt and debt-to-equity ratios will vary by industry and often reflect the relative level of capital investment necessary to operate in an industry. Again, both entity-specific trend analysis and industry peer ratios are effective measures of these ratios. Caution must also be used when analyzing these ratios, as too low a debt ratio may represent inefficient funding of operations, while too large of such ratios could indicate an inability to service debt and potentially going concern issues.

Interest coverage or times interest earned. This ratio, commonly known as interest coverage, is calculated as follows:

Times Interest Earned = Earnings Before Interest & Taxes/Interest Expense

Interest coverage ratio is a common debt covenant and demonstrates an entity's ability to pay the interest on its debt. A high coverage ratio represents potential additional borrowing capacity while a lower interest coverage ratio indicates the inability of an entity to acquire more debt. If the entity is heavily reliant on debt financing, such inability could be a red flag of a going concern issue.

Given the varying ways that entities in various industries finance operations, acceptable interest coverage can vary by industry. Both trend and industry peer analysis are useful benchmarks for comparison.

6. Common-size statements

Common-size financial statements express all accounts on the balance sheet and income statement as a percentage of some key figure. On the income statements, net sales are set equal to 100 percent, and all other items are expressed as a percentage of net sales. On the balance sheet, all assets accounts are listed as a percentage of total assets. All liabilities and equity accounts are listed as a percentage of total liabilities and equity.

Common-size financial statement analysis is an effective tool to identify trends which other, more detailed analytical procedures may miss.

C. The analytical review process

While not performed in order to obtain audit evidence, analytical procedures performed on review engagements should follow the same four-step process as those used on audit engagements. There are just some differences on how much follow-up the accountant must perform on differences between the expectation for the analytic and the actual result of the test.

The four-step process, as applied to a review, consists of the following:

1. Step 1 – Develop your expectation.
2. Step 2 – Set a threshold for investigation. The accountant is concerned when the results of the test do not meet the expectation. A threshold for acceptable variation should be established before the test is performed. When the variance is less than the threshold, the expectation has been met and no future work is required. However, if the results of the analytic are beyond the established threshold, the accountant needs to investigate the difference, which is Step 4 of the process. Thresholds should be established in the context of overall materiality, especially with the requirements of SSARS No. 25 related to the assessment of materiality, and are often set at levels that are less than materiality. This is a matter of professional judgment.
3. Step 3 – Perform the test.
4. Step 4 – The accountant investigates variances that are greater than the threshold.

1. Developing expectations

An analytical procedure is only as strong as the quality of the expectation that the accountant has concerning the relationship being explored. Peer and PCAOB reviews of both audits and review engagements have identified deficiencies with the expectations that accountants developed as part of their analytical procedures on these engagements which negatively impacted the assurance that the accountant obtained from the procedure. This may result in the accountant not obtaining sufficient evidence to support the report issued.

Expectations can be thought of as your "predictions" of financial statement amounts, account balances, or relationships between data. With that said, you can see that there is a specific order to these things; you must first develop your expectations of the results of your analytical procedures before performing them. Put in its reverse context, you do not first perform your analytical procedures and then say, "Yeah, that is what I would have expected the result would have been." Additionally, all analytical procedures require an expectation.

You develop expectations and relationships based upon your knowledge of the client and the industry in which it operates, for example:

- By comparing this year's financial statement figures to last year's and factoring in your knowledge that there has been a substantial downturn in the industry that your client operates in;
- By comparing actual results with budgeted amounts; or
- By reviewing relationships between financial and nonfinancial information such as salaries and wages expense to the number of employees.

Often times when we think of analytical procedures, we naturally assume quantitative type of analysis using financial data. However, there is also a lot of nonfinancial data that can be used in designing and performing analytical procedures as well, such as production figures and sales statistics. This type of data can provide a nice “independent” check on the reasonableness of financial statement amounts and disclosures.

However, the accountant needs to consider the reliability of the data from which the expectation is developed. The source, comparability and nature, and relevance of the data should be assessed to ensure that its usage will actually provide the assurance that the accountant desires.

Remember, analytical procedures are meant to provide you with review evidence and help you to identify those items that might be materially misstated.

The following exercise provides an example of developing expectations in a review engagement.

Developing Expectations

Assume that you are reviewing the 20X1 financial statements of Acme Automotive, a small parts manufacturer for the U.S. automobile industry. Because of the significant downturn in U.S. economy, you reasonably expect sales to decrease. Based on your knowledge of the U.S. automobile industry and Acme’s business, you expect to see a 20 percent decrease in sales. Along with this expected decrease in sales, you also expect a corresponding decrease in Acme’s cost of goods sold and its accounts receivable and accounts payable. Acme’s financial statements include the following data:

	20X1	20X0	Difference	% Difference
Sales	988,683	1,214,598	(225,915)	(18.6)%
Cost of Sales	744,718	901,128	(156,410)	(17.4)%
Gross Profit	243,965	313,470		
Gross Profit %	24.7	25.8		
Accounts Receivable	456,963	526,888	(69,925)	(13.3)%
Days Sales in	169	158	11	7%
Accts Payable	498,742	587,564	(88,822)	(15.1)%

Considering your expectations and given the above results, how would you conclude as to Acme’s sales, costs of sales, accounts receivable, and accounts payable figures?

Going hand-in-hand with developing strong assumptions for analytical procedures is establishing appropriate thresholds for investigating the differences identified when performing the test. The threshold is linked to the perceived risk of material misstatement, with a higher risk resulting in in a lower threshold for investigation. Again, thresholds used in reviews do not need to be as precise as those used in audits but still need to be sufficient to provide you with the assurance you need to support your review report.

2. *"Flux analysis"*

Fluctuation analysis, or "flux analysis" as it is commonly referred to, is a type of analytical procedure that is widely used in practice today. Flux analysis is the process of comparing recorded amounts (or developing ratios off of those recorded amounts) with expectations and following up on those that appear to be inconsistent, for example:

> If you know that Candy Baskets.com has doubled its sales volume in a given period, you would reasonably expect to see a significant increase in its cost of sales as well. If you did not see this corresponding increase in the cost of sales, you would inquire of Mr. Owner as to why this particular relationship was not holding true.

Do not forget, just because an expected relationship is not quite holding true, does not mean that there is not a plausible explanation for the inconsistency. Maybe Mr. Owner was able to purchase candy this period at a substantial discount because a new supplier is trying to break into the market.

3. *Scanning*

Scanning is another analytical procedure commonly used in practice today. Scanning is basically reviewing (scanning) various sources of financial information in an attempt to identify any significant or unusual items to then follow up on. What constitutes a significant or unusual item will be a matter of your professional judgment reflective of the particular circumstances of the review engagement.

Scanning can be used with a number of different types of financial information including, for example, the general ledger and its underlying subsidiary ledgers, summary and detail account balances, standard and adjusting journal entries, reconciliations, and management reports.

Scanning can also provide review evidence about the items that you did not select for follow up because by default, you used your professional judgment to determine that the items not selected for follow up are less likely to be misstated.

4. *Other analytical procedures*

A variety of other analytical procedures are also commonly used in practice today, including:

1. *Trend analysis* – Which compares a current year's balance with its corresponding previous years or years' balance(s) to see if the balances are varying significantly over time. Significant changes need to be investigated further.
2. *Ratio analysis* – Which compares current year ratios with those from the prior year(s), or to industry averages to uncover inconsistencies that will have to be explained. Common ratios used in analytics include gross profit percentage, inventory and accounts receivable days outstanding and turnover, and leverage or liquidity ratios. These are best performed on a disaggregated basis, when appropriate.
3. *Modeling* – Such as regression analysis, which can also be used to establish relationships amongst various data, both financial and nonfinancial, to predict current balances.

Although you are not required to use any particular form of analytical procedures in conducting your review engagement, you should focus your work in those areas that you believe have an increased risk of misstatement and tailor your procedures based on your knowledge of the client and its industry. In the end, use your professional judgment to determine the exact nature, timing, and extent of analytical procedures at both the financial statement level as well as the detailed account level.

In some situations, the lack of a change between periods could be a red flag, since your knowledge of the client and its industry would make such consistency unusual. Two difficult issues accountants often need to deal with include:

1. Should there be a change when the general ledger does not show one? What should have changed, but did not?
2. Are there any unrecorded transactions that are being “hidden”? What should be there, but is not?

These types of questions point out the importance of developing expectations. Generally, your knowledge of the client’s business activities and the relationships within the financial data may be the only way to figure out what follow up may be needed.

5. Limitations of analytical procedures

Analytical procedures are not meant to be the do-all end-all when performing a review engagement because they do have their shortcomings, for example:

- They can be somewhat subjective in nature because of the professional judgment involved in determining their nature, timing, and extent.
- Materiality considerations play a part in their design and performance.
- Many analytical procedures are based on a past-to-present type relationship, which of course might not always hold true.
- Analytical procedures can be negatively affected by their underlying data, that is, garbage in, garbage out.
- The use of accounting estimates can skew both expectations and outcomes.

Lastly, accountants need to consider the impact of the adoption of new accounting pronouncements in both the development of their expectations and their assessment of the results of their analytical procedures. For example, with the adoption of ASC 606, *Revenue from Contracts with Customers*, reporting entities may see a significant change in either or both of the timing and amount of revenue recognized.

Similarly, the adoption of ASC 842, *Leases,* poses similar challenges in developing and analyzing the results of analytics related to intangible assets, debt and liquidity, and leverage ratios. Unlike the impact of adopting ASC 606, the impact of adopting ASC 842 is likely to be easily identified. However, given the implementation approaches for ASC 842, financial statements are not comparable in their reporting of lease liabilities and the related right-of-use assets. Again, this should be reflected in the analytics expectation and addressed in the documented results of the procedures.

Accountants can deal with the effects of the adoption of these standards in a number of ways. If possible, the best way to deal with the impact of adopting a new accounting standard is to attempt to isolate its effects in any analytical procedure performed. For instance, the cumulative effect of adopting ASC 842 on both the lease liability and ROU asset can be added back to the prior year’s amounts in order to create an “apples to apples” comparison. Financial statement ratios from the prior year can be re-run to reflect these adjustments as well. This is probably the best way to adjust analytics impacted by the adoption of ASC 842.

Generally, when entities have seen a significant impact from adopting ASC 606, the impact was due to one or a few discrete changes in their revenue recognition approach, often impacting only a few contracts, which drove the change. By asking the client to isolate the impact of ASC 606 adoption in its current year results, the accountant can both isolate the effects and appropriately consider this impact when assessing the reasonableness of his or her analytics.

You should always take a fresh approach to performing your analytics on review engagements each year. However, with the adoption of these significant new accounting standards, as well as others which may also have a material impact on entity financial statements, it is important to adjust your procedures to reflect these changes. The quality of your work depends on it, and peer reviewers will definitely be on the lookout for evidence of addressing the adoption of these new standards.

6. Investigating the results of the analytics

Whatever the analytical procedure that the accountant performs, its result needs to be investigated if the result is outside the established acceptable threshold for investigation. The accountant should inquire of management as to the cause of the unexpected result or consider performing additional analytical procedures in order to obtain the level of assurance required to support the review opinion. While the explanations obtained from management need to be plausible, they do not need to be corroborated with other substantive evidence, as would be the case with an audit. However, even a reasonable explanation from the client may result in the accountant performing additional review procedures. Additionally, the accountant should get an explanation for the full variance, not just the amount that exceeds the threshold. Lastly, the accountant should be alert for offsetting explanations, which net to a small number. These may be hiding potential misstatements which would be identified when explanations are analyzed on a gross, as opposed to net, basis.

V. Inquiries

If analytical procedures are the “number crunching” side of a review engagement, then inquiries are the “probing and discussion” side of things. Inquiries are a fundamental procedure performed for every review engagement and are used both independently of, and in connection with, your analytical procedures.

Like your analytical procedures, your inquiries should be tailored to each individual review engagement. They should not simply be the “same old same old” questions pulled directly from some checklist somewhere, asked in a mechanical fashion, and answered in a mechanical fashion.

Even though there is a “standard” set of questions that should be asked in most review engagements, the point is that you still need to give some serious thought to your entire line of questioning and base it on the circumstances of the particular engagement you are performing.

Your inquiries might be presented using a somewhat formal approach, for example, by interviewing various people and documenting their responses, or using a somewhat informal approach, allowing the responses to help determine the direction of the line of questioning, similar to the approach an attorney might use when questioning witnesses in a legal trial.

Responses to your inquiries constitute review evidence and you are ordinarily not required to corroborate the responses with other review evidence unless you consider the responses to be inconsistent with what you know about the industry in which the client operates, the client’s business, or other review evidence you have already obtained from performing other review procedures. If this is the case, you will need to perform additional review procedures.

As with your analytical procedures, your inquiries should also reflect the impact of the adoption of new accounting pronouncements. Consider broad, open-ended questions concerning how the entities adopted the new standards; and then follow up with probing and/or close-ended questions that will allow you to assess the adequacy of their approach to adopting the new standards, as well as obtain the necessary comfort over both their accounting for the cumulative effect of adoption and their going-forward accounting.

A. Inquiries independent of analytical procedures

Inquiries performed in a review engagement are often mischaracterized as discussions with only the CFO, controller, or accounting manager. Of course, your inquiries to the accounting staff do play a critical role in gathering review evidence, but they are not the only people you should be talking with.

Inquiries can be (and most likely should be) made of many of the client's non-accounting personnel as well. This might include for example, the sales manager, the production manager, the human resources manager, legal counsel, etc. These individuals can provide you with valuable insight into their departments and how and how their operation affects the day-to-day operations of the business. They may also provide insights that impact your assessment of fraud risk at the entity.

The types of inquiries you make, and with whom you have your discussions, are based on your professional judgment and will vary depending on a number of factors such as the industry in which the client operates, the type of business operations the client undertakes, the size and complexity of the organization, and the overall state of the current economy.

1. Standard inquiries

AR-C section 90 provides a set of "standard" inquiries applicable to most review engagements. Inevitably, the answers you receive to these types of basic questions will typically lead to more in-depth questions as you apply your professional judgment (and professional skepticism) to the client's responses. In addition to those questions that arose in the performance of other review procedures, such as analytical reviews, the following questions should be directed to the client's accounting personnel and others within the entity, as appropriate.

SSARS No. 25 modified these standard inquiries to include the following:

- Whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied***, including how management determined that significant accounting estimates are reasonable in the circumstances***.
- ***The identification of related parties and related party transactions, including the purpose of those transactions.***
- ***Whether there are significant,*** unusual*,* or complex situations ***transactions, events, or matters*** that may have ***affected or may affect*** an effect on the ***entity's*** financial statements***, including the following:***
    - Significant changes in the entity's business activities or operations.
    - Significant changes to the terms of contracts that materially affect the entity's financial statements, including terms of finance and debt contracts or covenants.

- ○ Significant journal entries or other adjustments to the financial statements.
- ○ Significant transactions occurring or recognized during the period, particularly those in the last several days of the reporting period.
- ○ The status of any uncorrected misstatements identified during the previous review (that is, whether adjustments were recorded subsequent to the periods covered by the prior review and, if adjustments were recorded, the amounts recorded and period in which such adjustments were recorded).
- ○ Effects or possible implications for the entity of transactions or relationships with related parties.

- Matters about which questions have arisen in the course of applying the review procedures.
- The existence of any ***actual, suspected, or alleged*** *fraud or noncompliance with laws and regulations affecting the entity and noncompliance with provisions of laws and regulations* that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations.
- ***Whether management has identified and addressed*** events subsequent to the date of the financial statements that ***require adjustment of, or disclosure in, the statements,*** which could have a material effect on the fair presentation of such financial statements.
- The ***basis for management's assessment*** of the entity's ability to continue as a going concern.
- Whether there are ***events or conditions that appear to cast doubt on the entity's ability to continue as a going concern.***
- ***Material commitments, contractual obligations, or contingencies that have affected or may affect the entity's financial statements, including disclosures.***
- ***Material nonmonetary transactions or transactions for no consideration*** in the financial reporting period under consideration.
- **Communications from regulatory agencies,** if applicable.
- Any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management's response to the accountant's inquiry.
- Notes taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.
- Any other matters that the accountant may consider necessary.

