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Compilation and Review Alert

Compilation and Review Alert—1996/97

Update on Practice Developments and Professional Standards

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NOTICE TO READERS

This Compilation and Review Alert is intended to provide CPAs with an overview of recent practice developments and professional standards that may affect the compilations and reviews they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

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Compilation and Review Alert—1996/97

Introduction

The *Compilation and Review Alert—1996/97* is a nonauthoritative practice aid designed to help accountants plan and perform their 1996 and 1997 compilation and review engagements. It clarifies certain existing professional standards, suggests ways of implementing Statements on Standards for Accounting and Review Services (SSARSs) in special circumstances, points out pitfalls that frequently occur in compilation and review engagements, and summarizes new professional pronouncements.

Practice Problems Identified in Comment Letters on the Assembly Exposure Draft

In September 1995, the Accounting and Review Services Committee (ARSC) issued an exposure draft of a proposed SSARS entitled *Assembly of Financial Statements for Internal-Use Only*. The proposed SSARS would allow CPAs to prepare financial statements for their clients without having to comply with the requirements of SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), if distribution of the financial statements were restricted to internal personnel. The proposed Statement would introduce a new financial-statement service for nonpublic entities because under existing standards, an accountant is required to at least compile financial statements that he or she submits to a client or others, and report on them accordingly.

The AICPA received over 500 comment letters on this highly controversial proposal, and when the ARSC met in February 1996 to discuss the comment letters, they concluded that they needed additional information about the kinds of problems CPAs encounter when performing compilation engagements under SSARSs. To obtain this information, the ARSC sent a questionnaire to all the commenters who had written letters in support of the exposure draft, called some of those commenters, and invited members of the AICPA Small Firm Advocacy Committee to the May 1996 ARSC meeting to talk about the problems practitioners are experiencing.

The primary complaint expressed by supporters of the exposure draft was that performing compilation engagements is too time-consuming and too costly and that clients are reluctant to pay for these services. A careful analysis of these practitioners' comments revealed that the following factors appear to increase the time and cost entailed in performing compilation engagements.

- *Making Cosmetic Improvements to Financial Statements*—Many CPAs generate financial statements at their clients' offices using their clients' software. In some cases, limitations of the software prevent the CPA from being able to modify the statements as needed. For example, the software might not allow the CPA to change the title of a financial statement from "Income Statement" to a title that would be appropriate for a cash-basis statement, such as "Statement of Revenue Collected and Expenses Paid." Also, the software might provide a limited amount of space for captions in the statements so that certain captions would have to be abbreviated. These limitations require that the CPA cross out inappropriate information and write in corrected information or expand on abbreviated information. CPAs find that the resulting financial statements are unprofessional-looking and are concerned that the statements do not meet professional standards. Many of these CPAs go back to their offices to reenter the financial-statement data using more sophisticated word-processing software that produces a more polished statement. These practitioners contend that the statements produced in their clients' offices are "good enough" for their clients, and when the ARSC inspected some of these computer-produced financial statements (with appropriate modifications as needed), they concurred. The additional work performed at the CPA's office delays submission of the financial statements to the client and makes the engagement more time-consuming and costly than it need be. SSARSs does not require this additional effort, and if a CPA has complied with the requirements of SSARSs and believes the financial statements are presented in accordance with the stated basis of accounting, there is no need for cosmetic improvements, especially if the financial statements are for a client's use only.

  An option available to a CPA in this situation is to mark the rough financial statements with words such as, "Draft—Subject to Change" and to leave the statements with the client. The accountant may submit revised financial statements to the client with an appropriate compilation report after any additional work is completed, as provided for in Interpretation No. 17 of SSARS No. 1, "Submitting Draft Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.61–.62).

- *Stationery and Signature for Compilation and Review Reports*—Many of the CPAs who wrote letters in support of the assembly exposure draft indicated that an assembly service would be helpful to them because it would enable them to submit financial statements to their clients at their clients' offices without having to go back to their own offices to print the compilation report on firm letterhead and have the compilation report manually signed by a specified individual. SSARS No. 1 requires neither that a compilation or review report be printed on firm letterhead, nor that the report be manually signed. A compilation or review report may be printed on plain stationery, without any letterhead, and the signature on the report may be manually signed, typed, computer printed, or stamped with a signature facsimile.

- *Overlooking Simpler Options Available Under Existing Standards*—Many CPAs are unaware of the wide range of financial statement services they may provide to their clients under existing standards, such as compiling cash or tax-basis financial statements or statements that omit substantially all disclosures. They mistakenly believe that all financial statements must be full-disclosure generally accepted accounting principles (GAAP) financial statements. If a CPA compiles cash-basis interim financial statements that omit substantially all disclosures, the compilation report generally will not change from period to period because only items representing departures from the cash basis must be identified in the compilation report, and such departures are extremely rare. If a client requests that a CPA prepare monthly GAAP-basis financial statements, but does not require that the financial statements be adjusted for certain accruals and deferrals until year end, a CPA may forgo making those adjustments and may prepare standardized interim compilation reports, in advance, identifying the anticipated GAAP departures. Doing this will enable the CPA to save time in drafting the compilation report and perform a service that meets client needs.