Two things to note. First, this is not a complete list of the inquiries which the accountant should make of management and those responsible for the financial statements. Second, while the accountant should evaluate the reasonableness of the explanations and ask appropriate follow-up questions, it is not necessary to corroborate the responses with other evidence.

Additional examples of unusual or complex situations, transactions, events, or matters about which the accountant may inquire of management are as follows:

- Correction of an error.
- Business combinations.
- New or complex revenue recognition methods.
- Impairment of assets.
- Disposal of a segment of a business.

- Use of derivative instruments and hedging activities.
- Sales and transfers that may call into question the classification of investments in securities, including management's intent and ability with respect to the remaining securities classified as held to maturity.
- Adoption of new stock compensation plans or changes to existing plans.
- Restructuring charges taken in the current and prior periods.
- Significant, unusual, or infrequently occurring transactions.
- Changes in litigation or contingencies.
- Application of new accounting principles.
- Changes in accounting principles or the methods of applying them.
- Trends and developments affecting accounting estimates, such as allowances for bad debts and excess or obsolete inventories, provisions for warranties and employee benefits, and realization of unearned income and deferred charges.
- Compliance with debt covenants.
- Material off-balance-sheet transactions, variable interest entities, and other equity investments.
- Unique terms for debt or capital stock that could affect classification.

2. Account and transaction level inquiries

In addition to the standard inquiries listed above, you should also make inquiries at the account level as necessary based on your knowledge of the client, its business operations, and your professional judgment.

The following are just a few examples of the types of inquiries you might make regarding various accounts as applicable to your particular review engagement.

1. **Cash**
   a. Is the entity's policy regarding the **composition of cash and cash equivalents** in accordance with FASB requirements? Has the policy been applied on a consistent basis?
   b. Are all cash and cash equivalents accounts **reconciled on a timely basis**?
   c. Have **old or unusual reconciling items** between bank balances and book balances been reviewed and adjustments made where necessary?
   d. Has there been a **proper cutoff** of cash receipts and disbursements?
   e. Has a **reconciliation of inter-company transactions** been prepared?
   f. Have checks that were written but not mailed as of the financial statement date (i.e., **held checks**) been properly reclassified into the liability section of the balance sheet?
   g. Have material **bank overdrafts** been properly reclassified into the liability section of the balance sheet?
   h. Are there c**ompensating balances or other restrictions** on the availability of cash and cash equivalents balances? If so, has consideration been given to reclassifying these amounts as non-current assets?
   i. Have **cash funds on hand** been counted and reconciled with control accounts?

2. Receivables
   a. Has an **adequate allowance for doubtful accounts** been properly reflected in the financial statements?
   b. Have **uncollectible receivables** been **written off** through a charge against the allowance account or earnings?
   c. Has **interest earned on receivables** been properly reflected in the financial statements?
   d. Has there been a **proper cutoff** of sales transactions?
   e. Are there **receivables from employees or other related parties**? Have receivables from owners been evaluated to determine if they should be reflected in the equity section (rather than the asset section) of the balance sheet?
   f. Are any **receivables pledged, discounted, or factored**? Are recourse provisions properly reflected in the financial statements?
   g. Have receivables been properly classified between **current and non-current**?
   h. Have there been significant numbers of **sales returns or credit memoranda issued subsequent to the balance sheet date**?
   i. Is the accounts receivable **subsidiary ledger reconciled to the general ledger** account balance on a regular basis?
3. Inventory
   a. Are **physical inventory counts performed** on a regular basis, including at the end of the reporting period? Are the count procedures adequate to ensure an appropriate count? If not, how have amounts related to inventories been determined for purposes of financial statement presentation? If so, what procedures were used to take the latest physical inventory and what date was the inventory taken?
   b. Have **general ledger control accounts** been **adjusted** to agree with the physical inventory count? If so, were the adjustments significant?
   c. If the physical **inventory counts were taken at a date other than the balance sheet date**, what procedures were used to determine changes in inventory between the date of the physical inventory counts and the balance sheet date?
   d. Were **consignments in or out** considered in taking physical inventories?
   e. Is any inventory **held at other locations or held for others**?
   f. What is the **basis of valuing inventory** for purposes of financial statement presentation?
   g. Do inventory costs include **material, labor, and overhead** where applicable?
   h. Has inventory been reviewed for **obsolescence or cost in excess of net realizable value**? If so, how are these costs reflected in the financial statements?
   i. Have **proper cutoffs** of purchases, goods in transit, and returned goods been made?
   j. Are there any inventory **encumbrances**?
   k. Is **scrap** inventoried and controlled?
   l. Have any **abnormal costs** associated with inventory been **expensed** as incurred?
4. PP&E
   a. Are property and equipment items properly **stated at depreciated costs** or other proper value?

b. When was the last time a **physical inventory** of property and equipment was taken?

c. Are all items reflected in property and equipment **held for use**? If not, have items that are held for sale been properly reclassified from property and equipment?

d. Have **gains or losses on disposal** of property and equipment been properly reflected in the financial statements?

e. What are the **criteria for capitalization** of property and equipment? Have the criteria been consistently and appropriately applied?

f. Are **repairs and maintenance costs** properly reflected as an expense in the income statement?

g. What **depreciation methods and rates** are utilized in the financial statements? Are these methods and rates appropriate and applied on a consistent basis?

h. Are there any **unrecorded additions, retirements, abandonments, sales, or trade-ins**?

i. Does the entity have any **material lease agreements**? If so, have those agreements been properly evaluated for financial statement presentation purposes?

j. Are there any **asset retirement obligations** associated with tangible long-lived assets? If so, has the recorded amount of the related asset been increased because of the obligation and is the liability properly reflected in the liability section of the balance sheet?

k. Has the entity **constructed any of its property and equipment** items? If so, have all components of costs been reflected in measuring these items for purposes of financial statement presentation, including, but not limited to, capitalized interest?

l. Has there been any **significant impairment** in value of property and equipment items? If so, has any impairments loss been properly reflected in the financial statements?

m. Are there any property and equipment items **mortgaged or otherwise encumbered**? If so, are these mortgages and encumbrances properly reflected in the financial statements?

n. Are **fully depreciated assets** still in service?

5. **Investments**

a. What is the **basis for accounting for investments** reported in the financial statements (e.g., securities, joint ventures, or closely held businesses)?

b. Are **derivative instruments** properly measured and disclosed in the financial statements? If those derivatives are utilized in hedge transactions, have the documentation or assessment requirements related to hedge accounting been met?

c. Are **investments in marketable debt and equity securities properly classified** as trading, available-for-sale, and held-to-maturity?

d. How were **fair values** of the reported investments **determined**? Have unrealized gains and losses been properly reported in the financial statements?

e. If the **fair values** of marketable debt and equitable securities are **less than cost**, have the declines in value been evaluated to determine whether the declines are other-than-temporary?

f. For any debt securities classified as **held-to-maturity**, does management have the positive **ability and intent to hold the securities until they mature**? If so, have those debt securities been properly measured?

g. Have **gains and losses related to disposal** of investments been properly reflected in the financial statements?

h. How was **investment income** determined? Is investment income properly reflected in the financial statements?

i. Has appropriate consideration been given to the classification of investments between **current and non-current**?

j. For investments made by the reporting entity, have **consolidation, equity, or cost method accounting requirements** been considered?

k. Are investments **encumbered**?

6. **Prepaids**

a. What is the nature of the amounts included in prepaid expenses?

b. How are these amounts being amortized?

7. **Intangibles and other assets**

a. What is the **nature of the amounts** included in other assets?

b. Do these assets represent **costs that will benefit future periods**? What is the **amortization policy** related to these assets? Is this policy appropriate?

c. Have other assets been properly classified between **current and non-current**?

d. Are intangible assets with finite lives being **appropriately amortized**?

e. Are the **costs associated with computer software** properly reflected as intangible assets (rather than properly and equipment) in the financial statements?

f. Are the **costs associated with goodwill** (and other intangible assets with indefinite lives) properly reflected as intangible assets in the financial statements? Has amortization ceased related to these assets, if applicable to the accounting policy?

g. Has there been any **significant impairment in value** of these assets? If so, has any impairment loss been properly reflected in the financial statements?

h. Are any of these **assets mortgaged or otherwise encumbered**?

8. **Accounts and short-term notes payable and accrued liabilities**

a. Have **significant payables** been reflected in the financial statements?

b. Are **loans** from financial institutions and other short-term liabilities properly classified in the financial statements?

c. Have **significant accruals** (e.g., payroll, interest, provisions for pension and profit-sharing plans, or other post-retirement benefit obligations) been properly reflected in the financial statements?

d. Has a **liability for employees' compensation for future absences** been properly accrued and disclosed in the financial statements?

e. Are any **liabilities collateralized or subordinated**? If so, are those liabilities disclosed in the financial statements?

f. Are there any **payables to employees and related parties**?

9. **Long-term liabilities**

a. Are **terms and other provisions of long-term liability agreements** properly disclosed in the financial statements?

b. Have liabilities been properly classified between **current and non-current**?

c. Has **interest expense** been properly accrued and reflected in the financial statements?

d. Is the company in **compliance with loan covenants** and agreements? If not, is the noncompliance properly disclosed in the financial statements?

e. Are any long-term **liabilities collateralized or subordinated**? If so, are these facts disclosed in the financial statements?

f. Are there any obligations that, by their terms, are **due on demand within one year** from the balance sheet date? If so, have these obligations been properly reclassified into the current liability section of the balance sheet?

g. Are there any **noncash financing activities** where loan proceeds were paid directly to a vendor or other third party?

10. **Income and other taxes**

a. Do the financial statements reflect an appropriate **provision for current and prior-year income taxes** payable?

b. Have any **assessments or reassessments** been received? Are there any authority examinations in process?

c. Are there any **temporary differences** between book and tax amounts? If so, have deferred taxes on these differences been properly reflected in the financial statements?

d. Do the financial statements reflect an appropriate provision for **taxes other than income taxes** (e.g., franchise, sales)?

e. Have all **required tax payments been made** on a timely basis?

f. Has the entity assessed **uncertain tax positions** and related disclosures?

11. **Other liabilities, contingencies, and commitments**

a. What is the **nature of the amounts** included in other liabilities?

b. Have other liabilities been properly classified between **current and non-current**?

c. Are there any **guarantees**, whether written or verbal, whereby the entity must stand ready to perform or is contingently liable related to the guarantee? If so, are these guarantees properly reflected in the financial statements?

d. Are there any **contingent liabilities** (e.g., discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims)? Are there any potential **unasserted claims**? Are these contingent liabilities, claims, and assessments properly measured and disclosed in the financial statements?

e. Are there any material **contractual obligations for construction or purchase** of property and equipment or any commitments or options to purchase or sell company securities? If so, are these facts clearly disclosed in the financial statements?

f. Is the entity responsible for any **environmental remediation liability**? If so, is this liability properly measured and disclosed in the financial statements?

g. Does the entity have any **agreement to repurchase items** that previously were sold? If so, have the repurchase agreements been taken into account in determining the appropriate measurements and disclosures in the financial statements?

h. Does the entity have any **sales commitments at prices expected to result in a loss** at the consummation of the sale? If so, are these commitments properly reflected in the financial statements?

i. Are there any **purchase commitments** for quantities in excess of requirements or at prices in excess of market?

j. Are there any **violations, or possible violations, of laws or regulations** the effects of which should be considered for financial statement accrual or disclosure?

12. **Stockholders' equity**

a. What is the **nature of any changes** in equity accounts during each reporting period?

b. What **classes of stock** (other ownership interests) have been authorized?

c. What is **the par or stated value** of the various classes of stock (other ownership interests)?

d. Do amounts of **outstanding shares** of stock (other ownership interests) agree with subsidiary records?

e. Have pertinent **rights and privileges of ownership interests** been properly disclosed in the financial statements?

f. Does the entity have any **mandatorily redeemable ownership interests**? If so, have these ownership interests been evaluated to determine whether they should be measured and reclassified to the liability section of the balance sheet? Are redemption features associated with ownership interests clearly disclosed in the financial statements?

g. Have **dividend (distribution) and liquidation preferences** related to ownership interests been properly disclosed in the financial statements?

h. Do **disclosures related to ownership interests** include any applicable call provisions (price and dates), conversion provisions (prices and rates), unusual voting rights, significant terms of contracts to issue additional ownership interests, or any other unusual features associated with the ownership interests?

i. Are **syndication fees** properly reflected in the financial statements as a reduction of equity (rather than an asset)?

j. Have any **stock options or other stock compensation awards** been granted to employees or others? If so, are these options or awards properly measured and disclosed in the financial statements?

k. Has the entity made any **acquisitions of its own stock**? If so, are the amounts associated with these reacquired shares properly reflected in the financial statements as a reduction in equity? Is the presentation in accordance with applicable state laws?

l. Are there any **restrictions or appropriations on retained earnings or other capital accounts**? If so, are these restrictions or appropriations properly reflected in the financial statements?

13. **Revenue and expenses**

   a. What is the entity's **revenue recognition policy**? Is the policy appropriate? Has the policy been consistently applied and appropriately disclosed?

   b. Are revenues from sales of products and rendering of services recognized **in the appropriate reporting period** (that is, when the products have been delivered and when services have been performed)?

   c. Were any sales recorded under a "**bill and hold**" arrangement? If yes, have the criteria been met to record the transaction as a sale?

   d. Are **purchases and expenses recognized in the appropriate reporting period** (that is, matched against revenue) and properly classified in the financial statements?

   e. Do the financial statements include **discontinued operations, items that might be considered extraordinary**, or both? If so, are amounts associated with discontinued operations, extraordinary items, or both properly displayed in the income statement?

   f. Does the entity have any gains or losses that would necessitate the display of **comprehensive income** (e.g., gains/losses on available-for-sale securities or cash flow hedge derivatives)? If so, have these items been properly displayed within comprehensive income (rather than included in the determination of net income)?

14. **Other**

   a. Have **events occurred subsequent to the balance sheet date** that would require adjustment to, or disclosure in, the financial statements?

   b. Have **actions taken at** stockholders, directors, committees of directors, or comparable **meetings** that affect the financial statements been reflected in the financial statements?

   c. Are **significant estimates and material concentrations** (e.g., customers or suppliers) properly disclosed in the financial statements?

   d. Are there **plans or intentions that may materially affect the carrying amounts or classification** of assets and liabilities reflected in the financial statements?

   e. Have there been material transactions between or among **related parties** (e.g., sales, purchases, loans, or leasing arrangements)? If so, are these transactions properly disclosed in the financial statements?

   f. Are there **uncertainties** that could have a material impact on the financial statements? Is there any change in the status of previously disclosed material uncertainties? Are all uncertainties (including going concern matters) that could have a material impact on the financial statements properly disclosed in the financial statements?

   g. Are **barter or other non-monetary transactions** properly recorded and disclosed?

B. Inquiries resulting from analytical procedures

Similar to responses to your analytics questions, responses to your inquiries constitute review evidence when you evaluate them in relation to your knowledge of the client, its industry, and other review evidence that you have gathered during the engagement.

If your analytical procedures identify fluctuations or relationships that are inconsistent with your expectations or other relevant information, you need to follow up with inquiries of management concerning these inconsistencies, and document management's responses.

If you are satisfied with management's responses, you do not need to corroborate them with other review evidence. However, if management is not able to adequately explain inconsistent data fluctuations or relationships, or if their explanations do not seem quite right in light of your other review evidence, you should perform additional review procedures.

VI. Additional review procedures

Additional review procedures can run the gamut from performing additional analytical procedures, perhaps in a more precise fashion or using a drill-down approach, to additional more aggressive and investigative inquiries of an expanded group of entity personnel or those charged with governance.

Additional review procedures are a matter of your professional judgment.

Examples of additional review procedures you might perform during your engagement include:

- Confirming accounts receivable balances;
- Checking physical inventory items for obvious obsolescence; and
- Reviewing the minutes of any stockholder (or board of directors) meetings for information that might affect the financial statements.

However, these would be performed generally when the results of your planned analytical procedures and other inquiries do not provide the required assurance to support the review opinion.

A. Procedures related to suspected fraud and noncompliance with laws or regulations

When there is an indication that fraud or noncompliance with laws or regulations has occurred, or is suspected to have occurred, the effects of which should be considered when preparing financial statements, the accountant should do the following:

- Communicate identified or suspected fraud as soon as practical to the appropriate level of senior management (at a level above those involved with the suspected fraud, if possible) or those charged with governance, as appropriate.
- Communicate to management identified or suspected noncompliance with laws and regulations whose effects should be considered when preparing financial statements, other than matters that are clearly inconsequential.
- Request management's assessment of the effects, if any, on the financial statements.
- Consider the effect, if any, of management's assessment of the effects of fraud or noncompliance with laws or regulations communicated to the accountant on the accountant's conclusion on the financial statements and on the accountant's report.
- Determine whether there is a responsibility to report the occurrence or suspicion of fraud or noncompliance with laws and regulations to a party outside the entity.

If the fraud or noncompliance with laws or regulations involves senior management or results in a material misstatement of the financial statements, the accountant should communicate the matter directly to those charged with governance. The accountant should consider the need to obtain legal advice and take appropriate action – including potential withdrawal – if management or, as appropriate, those charged with governance, do not provide sufficient information that supports either of the following:

- The financial statements are not materially misstated due to fraud; and
- The entity is in compliance with laws and regulations, and in the accountant's professional judgment, the effect of the suspected noncompliance may be material to the financial statements.

B. Procedures to address related party transactions

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

If the accountant identifies significant transactions outside the entity's normal course of business when performing the review procedure required by the above or through other review procedures, the accountant should inquire of management about the following:

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

C. Using the work of others

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

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

D. Reconciling the financial statements to the underlying accounting records

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

E. Additional procedures when the accountant becomes aware that the financial statements may be materially misstated

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

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

Additional procedures are required when the accountant becomes aware of a matter that causes the accountant to believe that the financial statements may be materially misstated. However, the response will vary based on the circumstances, is based on professional judgment, and is guided by the following:

- Information obtained from the accountant's evaluation of the results of the procedures already performed;
- The accountant's updated understanding of the entity and its environment obtained throughout the course of the engagement; and
- The accountant's view on the persuasiveness of review evidence needed to address the matter that causes the accountant to believe that the financial statements may be materially misstated.

The additional procedures should focus on allowing the accountant to conclude on matters which the accountant believes may cause the financial statements to be materially misstated. They may consist of additional inquiry or analytical procedures, performed in greater detail or focused on the affected items or other types of procedures; for example, a substantive test of details or external confirmations.

VII. Consideration of an entity's ability to continue as a going concern under AR-C 90

A. ASU No. 2014-15

In August 2014, the FASB issued ASU No. 2014-15. This Update provided guidance on management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures, which should reduce diversity in the timing and content of footnote disclosures. Currently, there is no guidance in U.S. GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern or to provide related footnote disclosures. Because of the lack of guidance in U.S. GAAP and the differing views about when there is substantial doubt about an entity's ability to continue as a going concern, there is diversity in whether, when, and how an entity discloses the relevant conditions and events in its footnotes.

The Update applies to all entities.

ASU No. 2014-15 requires management to assess an entity's ability to continue as a going concern, incorporating and expanding on certain principles currently in U.S. auditing standards.

Specifically, ASU No. 2014-15:

- Provides a definition of the term *substantial doubt about an entity's ability to continue as a going concern*;
- Requires an evaluation every reporting period, including interim periods;
- Provides principles for considering the mitigating effect of management's plans;
- Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans;
- Requires an express statement and other disclosures when substantial doubt is not alleviated; and
- Requires an assessment for a period of one year after the date that the financial statements are issued (or available to be issued).

In connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued (or at the date that the financial statements are available to be issued when applicable).

ASU No. 2014-15 amends the Master Glossary of the Codification to add the new term *substantial doubt about an entity's ability to continue as a going concern*, which is defined as follows:

Substantial Doubt about an Entity's Ability to Continue as a Going Concern – Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). The term probable is used consistently with its use in ASC 450, *Contingencies*.

When management identifies conditions or events that raise substantial doubt about an entity's ability to continue as a going concern, management should consider whether its plans that are intended to mitigate those relevant conditions or events will alleviate the substantial doubt. The mitigating effect of management's plans should be considered only to the extent that it is probable that the plans will be effectively implemented; and, if so, it is probable that the plans will mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.

If conditions or events raise substantial doubt about an entity's ability to continue as a going concern, but the substantial doubt is alleviated as a result of consideration of management's plans, the entity should disclose information that enables users of the financial statements to understand all of the following (or refer to similar information disclosed elsewhere in the footnotes):

1. Principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern (before consideration of management's plans);
2. Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations; and
3. Management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern.

If conditions or events raise substantial doubt about an entity's ability to continue as a going concern, and substantial doubt is not alleviated after consideration of management's plans, an entity should include a statement in the footnotes indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued).

Additionally, the entity should disclose information that enables users of the financial statements to understand all of the following:

1. Principal conditions or events that raise substantial doubt about the entity's ability to continue as a going concern;
2. Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations; and
3. Management's plans that are intended to mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.

1. Impact on existing auditing and accounting and review services standards

Both auditing and SSARS guidance issued prior to the effective date of ASU No. 2014-15 needed to be updated in order to reflect the accountant's new responsibilities in evaluating management's disclosures related to going concern under ASU No. 2014-15. Also, reporting guidance needed to be updated to reflect circumstances related to the inadequacy of management's going concern disclosures as well as the reporting implications when substantial doubt does exist related to an entity's ability to continue as a going concern.

On the audit side, SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* conformed the auditing requirements with the new financial reporting requirements. However, the SSARS guidance also needed to be conformed. That's where SSARS No. 24 comes into play.

2. Impact on review services and SSARS No. 24

Specifically, the amendments to AR-C section 90 to conform the going concern guidance are as follows:

- Revises paragraph .05 to include the definition of "reasonable period of time" and adds application guidance. Per this definition, a reasonable period of time is the period of time required by the applicable reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable).
- Revises paragraph .34 to include a specific written representation regarding disclosure of all information relevant to the use of the going concern assumption in the preparation of the financial statements.
- Revises paragraph .39 to make the requirements regarding the contents of the accountant's review report consistent with the illustrative report examples in Exhibit C of AR-C section 90. (Note: this amendment would be effective immediately upon issuance of the new SSARS.)
- Adds paragraph .65 to require the accountant, if the applicable financial reporting framework includes requirements for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements, to perform review procedures related to: (a) whether the going concern basis of accounting is appropriate; (b) management's evaluation of whether there are conditions or events that raised substantial doubt about the entity's ability to continue as a going concern; (c) if there are conditions or events that raised substantial doubt about the entity's ability to continue as a going concern, management's plans to mitigate those matters; and (d) the adequacy of the related disclosures in the financial statements. Adds paragraphs .A116 and .A117 to provide additional guidance regarding the requirement.

- Revises extant paragraph .65 to require the accountant, if the applicable financial reporting framework does not include a requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements and: (a) conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time existed at the date of the prior period financial statements, regardless of whether the substantial doubt was alleviated by the accountant's consideration of management's plans; or (b) in the course of performing review procedures on the current period financial statements, the accountant becomes aware of conditions or events that raise substantial doubt, to do the following:
    - Inquire of management whether the going concern basis of accounting is appropriate;
    - Inquire of management about its plans for dealing with the adverse effects of the conditions and events; and
    - Consider the adequacy of the disclosure about such matters in the financial statements.
- Amends paragraph .A115-.A116 and adds paragraph .A120 to provide additional guidance regarding the requirement.
- Adds paragraph .67 to require the accountant to include an emphasis-of-matter paragraph in the accountant's review report if, after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable time remains. Revises paragraphs .A118-.A119 and adds paragraphs .A124-.A125 to provide guidance.
- Adds paragraph .78 to preclude the accountant from referencing, in the accountant's review report, the review or audit report of other accountants if such accountant's report includes an alert that restricts the use of such report.
- Revises paragraph .79 of AR-C section 90 to include a requirement that the accountant of the reporting entity communicate with the other accountants and determine the other accountants understand the ethical requirements relevant to the engagement and, in particular, are independent. Adds paragraphs .A134-.A135 to AR-C section 90 to provide guidance with respect to the new requirement and the requirement for the accountant of the reporting entity to communicate with the other accountants and determine the other accountants are familiar with the applicable financial reporting framework and with SSARS or with auditing standards generally accepted in the United States of America, and as applicable, will conduct the review or audit in accordance therewith.
- Adds paragraph .80 to preclude the accountant, if the component's financial statements are prepared using a different financial reporting framework from that used for the financial statements of the reporting entity, from referencing the review or audit of the other accountants in the review report of the accountant of the reporting entity unless:
    - The accountant has determined that the measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements in accordance with the financial reporting framework used by the component are similar to the criteria that are applicable to all material items in the reporting entity's financial statements in accordance with the financial reporting framework used by the reporting entity.

- The accountant of the reporting entity has obtained sufficient appropriate review evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the reporting entity without the need to assume responsibility for, and thus be involved in, the work of the other accountants.

SSARS No. 25 amended AR-C section 90 to require the certain procedures regarding considerations related to going concern. If the applicable financial reporting framework includes requirements for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements, the accountant should perform review procedures related to the following:

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

If the applicable financial reporting framework does not include a requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements, and conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of the prior period financial statements (regardless of whether the substantial doubt was alleviated by the accountant's consideration of management's plans) or, in the course of performing review procedures on the current period financial statements, the accountant becomes aware of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, the accountant should do the following:

- Inquire of management whether the going concern basis of accounting is appropriate.
- Inquire of management about its plans for addressing the adverse effects of the conditions and events.
- Consider the adequacy of the disclosure about such matters in the financial statements.

However, note that a review of financial statements is not designed to identity conditions or events that raise doubts about an entity's ability to continue as a going concern for a reasonable period of time. However, such conditions may have existed at the date of the prior year's financial statements or may have been identified as a result of performing review procedures. The following are examples of conditions or events that may give rise to substantial doubt:

- Negative trends;
- Other indications of possible financial difficulties;
- Internal matters; and
- External matters.

The significance of such events can be mitigated by actions that management plans to take to address this risk. Such actions include:

- Plans to dispose of an asset or business;
- Plans to borrow money or restructure debt;
- Plans to reduce or delay expenditures; and
- Plans to increase ownership equity.

Management should consider the feasibility of such plans; legal, regulatory or other restrictions which may impact its ability to implement the plan; and other restrictions, as appropriate, when determining the feasibility of its plan and consider the requirements of the financial reporting framework which it used when developing its disclosures.

Reporting issues related to going concern are discussed in the reporting section of this chapter.

VIII. "Final read"

After you have performed your analytical procedures, inquiries, and any additional review procedures, you should take an overall review of the financial statements to make sure they are in conformity with the financial reporting framework used to prepare them. This overall review is also intended to make sure there are no obvious errors (typos, math, application of accounting principles, inadequate disclosures) in any of the statements before submitting them to the client.

The objective of this "final read" is basically to make sure you do not end up associating yourself with misleading financial statements, which is an ethics violation. If you do end up concluding that the financial statements are in fact misleading (for whatever reason), you should withdraw from the engagement.

Additionally, the accountant should obtain and read the reports from other accountants if those other accountants issued a report on a significant component of the financial statements, such as a material subsidiary or an equity investee. You will also need to determine if you will be referring to these other accountants' reports in your review report.

The accountant, as part of the review procedures, should also ensure that financial statements agree or reconcile to the underlying accounting records.

IX. Evaluating the evidence obtained

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

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

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

A. Considerations related to the financial reporting framework

SSARS No. 25 added specific guidance on the consideration of the applicable financial reporting framework in relation to the financial statements. In forming the conclusion on the financial statements, the accountant should do the following:

- Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework;
- Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:

- The terminology used in the financial statements, including the title of each financial statement, is appropriate;
- The financial statements adequately disclose the significant accounting policies selected and applied;
- The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- Accounting estimates made by management appear reasonable;
- The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and
- The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements.

The accountant should consider the impact of the following:

- Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole.
- Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

The accountant's consideration should also include the overall presentation, structure, and content of the financial statements and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

X. Subsequent events and subsequently discovered facts

A. Subsequent events

When evidence or information that subsequent events that require adjustment of, or disclosure in, the financial statements comes to the accountant's attention, the accountant should request that management consider whether each such event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework. This information may be obtained from performing review procedures or subsequent to the report date but before its release.

If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, the accountant should consider modifying the report, as appropriate, for the departure from the financial reporting framework.

B. Subsequently discovered facts that become known to the accountant before the report release date

The accountant is not required to perform any review procedures regarding the financial statements after the date of the accountant's review report. However, if a subsequently discovered fact becomes known to the accountant before the report release date, the accountant should both discuss the matter with management and, when appropriate, those charged with governance and determine whether the financial statements need revision; and, if revision is needed, inquire how management intends to address the matter in the financial statements.

1. Financial statements revised by management

If management revises the financial statements, the accountant should perform the review procedures necessary in the circumstances on the revision.

The accountant should also do either of the following:

a. Date the accountant's review report as of a later date, or
b. Dual-date the accountant's review report for that revision only.

2. Financial statements not revised by management

If management does not revise the financial statements in circumstances in which the accountant believes they need to be revised, the accountant should modify the accountant's review report or withdraw, as appropriate.

C. Subsequently discovered facts that become known to the accountant after the report release date

If a subsequently discovered fact becomes known to the accountant after the report release date, the accountant should both discuss the matter with management and, when appropriate, those charged with governance and determine whether the financial statements need revision; and, if revision is needed, inquire how management intends to address the matter in the financial statements.

If management revises the financial statements, the accountant should date the revised report as of the later date or dual-date the report only for the adjustment.

Further, if the reviewed financial statements (before revision) have been made available to third parties, the accountant must assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of those financial statements is informed of the situation, including that the reviewed financial statements are not to be used. Such steps include notifying anyone who is using or is likely to be using the financial statements; issuing revised financial statements, with appropriate disclosures; and issuing the subsequent period's financial statements, with appropriate disclosures. If management does not take the necessary steps, the accountant should apply the requirements below dealing with management not revising financial statements which the accountant believes should be revised.

If the accountant's conclusion on the revised financial statements differs from the accountant's conclusion on the original financial statements, the accountant should disclose in an emphasis-of-matter paragraph that includes:

- The date of the accountant's previous report;
- A description of the revisions; and
- The substantive reasons for the revisions.

If management does not revise the financial statements in circumstances in which the accountant believes they need to be revised, then the accountant should do the following:

a. If the reviewed financial statements have not been made available to third parties, notify management and those charged with governance (unless all of those charged with governance are involved in managing the entity) not to make the reviewed financial statements available to third parties before the necessary revisions have been made and a new accountant's review report on the revised financial statements has been provided.

If the reviewed financial statements are, nevertheless, subsequently made available to third parties without the necessary revisions, the accountant should apply the guidance in b., below.

b. If the reviewed financial statements have been made available to third parties, assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of the reviewed financial statements is informed of the situation, including that the reviewed financial statements are not to be used. If management does not take the necessary steps, the accountant should perform the following as well.

If management does not take the necessary steps to ensure that anyone in receipt of the financial statements is informed of the situation, the accountant should notify management and those charged with governance (unless all of those charged with governance are involved in managing the entity) that the accountant will seek to prevent future use of the accountant's review report. If, despite such notification, management or those charged with governance do not take the necessary steps, the accountant should take appropriate action to seek to prevent use of the accountant's review report.

XI. Management representations

You are required to obtain written representations from management for all of the periods covered in your review report. The specific representations are a matter of your professional judgment and of course will depend on the particular engagement circumstances. However, they should include any representations management made to you, explicitly or implicitly, during your engagement.