  Another option is for the CPA to compile only one financial statement, such as the balance sheet, and not the other related financial statements, as provided for in paragraph 18 of SSARS No. 1. A CPA also may provide his or her client with monthly presentations containing only selected information requested by the client. This information might consist of account balances, such as cash or accounts receivable, operating information, such as the number of meals served during a particular month, or a combination of financial and operating information. Interpretation No. 8 of SSARS No. 1, "Reports on Specified Elements, Accounts, or Items of a Financial Statement," (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.27–.28) excludes the presentations of elements, accounts, or items of a financial statement from the applicability of SSARS No. 1. Thus, an accountant is not required to report on such presentations. Finally, another option is to provide a client or other users with a copy of the client's tax return, if that meets users' needs. Interpretation No. 10 of SSARS No. 1, "Reporting on Tax Returns" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.31–.32), states that SSARS No. 1 imposes no requirement on an accountant to report on financial information contained in a tax return. The fact that a tax return is subsequently used for purposes other than submission to taxing authorities does not affect that exception.

- *Performing More Work Than Is Required Because of Concerns About Peer Review*—CPAs are distressed about the time and cost entailed in peer review, especially if they only perform compilation engagements for one or very few clients. Some practitioners perform more work than is required in a compilation engagement in anticipation of peer review. The ARSC has been meeting with representatives of the AICPA Peer Review Program in an effort to reconcile some of the differences that might exist between the expectations of some peer reviewers and the requirements of SSARSs for compilation engagements. Although many CPAs use procedural and disclosure checklists to assist them in performing compilation engagements, SSARSs does not require the use of checklists or any other working paper documentation in a compilation engagement.

In addition to factors that increase the time and cost of performing compilation engagements, supporters of the exposure draft also indicated that they are concerned about the following matters.

- *CPAs Providing Controllership Services to Clients*—Many CPAs are engaged to provide part-time or full-time controllership services to their clients. They maintain the accounting books and records, prepare financial statements, and perform significant management functions for their clients, such as hiring employees, authorizing purchases, investing idle cash, and signing checks. They contend that the services they perform are the same as those performed by management and that they are well beyond being *non-independent*. They believe that SSARSs should not be applicable to the financial statements they prepare because a compilation report is used by an outside accountant to report on financial statements that are the representations of another party. The ARSC agrees that SSARSs probably should not be applicable to such financial statements; however, the ARSC is struggling with the problem of differentiating between services that impair an accountant's independence and those that are equivalent to management. Under existing standards, an accountant whose independence is impaired may compile financial statements for a client as long as the accountant indicates his or her lack of independence in the compilation report. If a CPA were deemed to be performing significant management functions for a client, the CPA would no longer be able to compile financial statements for that client.

- *Submission of Financial Statements*—The definition of the term *submission of financial statements* is very important in SSARS No. 1 because if an accountant submits financial statements to a client or others, he or she is required to at least compile those statements. Paragraph 7 of SSARS No. 1 defines the submission of financial statements and specifies which acts trigger the requirement to compile financial statements. Submission of financial statements is currently defined as presenting to a client or others financial statements that the accountant has—

  1. Generated, either manually or through the use of computer software, or
  2. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements

  Some CPAs are uncertain about whether they have "generated" financial statements when they perform certain services for a client, especially in the context of computer-generated financial statements. For example, consider a situation in which a CPA prepares adjusting journal entries for a client and enters them into a client's computerized financial-statement database using software that automatically updates the existing data to produce revised financial statements. The CPA may not have intended to generate financial statements, but the computer automatically performs this function. Has the CPA generated financial statements if the statements exist in the computer's memory or on the screen of the computer's monitor, or does generation require that the statements be printed? (Additional examples of submission-related scenarios are presented in the article, "When Has a CPA Submitted Financial Statements," in this Alert). The ARSC is wrestling with this issue and may have to amend SSARS No. 1 to clarify the guidance on this topic. In addition, an AICPA task force is studying the impact of electronic transmission on financial statements and accountants' reports, and is addressing issues related to reporting on compiled financial statements that are produced and transmitted electronically.

- *Status of the Exposure Draft*—The ARSC is grappling with the aforementioned issues with the expectation that a substantial number of the problems encountered by practitioners in performing compilation engagements will disappear once the ARSC has provided solutions to these problems. The ARSC is examining the pros and cons of various options before deciding whether to develop a modified version of the exposure draft or whether to abandon the concept of an assembly service. If the ARSC decides not to issue the exposure draft as a final standard, it will need to amend or interpret SSARSs to address the problems identified in the comment letters. A conclusion that most parties agree on is that there is a need to make the guidance on how to perform cost-effective compilation engagements readily available to all CPAs, and especially to individual practitioners and others practicing in small firms. It has been suggested that this guidance be provided in the form of low-cost or free continuing professional education (CPE) programs or presented in brief installments in *The CPA Letter*.