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

Management's representations should come from those who have appropriate responsibility for the financial statements as well as knowledge of the matters concerned. Standard representations should include that:

a. Management has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
b. Management acknowledges its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements, including its responsibility to prevent and detect fraud.
c. All transactions have been recorded and are reflected in the financial statements.
d. Management has provided the accountant with all relevant information and access to information, as agreed upon in the terms of the engagement.
e. Management has responded fully and truthfully to all of the accountant's inquiries.
f. Management has disclosed to the accountant the identity of the entity's related parties and all the related party relationships and transactions of which it is aware, and it has appropriately accounted for and disclosed such relationships and transactions.
g. Management has disclosed to the accountant significant facts related to any fraud or suspected fraud known to management that may have affected the entity involving:
   (i) Management;
   (ii) Employees who have significant roles in internal control; or
   (iii) Others, when the fraud could have a material effect on the financial statements.

h. Management has disclosed to the accountant significant facts relating to any allegations of fraud or suspected fraud known to management that may have affected the entity's financial statements communicated by employees, former employees, regulators, or others.
i. Management has disclosed to the accountant all known actual or possible instances of noncompliance with laws and regulations whose effects should be considered when preparing financial statements.
j. Management has disclosed to the accountant all information relevant to the use of the going concern assumption in the financial statements.
k. Management has properly accounted for all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure, and it has made the necessary adjustments or disclosures.
l. Whether management believes that the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation.
m. Management has disclosed to the accountant all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements, and it has appropriately accounted for and disclosed such litigation and claims in accordance with the applicable financial reporting framework.
n. Whether management believes that significant assumptions used by it in making accounting estimates are reasonable.

If, in addition to the representations required by paragraph .34 of AR-C section 90, the accountant determines that it is necessary to obtain one or more written representations to support other review evidence relevant to the financial statements, the accountant should request these additional written representations.

Further, the accountant should consider withdrawing from the engagement if management does not provide the necessary written representations or the accountant concludes there are reasons to doubt management's integrity such that the representations provided are not reliable.

XII. Documentation in a review engagement

Just like our financial statement preparation and compilation engagements, you need to document the work you have done on your review engagement in sufficient detail to provide a clear understanding of what you did. The standard established in SSARS No. 21 is that the documentation should allow an experienced accountant, with no prior connection to the review, to understand the following:

a. The nature, timing, and extent of the review procedures you performed;
b. The review evidence obtained from those procedures and the accountant's conclusions formed on the basis of that review evidence;
c. All of the review evidence obtained and its source; and
d. The significant matters arising during the review, the conclusions you reached in connection with all of your work, and the professional judgments made in reaching those conclusions.

This type of documentation will provide the primary support for the statements in your review report that you performed the engagement in accordance with SSARSs and that you are 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 statement framework.

The specific documentation (form, content, and extent) will of course depend on how you conducted the particular engagement and your professional judgment, but should include:

- Your engagement letter;
- The analytical procedures you performed, including:
  - Your expectations and the factors used to develop them;
  - The results of your procedures; and
  - Management's responses to your inquiries regarding any inconsistent results.
- Any additional review procedures you performed and their results;
- Your inquiries of management and their responses;
- Any issues or unusual matters in your professional judgment that are significant and the actions (and basis for those actions) you took to address and resolve them;
- Communications with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters;
- If, in the course of the engagement, the accountant identified information that is inconsistent with the accountant's findings regarding significant matters affecting the financial statements, how the inconsistency was addressed;
- Communications with other accountants that have audited or reviewed the financial statements of significant components of the financial statements;
- The management representations letter;
- A copy of the reviewed financial statement and review opinion; and
- Communications with management concerning the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report.

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

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

XIII. Work of other accountants

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

Also, if other accountants audited or reviewed the financial statements of significant components, such as consolidated and unconsolidated subsidiaries and investees, and the accountant of the reporting entity decides not to assume responsibility for the audit or review performed by the other accountants, the accountant of the reporting entity should make reference to the review or audit of such other accountants in the accountant's review report. In that instance, the accountant should clearly indicate in the accountant's review report that the accountant used the work of other accountants and should include the magnitude of the portion of the financial statements audited or reviewed by the other accountants. AR-C section 90 contains an example of the wording of such a report.

The accountant of the reporting entity may make reference to any or all other accountants who audited or reviewed significant components. For example, if a significant component is audited or reviewed by an other accountant and a second significant component is audited or reviewed by a different other accountant, the accountant of the reporting entity may decide to make reference to one of the other accountants, both of the other accountants, or neither. The decision is solely at the discretion and judgment of the accountant of the reporting entity.

The disclosure of the magnitude of the portion of the financial statements audited or reviewed by other accountants may be achieved by stating the dollar amounts or percentages of total assets, total revenues, other appropriate criteria, or a combination of these, whichever most clearly describes the portion of the financial statements audited or reviewed by other accountants. When two or more other accountants participate in the audit or review, the dollar amounts or the percentages covered by the other accountants may be stated in the aggregate.

Also, reference to the audit or review of other accountants in the accountant's review report on the reporting entity should not be made if the other accountants issued an auditor's or an accountant's review report that includes an alert that restricts the use of such report.

Regardless of whether the accountant of the reporting entity decides to make reference to the review or audit of other accountants, the accountant of the reporting entity should communicate with the other accountants and determine the following:

- The other accountants are aware that the financial statements of the component that the other accountants have audited or reviewed are to be included in the financial statements on which the accountant of the reporting entity will report and that the other accountants' report thereon will be relied upon and, where applicable, referred to by the accountant of the reporting entity.
- The other accountants are familiar with the applicable financial reporting framework and with SSARS or GAAS, as applicable, and will conduct the review or audit in accordance therewith.
- The other accountants understand the ethical requirements that are relevant to the engagement and, in particular, are independent.
- A review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

If the component's financial statements are prepared using a different financial reporting framework from that used for the financial statements of the reporting entity, reference to the review or audit of the other accountants in the review report of the accountant of the reporting entity should not be made unless the following apply:

1. The accountant has determined that the measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements in accordance with the financial reporting framework used by the component are similar to the criteria that are applicable to all material items in the reporting entity's financial statements in accordance with the financial reporting framework used by the reporting entity.

2. The accountant of the reporting entity has obtained sufficient appropriate review evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the reporting entity without the need to assume responsibility for, and thus be involved in, the work of the other accountants.

AR-C section 90 provides further guidance on the application of this guidance.

XIV. Client communications

Paragraph .18 of AR-C section 90 states that the accountant should communicate with management, on a timely basis, all matters concerning the review engagement that are of significant importance to merit such communication. Unlike an audit, where such required communications are delineated, the accountant must use professional judgment in determining what to communicate and when to do it.

In a review engagement, the accountant's communications with management and those charged with governance consist of inquiries the accountant makes in the course of performing the procedures for the review and other communications, in the context of having effective two-way communication to understand matters arising and to develop a constructive working relationship for the engagement.

The appropriate timing for communications will vary with the circumstances of the engagement. Relevant factors include the significance and nature of the matter and any action expected to be taken by management or those charged with governance. For example, it may be appropriate to communicate a significant difficulty encountered during the review as soon as practicable if management or those charged with governance are able to assist the accountant to overcome the difficulty.

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

A. Communicating matters concerning the review

Matters to be communicated to management or those charged with governance, as appropriate, may include the following:

- The accountant's responsibilities in the review engagement, as included in the engagement letter or other suitable form of written agreement.
- Significant findings from the review, such as:
  - The accountant's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.
  - Significant findings from the performance of procedures, including situations when the accountant considered performance of additional procedures necessary. The accountant may need to confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

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

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

B. Communication with third parties

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

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance.
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies or, in some cases, make such reports publicly available.

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

XV. Reporting on a review engagement

As we stated at the beginning of this chapter, one of the biggest areas of change between SSARS No. 19 and SSARS No. 21 is in the area of the accountant's review report.

Under SSARS No. 21, the accountant's review report has been enhanced, including its required elements and format, to better communicate management's and the accountant's responsibilities, and the accountant's conclusions.

While often provided for single year financial statements, an accountant's review opinion can cover comparative financial statements. In such instance, the report should refer to both years presented in the financial statements. The report on the prior periods presented should be updated and be dated no earlier than the appropriate date used for the current year financial statements. The accountant should consider any information obtained in the current year procedures that would impact the prior period financial statements presented.

Below is the format of the standard accountant's review report on comparative financial statements. Note the following changes made to the standard review report following SSARS No. 25, summarized as follows:

- Within the Accountant's Responsibility section, a statement that the accountant is required to be independent of the entity and to meet the accountant's other ethical responsibilities, in accordance with the relevant ethical requirements related to the review.
- A concluding section with an appropriate heading that includes the accountant's conclusion and that identifies the country of origin of the financial reporting framework, if applicable.
- When the accountant's conclusion is modified, both a paragraph under the appropriate heading that contains the accountant's modified conclusion and a paragraph under an appropriate heading that provides a description of the matter(s) giving rise to the modification.

Independent Accountant's Review Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

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

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

Accountant's Conclusion

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

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

A. Title and independence

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."

B. Addressee and entity

Your review report should be addressed to the proper person or persons, for example, the owner of XYZ Company, or perhaps to the board of directors.

C. Introductory paragraph

Your introductory paragraph includes:

- The type of engagement – "I have reviewed"
- The specific financial statements of the business and timeframe
    - The accompanying annual statement of assets, liabilities, and equity of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income and cash flows for the year then ended;
- What a review is and its context relative to an audit
    - 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; and
- That you are not expressing an opinion on the financial statements
    - "Accordingly, I do not express such an opinion."

D. Responsibility paragraphs

1. Management's responsibilities

Just as was the case in our compilation, in a review engagement management (or the business owner) is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework being used, in our case, U.S. GAAP, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

2. Your responsibility

Your responsibility is to conduct the review in accordance with the SSARSs issued by the AICPA. Your report also needs to specifically state what SSARSs require of you and the basis of your report:

- Those standards [SSARSs] require me to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I believe that the results of my procedures provide a reasonable basis for my report.
    - Note the reference to the accountant being independent and meeting other ethical requirements. This phrase was added by SSARS No. 25.

E. Your conclusion – NOT opinion

Remember, you are not expressing an opinion on the financial statements (which is audit language), but rather simply that you are not "aware."

- Based on my review, I am 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.

F. Sign and date it

Sign your report, and date it. Note that the report date should be no earlier than the date that the accountant completed procedures that were sufficient to obtain limited assurance that the financial statements were free of material misstatement.

In certain instances, another accountant may have either audited or reviewed the financial statements of significant components, such as a division or subsidiary, of the entity's financial statements. The entity's reporting accountant needs to decide whether to assume responsibility for this work performed by the other accountant. If not taking responsibility, the reporting entity's accountant should make reference to the other accountant's audit or review report in its review report, stating that the accountant used the work of the other accountant and include the magnitude of the portion of the financial statements audited or reviewed by the other accountant.

Whether accepting responsibility or not for the other accountant's work, the reporting entity accountant should communicate with the other accountant to determine the following:

- That the components that the other accountant reviewed or audited will be included in the reporting entity financial statements on which a review report will be issued.
- Whether the other accountant's review or audit report will be relied upon and reference made in the reporting entity's review opinion.
- That the other accountants are familiar with the SSARS and that their engagement will be carried out in accordance with them.
- That a review of the elimination of intercompany transactions and accounts will be performed as well as a review of the uniformity of accounting polices used by the component.

When the accountant is using the work of other accountants who have audited or reviewed components of the reporting entity's financial statements, the Accountant's Responsibility and Accountant's Conclusion paragraphs of the standard review report should be modified as follows:

> **Accountant's Responsibility**
> My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the AICPA. We have not reviewed the financial statements of ABC Company, a wholly owned subsidiary, whose financial statements reflect total assets constituting 25 percent and 28 percent, respectively, of consolidated total assets at December 31, 20X5 and 20X6, and total revenues constituting 20 percent and 22 percent, respectively, of consolidated total revenues for the years then ended. Those statements were reviewed by other accountants, whose report has been furnished to me (us), and our conclusion, insofar as it relates to the amounts included for ABC Company, is based solely on the report of the other accountants. SSARS requires me (us) to perform procedures to obtain limited assurance as a

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

I am (We are) required to be independent of ABC Company and to meet my (our) other ethical responsibilities, in accordance with the relevant ethical requirements related to my (our) reviews.

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

XVI. Emphasis-of-matter paragraphs

AR-C section 90 requires the accountant to include an emphasis-of-matter or other-matter paragraph in the accountant's review report relating to the following matters:

- Financial statements prepared in accordance with a special purpose framework.
- A changed reference to a departure from the applicable financial reporting framework when reporting on comparative financial statements.
- Reporting on comparative financial statements when the prior period is audited.
- Reporting a known departure from the applicable financial reporting framework that is material to the financial statements.
- Reporting when management revises financial statements for a subsequently discovered fact that became known to the accountant after the report release date and the accountant's review report on the revised financial statements differs from the accountant's review report on the original financial statements.
- Supplementary information that accompanies reviewed financial statements and the accountant's review report thereon.
- Required supplementary information.

In addition, AR-C section 90 also requires the accountant to include:

- An emphasis-of-matter paragraph in the accountant's review report when the accountant considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to the user's understanding of the financial statements, provided that the accountant does not believe that the financial statements may be materially misstated.
- An other-matter paragraph in the accountant's review report when the accountant considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the accountant's professional judgment, is relevant to the users' understanding of the review, the accountant's responsibilities, or the accountant's review report.

If the accountant expects to include an emphasis-of-matter or other-matter paragraph in the accountant's review report, AR-C section 90 requires the accountant to communicate with management regarding this expectation and the proposed wording of this paragraph.

Here is an example of an emphasis-of-matter paragraph that the accountant would add to highlight an entity's change in accounting estimate.

> **Emphasis-of Matter – Change in Estimate**
> As more fully described in Note X to the financial statements, during [insert period], XYZ Company changed the estimated useful lives of several depreciable items included in property, plant, and equipment.

We will review the impact of these circumstances on the accountant's report in the following section.

XVII. Other review engagement reporting issues

This section will review these and other unique reporting situations, beginning with reporting when the financial statements are prepared using a special purpose framework.

There are many circumstances where the accountant would want to add an emphasis-of-matter or other matter paragraph to the standard review report. As a general rule, whenever the accountants wants to draw the reader's attention to a matter appropriately presented or disclosed in the financial statements that is essential for the reader to be aware of this instance, the accountant would add an emphasis-of-matter paragraph to the review report that follows the conclusion paragraph presented above. The caption "Emphasis-of-Matter" would precede the paragraph and there would be a clear reference to the footnote where the item being emphasized in the paragraph is described in greater detail. It is important to note that, with such a paragraph, the accountant is not saying that the financial statements are materially misstated but merely drawing the reader's attention to the matter.

Additionally, if the accountant wants to draw the reader's attention to a matter that is not disclosed in the financial statements, the accountant would add an other-matter paragraph. This paragraph would go after the conclusion paragraph and any emphasis-of-matter paragraph, if applicable.

Lastly, the accountant should communicate the necessity and wording of either an emphasis-of-matter or other-matter paragraph with management as early as possible in the engagement.

However, remember that an accountant cannot issue a report on an incomplete review engagement. A review engagement is considered "incomplete" if:

- You are not able to perform the analytical procedures or inquiries you feel are necessary to obtain limited assurance that the financial statements are in conformity with the applicable financial reporting framework; or
- The client does not provide you with a representation letter.

Since these are the keystone requirements of a review engagement, you cannot issue a review report in these circumstances.

The following are common instances where an accountant would add either an emphasis-of-matter or other-matter paragraph or otherwise modify the standard review report.

A. Modified conclusion concerning presentation of financial statements in accordance with the applicable financial reporting framework

The consideration of whether anything came to the accountant's attention that would require an adjustment to the financial statements may lead the accountant to believe that the standard conclusion on the financial statements should be modified. In such instances, the accountant should express a modified conclusion in the accountant's review report on the financial statements as a whole when the accountant determines, based on the procedures performed and the review evidence obtained, that the financial statements are materially misstated.

When the accountant modifies the conclusion expressed on the financial statements, the accountant should do the following:

- Use the heading "Qualified Conclusion" or "Adverse Conclusion," as appropriate, for the conclusion paragraph in the accountant's review report.
- Provide a description of the matter giving rise to the modification, under an appropriate heading (for example, "Basis for Qualified Conclusion," or "Basis for Adverse Conclusion," as appropriate), in a separate paragraph in the accountant's review report immediately before the conclusion paragraph (referred to as the basis for conclusion paragraph).

SSARS No. 25 added the option for the accountant to report that the financial statements are materially misstated. If the accountant, having obtained sufficient appropriate review evidence, determines, or is otherwise aware, that the financial statements are materially misstated, the accountant should express one of the following:

a. A qualified conclusion, when the accountant concludes that the effects of the matter or matters giving rise to the modification are material but not pervasive to the financial statements.
b. An adverse conclusion, when the effects of the matter or matters giving rise to the modification are both material and pervasive to the financial statements.

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

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

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

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

Note that an adverse conclusion does not justify the proper inclusion in the report of other matters that would require a modification of the accountant's conclusion.

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

- Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures) and the effects of the departure on the financial statements have been determined by management or are known to the accountant as a result of the accountant's procedures. If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to determine the effects of the departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.
- Explain how disclosures are misstated if the material misstatement relates to narrative disclosures.
- Describe the nature of omitted information if the material misstatement relates to the nondisclosure of information required to be disclosed. The accountant should include the omitted disclosures when practicable to do so.

B. Accountant's review report on financial statements prepared in accordance with a special purpose framework

When reporting on financial statements prepared in accordance with a special purpose framework, the accountant's report, this framework should be appropriately described in the accountant's report and the report that management takes responsibility that the applicable financial reporting framework is acceptable when it has a choice of options from which to choose. Examples of a special purpose framework include cash-basis, modified cash-basis, income tax-basis, the AICPA's Financial Reporting Framework for Small-and- medium Sized Entities™, contractual-basis of accounting, regulatory-basis of accounting, and other comprehensive basis of accounting.

A special purpose framework also includes a financial reporting framework generally accepted in another country that is not promulgated by the International Accounting Standards Board (IASB). Special purpose framework reporting is required in this instance.

If the entity's financial statements are prepared using a jurisdictional variation of *International Financial Reporting Standards* (IFRS) or *International Financial Reporting Standards for Small- and Medium-Sized Entities* (IFRS for SMEs) promulgated by the IASB, and the financial statements include an explicit and unreserved statement of compliance with IFRS as issued by the IASB, the jurisdictional variant of IFRS is not considered to be a special purpose framework (but rather international GAAP).

Lastly, if the applicable financial reporting framework is IFRS or IFRS for SMEs, which is promulgated by the IASB (a designated accounting standard setting body authorized in the U.S. to establish international GAAP), it is technically not a special purpose framework that requires the additional bold language inserted into the standard report. However, the accountant may opt to include an emphasis-of-matter paragraph that highlights that a framework other than accounting principles promulgated by the Financial Accounting Standards Board (FASB) is being applied to prepare the financial statements.

The accountant's review report on financial statements prepared in accordance with a special purpose framework should include an emphasis-of-matter paragraph, under that heading, that indicates that the financial statements were prepared under the special purpose framework. Additionally, the paragraph should include a reference to a note in the financial statements that describes the framework and states that the special purpose framework is a basis of accounting other than U.S. GAAP.

The report should be modified if the financial statements do not contain any of the following:

- A description of the special purpose framework;
- A summary of significant accounting policies;
- A description of how the special purpose framework differs from GAAP, though the effects of the differences need not be quantified; or
- Information disclosures similar to those required by GAAP for similar items.

For financial statements prepared in accordance with the provisions of a contract, the accountant should evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based. Further, for special purpose financial statements prepared in accordance with a contractual basis of accounting, the emphasis-of-matter paragraph should also state that, as a result, the financial statements may not be suitable for another purpose and an other matter paragraph, under an appropriate heading, which restricts the use of the accountant's report should be included.

The following is an example of the accountant's standard review report on financial statements prepared under a special purpose framework:

Independent Accountant's Review Report

We have reviewed the accompanying financial statements of XYZ Company, which comprise [*the statement of financial position as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, or other appropriate titles*]. 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 taken as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of the financial statements in accordance with [*the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, or other special purpose framework*]; this includes determining that [*the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, or other special purpose framework*] is an acceptable basis for the preparation of financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement whether due to fraud or error.

Accountant's Responsibility
Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with [*the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, or other special purpose framework*]. We believe that the results of our procedures provide a reasonable basis for our conclusion.

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

Accountant's Conclusion
Based on our review, we are not aware of any material modification that should be made to the accompanying financial statements in order for them to be in conformity with [*the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, or other special purpose framework*].

Basis of Accounting
I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements have been prepared in accordance with [*the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities, or other special purpose framework*], which is a basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). My (Our) conclusion is not modified with respect to this matter.

Signature of accounting firm or accountant, as appropriate

Accountant's city or state (letterhead may be sufficient)

Date of accountant's review report

The Basis of Accounting paragraph would be modified to reflect the identification of the actual basis used. Examples of this explanatory paragraph for other common special purpose frameworks follow.

Modification #1 – Modified Cash Basis of Accounting

> **Basis of Accounting**
> I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The Corporation's policy is to prepare financial statements on the modified cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). My (Our) conclusion is not modified with respect to this matter.

Note X should describe how this basis of accounting differs from GAAP. For example:

- Certain revenue and related assets have been recognized when received rather than when earned;
- Certain expenses and related liabilities have been recognized when paid rather than when the obligations were incurred; and
- Fixed assets are recorded and depreciated, and payroll liabilities are recognized.

Modification #2 – Income Tax Basis of Accounting

> **Basis of Accounting**
> I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements have been prepared on the accrual basis of accounting used by the Company for federal income-tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). My (Our) conclusion is not modified with respect to this matter.

Note X should describe how this basis of accounting differs from GAAP. For example:

- Accounts receivable are reported at the principle amount outstanding. Bad debts are recognized using the specific charge-off method instead of an allowance method;
- Depreciation of property and equipment is computed based on recovery periods used for federal income tax purposes rather than the estimated useful lives of individual assets; and
- Contract revenues and costs are recognized using the completed-contract method instead of the percentage-of-completion method of accounting.

Modification #3 – Contractual-Basis of Accounting

Important:

> If the financial statements are prepared in accordance with a contractual basis of accounting, the review report should describe the purpose for which the financial statements are prescribed (or refer to a note that provides that information). If these financial statements do not adequately describe any significant interpretations of the contract on which the financial statements are based, then the report should be modified for a known departure from the applicable financial reporting framework.

> The financial statements included in the accompanying financial statements are presented in accordance with the requirements of [*describe contract or regulation*] and are not intended to be a complete presentation of [*name of entity's*] assets and liabilities.

C. Financial statements prepared under a special purpose framework whose use is restricted

If the measurement or disclosure criteria of a special purpose framework are determined by the accountant to be suitable only for a limited number of users that can be presumed to have an adequate understanding of the criteria, or measurement or disclosure criteria is available only to specified parties, the accountant should restrict the use of the accountant's report. Examples where this would be appropriate include financial statements prepared on a contractual basis of accounting or those prepared on a regulatory basis of accounting.

In such instances, the following paragraph would be added after the emphasis-of-matter paragraph reviewed above:

> This report is intended solely for the information and use of [*specified parties*] and is not intended to be and should not be used by anyone other than the specified parties.

It is not uncommon for others to be added to the restricted distribution list after the report has been issued. In such instances, the report (but not the review report date) should be amended to add the additional users of the financial statements and report or the accountant should provide management with a written acknowledgement and the parties that these parties have been added as specified users but that no additional review procedures were performed subsequent to the review report date.

D. Other situations requiring modification from the accountant's standard report

SSARS No. 21 provides numerous examples when the accountant should add other explanatory language to the standard review report. This section will address some of these situations.

1. Changed reference to a departure from an applicable financial reporting framework

When there is a correction of a material misstatement in previously issued financial statements, the accountant should include an emphasis-of-matter paragraph in the accountant's review report when there are adjustments to correct this material misstatement. The accountant should include this type of emphasis-of-matter paragraph in the accountant's review report when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent periods. The emphasis-of-matter paragraph should include both:

- A statement that the previously issued financial statements have been restated for the correction of a material misstatement in the respective period; and
- A reference to the entity's disclosure of the correction of the material misstatement.

If the financial statement disclosures relating to the restatement to correct a material misstatement in previously issued financial statements are not adequate, the accountant should address the inadequacy of disclosure on the report.

The following is an example of the review report that would be issued in this circumstance:

Review Report on Comparative Financial Statements When the Accountant's Report on the Prior Period Includes a Changed Reference to a Departure from Accounting Principles Generally Accepted in the United States of America

Important:

> This assumes the entity restated the prior period financial statements to correct the misstatement. Place after Accountant's Conclusion paragraph in standard comparative review report.

Report on 20X5 Financial Statements
In my (our) report dated March 12, 20X6, with respect to the 20X5 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because the company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X5 financial statements in accordance with accounting principles generally accepted in the United States of America. Accordingly, my (our) present statement on the 20X5 financial statements, as presented herein, that I am (we are) not aware of any material modifications that should be made to the accompanying financial statements is different from that expressed in our previous report.

2. Reporting when one period is audited

When the prior period financial statements were audited and that audit opinion is not reissued, the accountant's current period review report should be modified. It should include an other-matter paragraph that states that the prior year financial statements were previously audited, the date of the auditor's report on the audited financial statements, the type of opinion issued and, if modified, the reasons why. Lastly, the other-matter paragraph should state that no audit work was performed after the date of the previous report.

The following is an example of the other-matter paragraph to be added in this circumstance:

Prior Year Financial Statements Were Audited and Current Year Financial Statements Were Reviewed in Comparative Financial Statements

Important:

> Reference just the financial statements of the year reviewed by the reporting accountant in the opening paragraph. Add the following paragraph after the Accountant's Conclusion paragraph in the standard review report for the current year.

Report on 20X5 Financial Statements
The 20X5 financial statements were audited by me (us) and I (we) expressed an unmodified opinion on them in my (our) report dated March 12, 20X6. I (We) have not performed any auditing procedures since that date.

3. Reporting in individual financial statements

The SSARS do not prohibit you from performing a review engagement and issuing a review report on an individual financial statement, such as a balance sheet or an income statement, as long as the scope of the analytical procedures and inquiries have not been restricted.

E. Reporting when going concern issues exist

The review accountant should consider whether the review procedures indicate going concern uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statements being reviewed or the time period specified in the applicable financial reporting framework. If uncertainty is noted, the review accountant should request that management review the possible effects, including adequacy of related disclosures. The accountant may add an emphasis-of-matter paragraph to highlight the disclosure.

If the entity's disclosures are deemed inadequate, a departure from the applicable financial reporting framework exists. The review report should be modified to disclose this known departure. If the review accountant deems the report modification to not be adequate to draw attention to the known financial statement deficiency, then withdrawal from the engagement is appropriate.

SSARS No. 24 revises AR-C Section 90 as follows:

- Revises the definition of "reasonable period of time" and adds guidance with respect to this new definition.
  - Reasonable period of time is the period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued or available to be issued.
  - GASB 12 requires an evaluation period of 12 months beyond the date of the financial statements. However, the entity should also consider information shortly thereafter, such as within an additional three months.
  - IASB requires an evaluation period of at least, but not limited to, one year from the end of the reporting period.
- Includes specific written representations regarding disclosure of all information relevant to the use of the going concern assumption in the financial statements, including that management has disclosed to the accountant all information relevant to use of the going concern assumption in the financial statements.
- Requires the accountant, if the applicable financial reporting framework (such as U.S. GAAP) includes requirements for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements, to perform review procedures related to the following:
  - Whether the going concern basis of accounting is appropriate.
  - Management's evaluation of whether there are conditions or events that raised substantial doubt about the entity's ability to continue as a going concern.
  - If there are conditions or events that raised substantial doubt about the entity's ability to continue as a going concern, management's plans to mitigate those matters.
  - The adequacy of disclosures in the financial statements.
- States that the nature and extent of the accountant's review procedures are matters of the accountant's professional judgment. For example, when a history of profitable operations and ready access to financing exists, inquiry alone might be sufficient to review the entity's ability to continue as a going concern for a reasonable period of time.

- States that if the applicable financial reporting framework does not include a requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing financial statements and either of the following circumstances exist, the accountant is required to: a) inquire of management whether the going concern basis of accounting is appropriate; b) inquire of management about its plans for dealing with the adverse effects of the conditions and events; and c) consider the adequacy of the disclosure about such matters in the financial statements.
  - Conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time existed at the date of the prior period financial statements, regardless of whether the substantial doubt was alleviated by the accountant's consideration of management's plans.
  - In the course of performing review procedures on the current period financial statements, the accountant becomes aware of conditions or events that raise substantial doubt.
- Requires the accountant to include an emphasis-of-matter paragraph in the accountant's review report if, after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

SSARS No. 25 also addressed the implications for the Accountant's Report when substantial doubt exists about the entity's ability to continue as a going concern. If, after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the accountant should include a separate section in the accountant's review report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" that:

a. Draws attention to the note in the financial statements that discloses:
   (i) The conditions or events identified and management's plans that deal with these conditions or events; and
   (ii) That these conditions or events indicate that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time.
b. States that the accountant's conclusion is not modified with respect to the matter.

The description in the "Going Concern" section about the entity's ability to continue as a going concern for a reasonable period of time should use terms consistent with those included in the applicable financial reporting framework. The accountant should not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

If adequate disclosure about an entity's ability to continue as a going concern for a reasonable period of time is not made in the financial statements, the accountant should do the following:

a. Express a qualified or adverse conclusion, as appropriate.
b. In the "Basis for Qualified (Adverse) Conclusion" section of the accountant's review report, state that:
   (i) Substantial doubt exists about the entity's ability to continue as a going concern and the financial statements do not adequately disclose this matter; or
   (ii) Substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans but the financial statements do not adequately disclose this matter.

If management is unwilling to perform or extend its evaluation to meet the period of time required by the applicable financial reporting framework when requested to do so by the accountant, the accountant should consider the implications for the accountant's review report.

The following is an example of this requirement when substantial doubt exists:

> ***Substantial Doubt about the Company's Ability to Continue as a Going Concern***
> *The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations, and has a net capital deficiency, and has stated that substantial doubt exists about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our conclusion is not modified with respect to this matter.*

Lastly, if substantial doubt has been alleviated by management's plans, the accountant may include an emphasis-of-matter paragraph making references to management's disclosures related to those conditions and events.

The following is an example of the optional additional paragraph added to the report when the substantial doubt about the entity's ability to continue as a going concern has been alleviated.

> ***Emphasis of Matter Regarding Going Concern***
> *As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note X. Our conclusion is not modified with respect to this matter.*

F. Reporting when material subsequent events have occurred

Subsequent events that have a material effect on the financial statements sometimes occur between the date of the statements and the date of your review report. Your response to these types of subsequent events is basically the same as for going concern issues, you should discuss the event with management, ask them to consider any potential effects on the financial statements, and evaluate their responses. Likewise, you should also discuss the need for additional disclosures in the notes to the financial statements describing the event. If you are not satisfied that a subsequent event has been properly accounted for in the financial statements or disclosed in the notes, you should again use the guidance relating to a departure from the applicable financial reporting framework discussed above to close the issue.

If the accountant becomes aware of the subsequent event matter after the completion of review procedures (the report date) and the report issuance, the item should be discussed with management, who should determine if the financial statements need modification. If the financial statements are modified, the review report should either be dated as of the date the review procedures performed on the modification were completed or dual-date the report for the performance of these procedures on the subsequent event.

After the date of your review report, you are under no obligation to perform any additional review procedures with respect to the financial statements unless new information comes to your attention that might have caused you to believe that data provided by the client was in some way unacceptable (incorrect, incomplete, etc.) had you been aware of such facts.

As was the case in our compilation engagement, the first thing you need to do in these situations is ask yourself "Just how much time has passed since I reported on these financial statements?" Recall that the SSARSs phrase this notion a bit differently but are basically saying the same thing "Consideration should be given to, among other things, the time elapsed since the financial statements were issued."

Also remember the "warning" included in the professional standards that notes:

> The accountant would be well advised to consult with his or her legal counsel when he or she encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein.

If management determines that the financial statements need revision for this subsequent discovery, the accountant should either reissue the report with a later date or dual-date for the date that the procedures performed on the subsequent information were performed.

Such report re-issuance and dual-dating can have significant impact on the users of the financial statements. AR-C section 90, paragraphs .74-77 provide guidance to follow in these circumstances. As a general rule, management should assure that third-party users know that modifications either have or should be made to the issued financial statements. Failure by management to adequately inform financial statement users of this situation could result in the accountant needing to take action to prevent use of the review report.

This is obviously a very challenging situation and requires a detailed reading of the professional guidance as well as legal or other consultation. The accountant should proceed with great care in such situations.

G. Supplementary information

Again, as we have already discussed in our coverage of compilation engagements, often times the financial statements will be accompanied by supplementary information such as a schedule of functional expenses or management's discussion and analysis (MD&A). AR-C section 90, as amended by SSARS No. 23, defines supplementary information as information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the reviewed financial statements or separate from the reviewed financial statement. Supplementary information includes additional details or explanation of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity. The supplementary information may be prepared in accordance with an applicable financial reporting framework, by regulatory or contractual requirements, in accordance with management's criteria, or in accordance with other requirements.

The key to dealing with supplementary information in a review engagement is to clearly indicate the degree of responsibility (if any) you are taking with respect to that information. This is included in either an other-matter paragraph in the review report or a separate report on the supplemental information.

If you have subjected the supplementary information to the review procedures applied in the review of the basic financial statements, your other-matter paragraph in the review report or separate review report should refer to the supplementary information and state the supplementary information is not a required part of the basic financial statement but rather presented for additional analysis. Further, the other-matter paragraph or separate review report should state that the supplementary information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Further, the report should state that the supplementary information has been subjected to review procedures applied in the accountant's review of the basic financial statements and whether any material modifications need to be made to the supplementary information and that the accountant has not audited the supplementary information and does not express an opinion on it.

The following is an example of the other-matter paragraph to be added when the supplementary information has been subjected to the review procedures applied in the accountant's review of the basic financial statements:

Supplementary Information Provided at the Discretion of Management

> **Other Matter – Supplementary Information**
> The accompanying supplementary information on pages XX through YY is presented for the purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and the other records used to prepare the financial statements. The supplementary information has been subjected to the review procedures applied in my (our) review of the basic financial statements. I am (We are) not aware of any material modification that should be made to the supplementary information. I (We) have not audited the supplementary information and do not express an opinion on such supplementary information.

If you have not subjected the supplementary information to review procedures applied in the review of the basic financial statements, you can issue a separate report on the supplemental information or add an other-matter paragraph to the review report. However, it should state that the supplementary information is being presented for additional analysis purposes only and is not a required part of the basic financial statements and that it has been compiled from information that is the responsibility of management, without review or audit, and that you do not provide any assurance on such supplementary information.

Here is an example of the other-matter paragraph that the accountant should add in this instance:

> **Other Matter – Supplementary Information**
> The accompanying supplementary information on pages XX through YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. I (We) have not audited or reviewed the unaudited supplementary information, and do not express an opinion, a conclusion, or provide any assurance on it.

If the supplemental information is required, the accountant's review report should include in an other-matter paragraph that clearly describes the scope of work the accountant performed on the supplemental information (i.e., a review or compilation, or none), whether the supplemental information is omitted, some is missing, or other departures from the appropriate guidelines.

If the required supplemental information has not been subject to a review or compilation, the accountant should include an other-matter paragraph in the review report that includes the elements of AR-C section 90, paragraph .84 or .85, as applicable.

The following provide examples of the other-matter paragraph to be added in the circumstances described above:

Other Matter – Required Supplementary Information

The following is an example of another matter paragraph when the required supplementary information is included and the accountant did not compile or review the required supplementary information.

> **Other Matter – Required Supplementary Information**
> Accounting principles generally accepted in the United States of America require that [*identify the required supplementary information*] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter*] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by us, and we do not express an opinion, a conclusion, nor provide any assurance on it.

Other Matter – Required Supplementary Information – Some or all information is omitted

The following is an example of when some or all required supplementary information is omitted in a compilation.

> **Other Matter – Required Supplementary Information**
> Management has omitted [*describe the missing required supplementary information*] that [*identify the applicable financial reporting framework*] require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter*] who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context.

If the measurement or presentation of the required supplementary information departs materially from prescribed guidelines, include a statement accordingly.

> **Other Matter – Required Supplementary Information**
> Material departures from prescribed guidelines exist. [*Describe the material departure(s) from the applicable financial reporting framework*.]

If the accountant has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, include a statement accordingly. For example:

> **Other Matter – Required Supplementary Information**
> I (We) have doubts about whether material modifications should be made to the required supplementary information to be presented in accordance with guidelines established by [*identify designated accounting standards-setter*.]

It should also be noted that even in the case of required supplemental information, for example, MD&A required by GASB No. 34, *Basic Financial Statements–and Management's Discussion and Analysis–for State and Local Governments*, you are not required to perform any review procedures on this type of required supplemental information.

H. Change in engagement services

On occasion, you may encounter a situation where a client that has engaged you to perform an audit changes their mind and asks you to instead perform a review. This is generally not a problem as long as you first consider the client's reasons behind the change. For example, if a client no longer needs an audit to satisfy a particular user's need, perhaps its bank, they may ask you to drop the engagement down to a review, which would seem to be a reasonable basis for the request to a change. (It would probably be a good idea to document the discussion you had with management and have them include a representation in their management representations letter that a review is appropriate.)

On the other hand, there are circumstances when you should not accept the client's request for a change. For example, if you have been engaged to perform an audit and the client refuses to let you correspond with its legal counsel or refuses to provide you with a management representation letter, you would ordinarily be precluded from issuing a review report on the financial statements.

In the end, use your professional judgment to determine whether the client's reasons provide the proper justification for the change. Of course, if you do make the change, you will then have to comply with the SSARSs in performing and reporting on your review work. And in this case, your review report should not include any references tying it back to the original engagement in any way (for example, audit procedures you performed, scope restrictions, etc.).

I. Other reporting responsibilities

Lastly, an accountant may be requested to address other reporting responsibilities in the accountant's review report on the financial statements that are in addition to the accountant's responsibilities in accordance with this section to report on the financial statements. In such situations, those other reporting responsibilities should be addressed by the accountant in a separate section in the accountant's review report, under the heading "Report on Other Legal and Regulatory Requirements," or otherwise, as appropriate to the content of the section, following the section of the report titled "Report on the Financial Statements."

XVIII. Common feedback from peer reviews on AR-C section 90 engagements

A. Peer review issue #1 – Review engagements: Analytical procedures are not properly performed

Analytical procedures are an integral part of the evidence-gathering activities in AR-C section 90 engagements. However, that evidence is only obtained when the analytical procedures are performed correctly.

We reviewed the requirements for analytical procedures in review engagements earlier in the course. Recent peer reviews on review engagements have focused on the analytical review process, with a particular emphasis on the following:

- Developing expectations.
- Appropriate thresholds, especially in light of the SSARS No. 25 guidance on materiality.
- Appropriate follow-up when the result of the analytical procedure exceeds the threshold for investigation.

The following are some representative comments from peer reviews related to analytical procedures.

1. Peer reviewers findings on analytical procedures

Peer reviewers have noted that accountants are not:

- Properly documenting rationale for development and basis for the accountant's expectations in analytical procedures.
- Evaluating whether the expectation is sufficiently precise to provide the accountant with limited assurance that a misstatement will be identified that, either individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- Properly documenting the comparison of recorded amounts or ratios developed from recorded amounts to expectations developed by the accountant through identifying and using relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates.

B. Peer review issue #2 – Other documentation failures

Peer reviewers have noted that accountants are not always properly documenting:

- Materiality;
- Significant unusual events and transactions and their disposition; and
- Significant findings or issues identified in the review.

Question to ponder:

How challenging was it to implement the requirements of SSARS No. 25 for your year-end AR-C Section 90 engagements?

XIX. Practice exercises

Use the following brief exercises to review what you have learned about performing and reporting on review engagements discussed above. Suggested solutions appear at the end of the chapter material.

Exercise 1

Match the following definitions with their terms

a.	Focus review procedures in those areas where there are increased risks of misstatements.	______ Review risk
b.	Result from significant conditions, events, or circumstances that could adversely affect a company's ability to achieve its objectives and execute its strategies.	______ Risk awareness
c.	Unknowingly failing to modify your review report on financial statements that are materially misstated.	______ Business risks

Exercise 2 – Part I

Based on its knowledge its client and its industry, the accountant has developed the following expectations concerning the analytical procedures that it plans to perform on its client, XYX Company, which is a retailer of high-end paper products:

- Increase in demand for high-end paper products due to increase in advertising program by largest supplier of such products. Expected increase is between 10 percent and 15 percent. The accountant expects a similar increase in accounts receivable and days sales in receivables.
- Because of an expected need to increase inventory ahead of a forecasted sale increase, the company had to borrow additional funds. Therefore, expected increase in loans payable and interest expense is between 10 percent and 15 percent.
- No significant change in either days sales in inventory or inventory turnover is expected. Although a build-up in inventory is expected, that build-up is not expected to correspond with the increase in sales because the products being advertised are expected to sell quickly. Any change greater than 5 percent will be subjected to additional inquiries.

The following is condensed financial statement information for XYZ for the past two years:

Income Statement Trend Analysis

	Current Year	Prior Year	Change	% Change
Sales	$5,250,000	4,800,000	450,000	9.3%
Cost of Sales	3,750,000	3,400,000	350,000	10.3%
Gross Margin	1,500,000	1,400,000	100,000	7.1%
GM %	28.6%	29.2%		
Selling Expense	650,000	490,000	160,000	32.7&
Interest Expense	58,000	61,750	(3,750)	(6.1%)

Balance Sheet Ratio Analysis

	Current Year	Prior Year	Two Years Prior
A/R, net	1,500,000	1,200,000	1,100,000
Inventory	1,300,000	1,250,000	1,000,000
Loans Payable	980,000	950,000	920,000

Given the expectations listed above, which accounts would you investigate further, based on the results of trend analysis being outside of your expectations?

Exercise 2 – Part II

Trend analysis is only one type of analytical procedure that an accountant can perform in order to obtain evidence in a review engagement. Given the financial results above, what are several other potential analytical procedures which the accountant could perform?

Exercise 2 – Part III

Given the following analytic trends, which would you investigate?

Days Sales in Receivable – EOY A/R/ (Net sales/365)

Current Year	Prior Year
104.3 Days	91.3 Days

A/R Turnover – Sales/average A/R

Current Year	Prior Year
3.9 Turns	3.8 Turns

Days Sales in Inventory – EOY Inventory / (COS/365)

Current Year	Prior Year
126.5 Days	134.2 Days

Inventory Turnover – Cost of sales /average inventory)

Current Year	Prior Year
2.9 Turns	3.0 Turns

Interest Expense as percentage of average debt

Current Year	Prior Year
6.2%	6.6%

Selling expense as percentage of Sales

Current Year	Prior Year
12.4%	10.2%

XX. Practice exercises – Suggested solutions

Exercise 1

Match the following definitions with their terms

a.	Focus review procedures in those areas where there are increased risks of misstatements.	**c.**	Review risk
b.	Result from significant conditions, events, or circumstances that could adversely affect a company's ability to achieve its objectives and execute its strategies.	**a.**	Risk awareness
c.	Unknowingly failing to modify your review report on financial statements that are materially misstated.	**b.**	Business risks

Exercise 2 – Part I

Based on its knowledge its client and its industry, the accountant has developed the following expectations concerning the analytical procedures that it plans to perform on its client, XYX Company, which is a retailer of high-end paper products:

- Increase in demand for high-end paper products due to increase in advertising program by largest supplier of such products. Expected increase is between 10 percent and 15 percent. The accountant expects a similar increase in accounts receivable and days sales in receivables.
- Because of an expected need to increase inventory ahead of a forecasted sale increase, the company had to borrow additional funds. Therefore, expected increase in loans payable and interest expense is between 10 percent and 15 percent.
- No significant change in either days sales in inventory or inventory turnover is expected. Although a build-up in inventory is expected, that build-up is not expected to correspond with the increase in sales because the products being advertised are expected to sell quickly. Any change greater than 5 percent will be subjected to additional inquiries.

The following is condensed financial statement information for XYZ for the past two years:

Income Statement Trend Analysis

	Current Year	Prior Year	Change	% Change
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Gross Margin	1,500,000	1,400,000	100,000	7.1%
GM %	28.6%	29.2%		
Selling Expense	650,000	490,000	160,000	32.7&
Interest Expense	58,000	61,750	(3,750)	(6.1%)

Balance Sheet Ratio Analysis

	Current Year	Prior Year	Two Years Prior
A/R, net	1,500,000	1,200,000	1,100,000
Inventory	1,300,000	1,250,000	1,000,000
Loans Payable	980,000	950,000	920,000

Given the expectations listed above, which accounts would you investigate further, based on the results of trend analysis being outside of your expectations?

Given the expectations set by the accountant, the following balance sheet and income statement fluctuation trends would warrant further investigation:

- **Increase in sales is just below the low end of the expected range. The accountant should inquire as to why the increase is below expectations.**
- **Interest expense has decreased as the loan payable balance has increased. Additionally, the accountant's expectation was that interest expense would increase as the loan payable balance increased. The accountant should inquire as to the reason why this expectation was not met.**
- **Accounts receivable increased much more significantly than sales and much more than what the accountant expected. Given the expectation of accounts receivable increasing in a similar proportion to the increase in sales, the accountant should investigate why this expectation was not met.**

Exercise 2 – Part II

Trend analysis is only one type of analytical procedure that an accountant can perform in order to obtain evidence in a review engagement. Given the financial results above, what are several other potential analytical procedures which the accountant could perform?

Days sales in inventory and accounts receivable are excellent ratios for accountants to compute in order to better understand trends in those accounts.

In addition to these accounts, common size financial ratios, where other income statement line items are measured as a percentage of sales, are useful to see if historical relationships have changed. Examples of these would be gross profit percentage and selling expense as a percentage of sales.

Lastly, there are relationships between related items in the balance sheet and income statement which could be reviewed for reasonableness and to see if they changed. In this example, interest expense as a percentage of debt would be a ratio which the accountant could explore to assess the reasonableness of both account balances.

Exercise 2 – Part III

Given the following analytic trends, which would you investigate?

Days Sales in Receivable – EOY A/R/ (Net sales/365)

Current Year	Prior Year
104.3 Days	91.3 Days

A/R Turnover – Sales/average A/R

Current Year	Prior Year
3.9 Turns	3.8 Turns

Days Sales in Inventory – EOY Inventory / (COS/365)

Current Year	Prior Year
126.5 Days	134.2 Days

Inventory Turnover – Cost of sales /average inventory)

Current Year	Prior Year
2.9 Turns	3.0 Turns

Interest Expense as percentage of average debt

Current Year	Prior Year
6.2%	6.6%

Selling expense as percentage of Sales

Current Year	Prior Year
12.4%	10.2%

Days sales in accounts receivable, as well as the overall accounts receivable balance, increased by more than the 10 percent expected. The accountant should investigate this difference, as it could represent a deterioration in credit and collectability as sales increase.

Selling expenses have increased well in advance of the increase in sales as well as a percentage of sales. The accountant should inquire as to the reasons why this increase in selling expenses is above that for sales, as it is reasonable that these accounts would fluctuate in tandem.

Other Financial Reporting Frameworks Used in SSARS No. 21 Engagements

Other Financial Reporting Frameworks Used in SSARS No. 21 Engagements

Learning objective

After completing this chapter, you should be familiar with:
- Several other financial reporting frameworks used in financial statement preparation, compilation, and review engagements performed in accordance with SSARSs encountered in practice today.

I. Introduction

As accountant's we are most familiar with financial statements that use U.S. GAAP as the financial reporting framework. However, as we saw in the chapters in reviews, compilations, and financial statement preparation engagements, these engagements can be performed on financial statements that use other financial reporting frameworks. In this chapter, we will review in greater depth several of these frameworks, including:

1. Special purpose framework financial statements;
2. Personal financial statements;
3. Specified elements, accounts, or items of a financial statement; and
4. Financial statements that are not expected to be used by a third party.

II. Special purpose framework financial statements

The term *special purpose framework* (SPF) essentially replaced what was referred to as an other comprehensive basis of accounting or "OCBOA." Although *special purpose framework* is not defined in the accounting literature, it is defined in the auditing literature, specifically, in AU-C section 800, *Special Considerations–Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, as follows:

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

a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

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

Today's U.S. GAAP is complex and as it moves away from hard and fast rules ("bright lines") towards more principles-based standards, it could get even more complex. Many businesses preparing financial statements may find that using an SPF can provide an alternative to the complexity of U.S. GAAP.

The most widely used forms of SPFs include the cash, modified cash, and income tax bases of accounting. Many preparers, CPAs, and external users would argue that SPF financial statements are much easier to understand than financial statements prepared using U.S. GAAP. Additionally, SPF financial statements are generally less costly to prepare.

We already reviewed the authoritative guidance for engagements for preparing, compiling, and reviewing SPF financial statements using the cash, modified cash, and income tax bases of accounting in our review of SSARS No. 21. Our goal here is to explore these reporting frameworks themselves, so you can become more familiar with their requirements.

A. Applicable financial reporting framework

It is important to understand that it is the client, and not the accountant, who is responsible for choosing the SPF used to prepare the financial statements. The following is a review of the most widely used forms of SPF.

1. "Pure" cash basis

The "pure" cash basis of accounting is considered the simplest SPF because it is just a checkbook. That is, only transactions that increase or decrease cash are included in the financial statements. Cash receipts are revenue and cash disbursements are expenses. Businesses that use the pure cash basis of accounting generally include smaller, less complex organizations such as mom and pop retail stores, garage-based startups, and many sole proprietorships.

2. Modified cash basis

The modified cash basis of accounting is just as its name implies, it is the pure cash basis of accounting "modified" in some fashion, usually by recognizing certain transactions on an accrual basis. Interestingly, the various types of acceptable modifications and their extent are not well defined in any specific accounting guidance. Like the pure cash basis, businesses that use the modified cash basis of accounting generally include smaller, less complex organizations, in this case, for example, professional practitioner groups such as doctors, lawyers, and CPAs. Entities should be careful utilizing a great number of modifications. For example, financials that use GAAP for all accounting besides inventory would not be considered "modified cash basis." Instead, these financials would be considered GAAP with an error related to the accounting for inventory. Entities should document why any modifications from the cash basis are necessary.

3. Income tax basis

An income tax basis of accounting uses the federal income tax laws to prepare a business' financial statements. In certain situations, this approach can make a lot of sense for a business even though the tax laws do not generally address financial statement presentation and disclosure issues.

By preparing the financial statements on the same basis as the tax return, entities only have to collect and process the underlying data one time, which saves time, effort, and money. Businesses that use an income tax basis of accounting are generally small to medium-sized companies such as C corporations, partnerships, and not-for-profit organizations.

4. Other basis

As noted in the above definition, a special purpose framework includes a basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements. SAS No. 127, *Omnibus Statement on Auditing Standards–2013*, added this "other basis" category specifically so the AICPA's new special purpose framework, *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs™) could be included as a special purpose framework.

The AICPA released FRF for SMEs™ in June 2013 and it became available for use upon issuance.

FRF for SMEs™ is 206 pages long and includes 31 separate chapters of material covering a wide range of accounting topics from basic financial statement concepts all the way through foreign currency translation.

According to the AICPA, FRF for SMEs™ largely parallels the accrual method under the tax basis of accounting, with the recognition of revenues and expenses generally being the same between FRF for SMEs™ and the accrual method for income tax reporting purposes.

The critical thing to know regarding FRF for SMEs™ is:

> It has no official or authoritative status, that is, the framework will not be approved by the FASB, Private Company Council (PCC), or any senior technical committee of the AICPA.

B. Presentation issues

When preparing, compiling, or reviewing SPF financial statements, consideration should be given to the overall presentation of the financial statements and whether they provide a fair presentation. Fair presentation in this case includes all the financial statement disclosures that are appropriate for the SPF being used, particularly those that can help a user better understand and interpret the financial statements.

1. SPF financial statements

The term "financial statements" typically refers to a complete set of financial statements, but it can refer to a single financial statement as well. The following illustration provides an example of a single SPF financial statement.

Moose Lake Homeowners Association
Statements of Cash Receipts and Cash Disbursements
Year Ended December 31

	20X2	20X1
Cash Receipts		
HOA Assessments	$8,000	$8,000
Cash Disbursements		
Lighting	400	400
Landscaping Fees	6,500	6,200
Insurance, Liability	600	500
Legal Fees	100	100
Miscellaneous (PO Box and Stamps)	35	40
Total Cash Disbursements	7,635	7,240
Increase in Cash	365	760
Beginning Cash Balance	760	0
Ending Cash Balance	$1,125	$760

See Notes to the Financial Statements.
See Independent Accountant's Compilation Report.

Which financial statements, or statement, represent "a complete set of financial statements" when prepared using an SPF depends in part upon which specific basis of accounting is being used. For example:

(i) Financial statements prepared on the pure cash basis of accounting generally only include a statement of cash receipts and disbursements (income statement). Since the only asset is cash, there is really no need to prepare any sort of balance sheet.

(ii) Financial statements prepared on the modified cash basis of accounting or the income tax basis of accounting generally will include a statement of assets and liabilities and a statement of revenues and expenses.

(iii) SPF financial statements usually present the "statement of changes in stockholders' equity" on the face of the statement of revenues and expenses as a three-line reconciliation of beginning retained earnings plus/minus net income/loss equals ending retained earnings (assuming no changes in contributed capital) or in a note to the financial statements.

2. Statement of cash flows

A statement of cash flows is not a required SPF financial statement.

However, if an entity does present a statement of cash flows, it should conform to U.S. GAAP requirements or communicate the substance of those requirements.

Many SPF financial statement presentations do not include a statement of cash flows, particularly in the case of small closely held businesses where the owner is fully engaged in running the day-to-day operations of the business.

3. SPF financial statement titles

SPF financial statements should be properly titled, which basically means they should be "modified" from U.S. GAAP titles such as *Balance Sheet*, *Income Statement*, and *Statement of Cash Flows*. For example, a pure cash basis "income statement" might be titled as a statement of cash receipts and disbursements; a modified cash basis "balance sheet" might be titled as a statement of assets and liabilities – modified cash basis; or an income tax basis "statement of cash flows" might be titled as a statement of cash flows – income tax basis.

In the end, whatever titles are used, the objective in modifying them is to help the users of SPF financial statements clearly understand that they are not prepared in accordance with U.S. GAAP. The following illustration provides examples of modified SPF financial statement titles.

Example SPF Financial Statement Titles

Basis of Accounting	**Balance Sheet Modifications**
Cash Basis	Generally Not Applicable
Modified Cash Basis	Statement of Assets and Liabilities – Modified Cash Basis
Income Tax Basis	Statement of Assets and Liabilities – Income Tax Basis
	Income Statement Modifications
Cash Basis	Statement of Cash Receipts and Disbursements
Modified Cash Basis	Statement of Revenues and Expenses – Modified Cash Basis
Income Tax Basis	Statement of Revenues and Expenses – Income Tax Basis
	Statement of Cash Flows Modifications
Cash Basis	Statement of Cash Flows – Cash Basis
Modified Cash Basis	Statement of Cash Flows – Modified Cash Basis
Income Tax Basis	Statement of Cash Flows – Income Tax Basis

C. Disclosure issues

As we noted above, financial statements that are fairly presented include all of the disclosures that are appropriate for the SPF being used; again, particularly information that can help users better understand and interpret the financial statements.

This can be a real issue in the case of SPF financial statements because the professional accounting literature does not provide any authoritative guidance with respect to the adequacy of disclosures in SPF financial statements.

However, the auditing literature notes that if SPF financial statements contain items that are the same as, or similar to, those in U.S. GAAP financial statements, disclosures similar to those required by U.S. GAAP are necessary to achieve a fair presentation. For example, financial statements prepared on a modified cash basis of accounting or on an income tax basis of accounting usually reflect depreciation, and so the disclosures for depreciation in such statements should be comparable to those in U.S. GAAP statements. With that said, one of the advantages of SPF financial statements is that their disclosures can be a little less demanding than those required by U.S. GAAP. For example, an entity can substitute qualitative information for some of the quantitative information required by U.S. GAAP or simply provide information that communicates the substance of those requirements. Along these lines, an entity might disclose estimated percentages of revenues instead of the specific amounts that U.S. GAAP requires to sufficiently convey the significance of sales to major customers.

On the other hand, additional disclosures beyond those required by the SPF still might be necessary for the financial statements to be fairly presented. These might include for example, disclosures about related-party transactions, subsequent events, or significant uncertainties. In such circumstances, the SPF financial statements should basically include the same disclosures required by U.S. GAAP, or again, disclosures that communicate the substance of those requirements.

With this in mind, many small businesses preparing SPF financial statements will take advantage of the disclosure “short-cut” by substituting qualitative information for some of the quantitative information required by U.S. GAAP. For example, instead of providing the standard U.S. GAAP “long form” quantitative schedule of lease payments, a short-cut SPF disclosure might simply discuss the terms of the lease to sufficiently communicate such information to users of the SPF financial statements. Also, U.S. GAAP disclosure requirements that are not relevant to an SPF financial statement presentation can be ignored altogether. For example, when using the pure cash basis of accounting, disclosures related to the use of estimates would not be relevant.

Professional judgment is really the key as to the nature and extent of SPF financial statement disclosures. However, the authoritative auditing literature does provide us with some guidance in this area noting that SPF financial statement disclosures should include (notice how broad the parameters are):

- A summary of significant accounting policies including a description of the SPF and how it differs from U.S. GAAP.
- Disclosures similar to those required by U.S. GAAP for items in the SPF financial statements that are the same as, or similar to, those in U.S. GAAP financial statements.
- Any additional disclosures that may be necessary for the SPF financial statements to be fairly presented.

1. Summary of significant accounting policies

SPF financial statements are required to include a summary of significant accounting policies that discuss the basis of accounting being used to prepare the financial statements and how that basis differs from U.S. GAAP (although the differences do not need to be quantified). The discussion of the basis of accounting used can be very simple, for example:

> *The accompanying financial statements have been prepared on the accrual basis of accounting used for federal income tax reporting.*

Also, only the major differences from U.S. GAAP need to be discussed, for example, if the only significant difference is in the depreciation calculations, the following brief description is all that would be necessary:

> *Depreciation of property and equipment is computed based on recovery periods used for federal income tax purposes rather than the estimated useful lives of the individual assets.*

Notice the general structure and simplicity of the summary of significant accounting policies disclosures in the following illustrations.

Modified Cash Basis of Accounting

<u>Basis of Accounting</u>
The Corporation's policy is to prepare financial statements on the modified cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). This basis of accounting differs from GAAP primarily because certain revenue and related assets have been recognized when received rather than when earned and certain expenses and related liabilities have been recognized when paid rather than when the obligations were incurred. In addition, fixed assets are recorded and depreciated, and payroll liabilities are recognized.

Income Tax Basis of Accounting

<u>Basis of Accounting</u>
The accompanying financial statements have been prepared on the accrual basis of accounting used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). This basis of accounting differs from GAAP as follows:

- Accounts receivable are reported at the principle amount outstanding. Bad debts are recognized using the specific charge-off method instead of an allowance method.
- Depreciation of property and equipment is computed based on recovery periods used for federal income tax purposes rather than the estimated useful lives of individual assets.
- Contract revenues and costs are recognized using the completed-contract method instead of the percentage-of-completion method of accounting.

As discussed in Chapter 5, these differences do not need to be quantified.

2. Disclosures similar to those required by U.S. GAAP

As we said above, when SPF financial statements contain items that are the same as, or similar to, those in U.S. GAAP financial statements, disclosures similar to those required by U.S. GAAP should be included in the SPF financial statements.

However, in trying to ease the disclosures overload required by U.S. GAAP, when SPF financial statements include items for which U.S. GAAP would require disclosure, the SPF disclosures can simply provide information that communicates the substance of those disclosures. Remember, the “short-cut” of substituting qualitative information for some of the quantitative information required by U.S. GAAP is allowed in this context.

The following illustration shows the contrast between example property and equipment disclosures from financial statements prepared using U.S. GAAP and those prepared using an SPF.

Communicating the Substance of a U.S. GAAP Disclosure

U.S. GAAP

The components of property and equipment at June 30, 2011 were:

Land	553
Buildings and Improvements	6,521
Leasehold Improvements	2,345
Computer Equipment and Software	6,601
Furniture and Equipment	1,991
Total, at cost	18,011
Accumulated depreciation	(9,829)
Total, net	8,182

During fiscal year 2011, depreciation expense was $x.

SPF

The company owns its production facility and related land, which account for approximately 80 percent of the fixed asset balance reported in the accompanying Statement of Assets, Liabilities, and Shareholders’ Equity – Income Tax Basis. The remainder of the balance is comprised of small tools and equipment, and office furniture and fixtures.

In addition to “short-cut” disclosures that might be found in SPF financial statements, do not forget that if a U.S. GAAP disclosure requirement is not relevant to the SPF financial statements being prepared, it can be ignored.

3. Additional disclosures necessary for SPF financial statements to be fairly presented

A particular disclosure not being required by the SPF does not mean that the information cannot be included in the notes to the financial statements. A practitioner should combine professional judgment with the overall consideration of what might help users of the financial statements better understand and interpret the underlying data when deciding which disclosures to include (or not include) in the notes. Examples of such disclosures might include the following.

- **Related-party transactions** – Related-party transactions should always be considered for disclosure, and certainly those that are material to the overall financial statements should definitely be disclosed. For example:

  The Company leases office space from a close family member of the owner of the business. However, this lease was entered into as an arm's-length transaction at prevailing market rates.
- **Contingent Liabilities** – Disclosures surrounding contingent liabilities might include discussions regarding guarantees such as outstanding letters of credit, and any litigation the entity is involved in. These types of contingent liabilities should be carefully monitored by the entity's owner or management and legal counsel, and regularly assessed and disclosed as appropriate. For example:

  The Company guarantees its subsidiary for $3.5 million for any contingencies arising from construction contracts executed by the subsidiary.

  The Company is currently involved in legal proceedings, but it is not possible to make a reliable estimate of the expected financial effect, if any, that could result from ultimate resolution of the proceedings. As such, no provision has been made with respect to these legal proceedings in the accompanying financial statements.
- **Concentration of Risk** – Concentration of various types of risks to the entity should also be considered for disclosure. Such risks might include concentration of credit risk or dependence on a major customer for substantial sales amounts. For example:

  The Company maintains its cash deposits in interest bearing accounts at a local bank. At December 31, 20X1, cash deposits at this bank exceeded the FDIC insured limit of $250,000 by $7,566.

  The Company's customer base is concentrated and deterioration in the financial position of a major customer may have a negative impact on the Company's sales and profitability. The Company's three largest customers accounted for over 80 percent of net sales in 20X1. In addition, the Company is relatively small compared to these customers. However, the Company's management believes that the Company is well poised to maintain its position as a key supplier to these customers.

- **Commitments** – An entity's commitments should also be reviewed for possible disclosure. For example:

  Capital commitments contracted but not provided for in the financial statements include a sale and purchase agreement the Company entered into on August 15, 20X1, to purchase a piece of land for $560,000. As of the date of this report, the Company has paid a deposit of $140,000, representing 25 percent of the purchase price of the land. Final settlement of the remaining purchase price balance is currently pending fulfillment of certain key conditions under the sales and purchase agreement by the current owner of the land; or

  The Company leases space for certain of its offices, warehouses, and retail stores under leases expiring from one to twenty-seven years after May 31, 20X1. Rent expense was $x for the year ended May 31, 20X1. Amounts of minimum future annual rental commitments under non-cancelable operating leases in each of the five years ending May 31, 20X2 through 20X6 are $x, $x, $x, $x, $x, respectively, and $x in later years.

D. Common peer review feedback on special purpose framework engagements

As SPF SSARs engagements represent something out of the ordinary, accountants must show significant care to follow appliable professional standards when both performing and reporting on SPF engagements. The following is a summary of common peer review feedback on such engagements.

1. Peer review issue #1 – Disclosures related to special purpose frameworks

<u>Titles should be modified from GAAP</u>
One of the biggest issues related to special purpose frameworks is that the financial statements are prepared with titles that are not appropriate for the SPF. Statement of operations, and statement of cash flows, or similar unmodified titles, are only applicable to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP. AU-C 800 requires the auditor to evaluate whether the financial statements are suitably titled. For example, cash basis financial statements might be titled as a statement of assets and liabilities arising from cash transactions or as a statement of revenue collected and expenses paid; a financial statement prepared on a regulatory basis of accounting might be titled as a statement of income – regulatory basis.

<u>Summary of significant accounting policies</u>
The auditor should also include information about the SPF in the summary of significant accounting policies, describing how the special purpose framework differs from GAAP. The effects of these differences need not be quantified. This paragraph is not necessary when the cash or income tax basis is used since it is self-explanatory.

In the case of special purpose financial statements prepared in accordance with a contractual basis of accounting, the auditor should also evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

2. Reporting issues related to the use of special purpose frameworks

An emphasis of a matter paragraph is required for all but the regulatory basis of accounting – general use.

Example:	**Emphasis of a Matter Paragraph** We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

An other matter paragraph with an alert restricting the use of the report is required for the regulatory basis (not general) and the contractual basis of accounting.

3. Fair presentation considerations

When using a special purpose framework, it is important to consider whether the strict adherence to the basis provides sufficient information to inform the user of matters they need to understand for decision making. When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, accountants and auditors need to evaluate whether the financial statements include informative disclosures similar to those required by GAAP. The AICPA has stated that when special purpose financial statements contain items that would require disclosure using GAAP, then those statements may either provide the relevant disclosures or provide information that communicates the substance of the disclosures. The auditor's evaluation of whether the financial statements achieve fair presentation in accordance with the applicable financial reporting framework requires consideration of the overall presentation, structure, and content of the financial statements and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

When financial statements prepared on the cash basis or modified cash basis contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.

In addition, the financial statements should include all informative disclosures that are appropriate for a special purpose framework, including:

- Policy notes that describe the important differences between GAAP and the special purpose framework;
- A description of the special purpose framework, including a summary of significant accounting policies;
- A description of how the framework differs from GAAP (not necessary for cash and income tax basis as they are self-explanatory); and
- Any additional disclosures that may be necessary for the special purpose financial statements to achieve fair presentation.

Question to ponder:

> With the high volume and potentially high cost of complying with U.S. GAAP, have you seen your client's express interest in switching to a different financial reporting framework? Have any followed through on switching to another framework?

III. Personal financial statements

When we think about preparing financial statements or performing and reporting on a compilation or review engagement, we tend to naturally assume a small or medium-sized business entity.

However, working with the financial statements of an individual or of a family, that is, their personal financial statements, is an important service provided by many CPA firms, from the local sole practitioner to each of the “Big 4” accounting firms.

Along these same lines, more and more CPAs are garnering the professional credential of Certified Financial Planner, or “CFP” from the Certified Financial Planner Board of Standards (www.cfp.net), in order to better serve their current and potential future clients in this area.

Individuals and families have their personal financial statements prepared for a number of reasons, including simply to organize their financial affairs as well as perhaps to obtain credit or to use them for retirement and estate planning purposes.

Likewise, many political figures are also required to provide the public with their financial information through the use of personal financial statements. For example, Mitt Romney’s previous personal financial statements show a net worth of between $190 and $250 million.

The accounting principles for preparing personal financial statements are found in FASB *Accounting Standards Codification* (ASC) Topic 274, *Personal Financial Statements*. The guidance for compiling or reviewing personal financial statements is found in the SSARSs.

We will begin by first highlighting some of the basic accounting principles used to prepare personal financial statements and then review some of the issues relating to compilation and review engagements surrounding these particular financial statements.

The following illustration is an excerpt from the U.S. Small Business Administration’s “fill in the blank” personal financial statement (SBA Form 413) that is easy to use and available free of charge at their website – www.sba.gov.

Name	**Business Phone** *(xxx-xxx-xxxx)*
Home Address	**Home Phone** *(xxx-xxx-xxxx)*
City, State, & Zip Code	
Business Name of Applicant/Borrower	
Business Address *(if different than home address)*	
Business Type: ☐ **Corporation** ☐ **S-Corp.** ☐ **LLC** ☐ **Partnership** ☐ **Sole Proprietor** *(does not apply to ODA applicant)*	
This information is current as of [month/day/year] *(within 90 days of submission for 7(a)/504/SBG/ODA/WOSB or within 30 days of submission for 8(a) BD)*	
WOSB applicant only, Married ☐ **Yes** ☐ **No**	

ASSETS (Omit Cents)		**LIABILITIES** (Omit Cents)	
Cash on Hand & in banks		Accounts Payable	
Savings Accounts		Notes Payable to Banks and Others (Describe in Section 2)	
IRA or Other Retirement Account (Describe in Section 5)		Installment Account (Auto)	
Accounts & Notes Receivable (Describe in Section 5)		Mo. Payments	
Life Insurance – Cash Surrender Value Only (Describe in Section 8)		Installment Account (Other)	
Stocks and Bonds (Describe in Section 3)		Mo. Payments	
Real Estate (Describe in Section 4)		Loan(s) Against Life Insurance	
Automobiles (Describe in Section 5, and include Year/Make/Model)		Mortgages on Real Estate (Describe in Section 4)	
Other Personal Property (Describe in Section 5)		Unpaid Taxes (Describe in Section 6)	
Other Assets (Describe in Section 5)		Other Liabilities (Describe in Section 7)	
		Total Liabilities	$ 0
		Net Worth	
Total	$ 0	**Total** Must equal total in assets column.	$ 0

Section 1. Source of Income.		**Contingent Liabilities**	
Salary		As Endorser or Co-Maker	
Net Investment Income		Legal Claims & Judgments	
Real Estate Income		Provision for Federal Income Tax	
Other Income (Describe below)		Other Special Debt	

Description of Other Income in Section 1 (Alimony or child support payments should not be disclosed in "Other Income" unless it is desired to have such payments counted toward total income)

A. Presentation of personal financial statements

Personal financial statements generally focus on an individual's or a family's assets and liabilities which are typically recognized on the accrual basis of accounting. Assets are presented at their estimated current value and liabilities at their estimated current amount, as opposed to historical cost.

Lending institutions use the current values and amounts found in personal financial statements along with other information to assess collateral requirements for loans. CPAs use the data to assist clients with income tax, retirement, and estate planning, among other activities.

The following is a brief outline that shows some of the more common non-cash assets and liabilities you are likely to find in personal financial statements and how they should be presented:

- *Receivables* – Presented at the discounted amount of cash expected to be collected using relevant interest rates on the date of the financial statements.
- *Marketable equity and debt securities* – Presented at the quoted closing market price or within the range of published bid and asked prices on the date of the financial statements.
- *Options* – Presented at published prices if available or estimated based on the value of the assets subject to the option, considering exercise prices, option periods, etc.

- *Life insurance* – Presented at the cash value of the policy less the amount of any loans against it.
- *Payables and other liabilities* – Presented at the discounted amounts of cash to be paid. If the debt can currently be paid off at a lower amount, presented at that lower amount.
- *Estimated income taxes* – Presented as an amount of estimated income taxes on the differences between the estimated current values of assets and liabilities and their tax bases (including consideration of any negative tax bases of tax shelters).
  - For example, if an investment in say IBM that cost $100 is presented at its estimated current value of $1,100, then estimated incomes taxes of $200 should also be presented (assuming this is a long-term capital gains transaction at 20 percent).

Personal financial statements should also include sufficient disclosures to make the statements adequately informative. The disclosures may be made in the body of the financial statements or in the notes to the financial statements. (See FASB ASC 274 for a complete listing of disclosure requirements.)

The following illustration provides an example set of personal financial statements. Although a statement of changes in net worth is not required by FASB ASC 274, it is a best practice to include it in a complete set of personal financial statements.

Example Personal Financial Statements

Dr. Ali Gator
Statement of Financial Condition
December 31

		20X1	20X0
Assets			
Cash		$112,282	$114,845
Personal property	Note 2	500,000	500,000
Marketable equity securities	Note 3	6,410,962	6,388,004
Retirement plan	Note 4	164,735	144,958
Personal residence	Note 5	3,000,000	3,000,000
Total Assets		$10,187,979	$10,147,807
Liabilities			
Income taxes payable		16,485	15,231
Credit cards payable		12,152	8,945
Mortgage payable	Note 6	588,331	595,767
Total Liabilities		616,968	619,943
Estimated income taxes	Note 7	88,128	75,021
Net Worth		9,482,883	9,452,843
		$10,187,979	$10,147,807

The accompanying notes are an integral part of these financial statements.

See independent accountant's [*compilation or review*] report.

Dr. Ali Gator
Statement of Changes in Net Worth
December 31

	20X1	20X0
Realized increases in Net Worth		
Salary and bonus	$400,000	$385,000
Investment income	8,372	9,945
Total	408,372	394,945
Realized decreases in Net Worth		
Income taxes	108,993	104,324
Interest expense	15,885	16,477
Real estate taxes	61,230	60,451
Personal expenses	221,852	213,427
Total	407,960	394,679
Net realized increase in Net Worth	412	266
Unrealized increases in Net Worth		
Marketable equity securities	22,958	17,222
Retirement plan	19,777	19,986
Total	42,735	37,208
Unrealized decrease in Net Worth		
Estimated income taxes on the differences between the estimated current values of assets and estimated current amounts of liabilities and their tax bases	13,107	11,000
Net unrealized increase in Net Worth	29,628	26,208
Net increase in Net Worth	30,040	26,474
Net Worth at the beginning of year	9,452,843	9,426,369
Net Worth at the end of year	$9,482,883	$9,452,843

The accompanying notes are an integral part of these financial statements.

See independent accountant's [*compilation or review*] report.

Dr. Ali Gator
Notes to the Financial Statements

Note 1: Summary of Significant Accounting Policies

The accompanying financial statements include the assets and liabilities of Dr. Ali Gator. Assets are presented at their estimated current values and liabilities are presented at their estimated current amounts.

Note 2: Personal Property

The estimated current value of personal property is based on appraisals made by independent appraisers for insurance purposes.

Note 3: Marketable Equity Securities

The estimated current value of marketable equity securities is based on closing market quotations from the New York Stock Exchange on December 31, 20X1 and 20X0.

The portfolio consists of the following investments:

Estimated Current Value at December 31

	20X1	**20X0**
ABC, Inc.	$3,780,043	$3,311,999
XYZ, Inc.	2,630,919	3,076,005
	$6,410,962	$6,388,004

No securities were purchased or sold during 20X1 and 20X0.

Note 4: Retirement Plan

Dr. Gator participates in a deferred tax retirement plan administered by Merrill Lynch (Bank of America), a member of the New York Stock Exchange. The estimated current value of the plan as of December 31, 20X1 and 20X0, is based on information provided by the plan administrator.

Note 5: Personal Residence

The estimated current value of the residence is based on appraisals made by McKenna Real Estate Appraisal, Inc., an independent residential real estate appraisal firm, on January 8, 20X2 and January 12, 20X1.

Note 6: Mortgage Payable

The mortgage is payable in monthly installments of $11,250 and carries a 3.5% fixed interest rate through its maturity date in 20ZZ. The debt is collateralized by the residence.

Note 7: Estimated Income Taxes

The estimated current amounts of liabilities at December 31, 20X1 and 20X0, equal their tax bases. Estimated income taxes have been provided on the excess of the estimated current values of assets over their tax bases as if the estimated current values of the assets had been realized on December 31, 20X1 and 20X0, using applicable tax laws and regulations. The provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation and the tax laws and regulations in effect at the time of disposal, realization, or liquidation. The estimated current values of assets exceeded their tax bases by $774,748 at December 31, 20X1, and by $717,121 at December 31, 20X0. The excess of estimated current values of major assets over their tax bases are:

December 31, 20X1	Estimated Current Value	Tax Basis	Difference	Effective Income Tax Rate	Amount of Estimated Income Taxes	Assumption Used
Cash	$112,282	$112,282	$ -	-	$ -	
Personal property	500,000	400,000	100,000	20%	20,000	Long-term capital gains
Marketable equity securities	6,410,962	6,300,949	110,013	20%	22,003	Long-term capital gains
Retirement plan	164,735	0	164,735	28%	46,125	Retirement tax rate
Personal residence	3,000,000	2,600,000	400,000	-	-	No tax effect
	$10,187,979	$9,413,231	$774,748		$88,128	
December 31, 20X0						
Cash	$114,845	$114,845	$ -	-	$ -	
Personal property	500,000	425,000	75,000	20%	15,000	Long-term capital gains
Marketable equity securities	6,388,004	6,290,841	97,163	20%	19,433	Long-term capital gains
Retirement plan	144,958	0	144,958	28%	40,588	Retirement tax rate
Personal residence	3,000,000	2,600,000	400,000	-	-	No tax effect
	$10,147,807	$9,430,686	$ 717,121		$75,021	

Note 8: Life Insurance

Dr. Gator has a term life insurance policy in the amount of $1,000,000.

B. Preparing, compiling, and reviewing personal financial statements

When preparing, compiling, or reviewing personal financial statements, you will of course first have to be familiar with and understand the accounting requirements and guidance for preparing such statements that is found in FASB ASC 274, *Personal Financial Statements*.

Performing and reporting on a preparation, compilation, or review of personal financial statements follows all of the same basic steps and procedures required in a "standard" engagement. Since we have already discussed this in detail, we will not repeat it here again. Instead, we will first take a look at some of the sources of information included in personal financial statements, then review some example analytical procedures and inquires, and finally some representations letters typically seen in practice today in connection with compilation or review engagements of personal financial statements.

1. Where the information comes from

We will use Dr. Gator's personal financial statements above to identify some of the various sources of information included in them.

- *Cash* – Checkbooks, savings account ledgers, bank and brokerage statements.
- *Personal property* – Insurance policies, appraisal records, personal property tax returns.
- *Marketable equity securities* – Brokerage statements.
- *Retirement plan* – Plan administrator documents.
- *Personal residence* – Insurance policies, real estate tax records.
- *Income tax payable* – Quarterly income tax payment records, annual income tax return.
- *Credit cards payable* – Credit card statements, annual account activity summaries.
- *Mortgage payable* – Mortgage holder statements.
- *Salary and bonus* – Employment contracts, W-2s, income tax return.
- *Investment income* – Bank and brokerage statements.
- *Income taxes* – State, federal, and personal property tax returns.
- *Interest expense* – Mortgage holder statement, mortgage 1099s.
- *Real estate taxes* – Mortgage holder statement, mortgage 1099s.
- *Personal expenses* – Checkbooks, credit card statements, receipts.

2. Analytical procedures and inquiries

Analytical procedures performed in a review of personal financial statements typically focus on:

a. Comparing the current year financial statements to those from prior periods; and
b. A review of the various financial statement amounts and expected relationships, for example, comparing:
    (i) Investment portfolios to investment income;
    (ii) Real estate values to property tax;
    (ii) Debt outstanding to interest expense; and
    (iv) Income to income taxes.

Inquiries to use when reviewing personal financial statements include, for example, those concerning:

a. Accounting principles and procedures:
    (i) Have the client prepare a list of specific accounting principles, practices, methods, and significant assumptions used to prepare the financial statements.
b. Valuation methods and procedures:
    (ii) Determine whether the methods and procedures used to value assets and liabilities are consistent with those identified in FASB ASC 274, *Personal Financial Statements*.
c. Sources of information (as outlined above).
d. How the client keeps track of their financial transactions and information for disclosures.
e. Any changes in the client's financial activities.
f. Subsequent events.
g. The use of any specialists, for example, real estate appraisers.

3. Representations letter

Representation letters that are obtained in a compilation (not required but recommended) and a review were reviewed in the respective chapters on those services. We will not review these again here. However, remember it is important to establish management's responsibility for the selection of the appropriate financial reporting framework and the preparation of financial statements under that framework, including all required disclosures.