When Has a CPA Submitted Financial Statements?

The article, "Practice Problems Identified in Comment Letters on the Assembly Exposure Draft," in this Alert, notes that many CPAs are uncertain about whether the services they perform for their clients constitute a submission of financial statements. The term *submission of financial statements* is pivotal in SSARS No. 1 because if an accountant submits financial statements to a client or others, he or she is required to at least compile the financial statements. If a CPA has not submitted financial statements, SSARSs is not applicable to the engagement. As noted on page 9 of this Alert, paragraph 7 of SSARS No. 1 defines the submission of financial statements as presenting financial statements to a client or others that the accountant has—

1. Generated, either manually or through the use of computer software, or
2. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements

In most situations, the applicability of SSARSs is fairly clear; however; the applicability may become blurry in certain situations, especially those involving computer-generated financial statements. At its September 1996 meeting, the members of the ARSC focused on this problem by describing various scenarios they have encountered involving the submission of financial statements and offering conclusions as to whether each situation is subject to the requirements of SSARSs. The following are some of the scenarios that were described and the conclusions reached by the members of the ARSC, based on existing standards.

1. The CPA prepares financial statements for a client and attaches them to a tax return. The financial-statement information correlates with the information requested on the tax return. The CPA gives the returns and the statements to the client who submits them to the taxing authority.

   Conclusion: This engagement is excluded from the applicability of SSARSs based on Interpretation No. 10 of SSARS No. 1 "Reporting on Tax Returns," which states that SSARS No. 1 imposes no requirement on an accountant to report on financial information contained in a tax return.

2. The CPA performs the services described in the preceding situation. The client informs the CPA that he or she intends to submit the tax return packet to parties other than the taxing authority.

   Conclusion: This engagement is excluded from the applicability of SSARSs based on Interpretation No. 10 of SSARS No. 1, which states that the fact that a tax return is subsequently used for purposes other than submission to taxing authorities does not affect that exception.

3. The CPA attaches interim financial statements to an annual tax return. Since the financial statements are for only an interim period, they will not be submitted to the taxing authority.

   Conclusion: SSARSs is applicable to this engagement. Although not specifically stated, Interpretation No. 10 of SSARS No. 1 is predicated on the assumption that the financial information entered on a tax return or attached to a tax return correlates with the financial information requested on the tax return, and that the return will be filed with a taxing authority. Attaching a financial statement to a tax return that does not dovetail with the information requested on the tax return, and that will not be filed with the taxing authority, violates Interpretation No. 10.

4. A client gives client-prepared financial statements to a CPA. The CPA posts adjustments to the client's financial statements in a worksheet format (either manually or via computer) to reflect the tax closing, and carries the adjusted balances forward. The CPA gives the client the financial-statement worksheet so that the cli-

ent can enter the adjustments into the client's accounting system to reflect the tax closing.

Conclusion: SSARSs is applicable to this engagement for the following reasons.

a. The worksheet that the CPA gives to the client includes adjusted financial statements; therefore, the accountant has generated financial statements.

b. The accountant has materially modified the client's financial statements. This would be covered under paragraphs 7a and 7b of SSARS No. 1.

5. On a separate sheet of paper, the CPA prepares adjustments to client-prepared financial statements and gives the adjustments to the client. The client posts the adjustments to the financial statements and sends the adjusted financial statements to the CPA for his or her consideration.

   Conclusion: SSARSs is not applicable to this engagement. Paragraph 7 of SSARS No. 1 identifies the following service as one that does not constitute a submission of financial statements.

   > Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materially change client-prepared financial statements, <u>as long as the accountant does not directly modify the client-prepared financial statements</u>

6. The CPA enters adjustments to the client's financial-statement database using the client's computer, prints the adjusted financial statements, and takes the financial statements with him or her. The CPA does not give the statements to the client. The client has the ability to access the adjusted financial statements by viewing them on the computer monitor or printing them.

   Conclusion: SSARSs is applicable to this engagement because by causing the computer to create adjusted financial statements, the accountant has generated financial statements. Although the CPA did not "present" them to the client, the accountant made them available to the client.

7. The CPA is engaged to compile the client's financial statements. The CPA prepares the financial statements and shows them to the client for his or her review. The client or CPA notes a problem in the statements and the CPA adjusts the statements and shows a revised draft of the statements to the client. Several additional versions of the financial statements are prepared for the client's review.

Conclusion: Interpretation No. 17 of SSARS No. 1, "Submitting Draft Financial Statements," provides guidance for this situation. It states that an accountant should not submit draft financial statements without intending to submit those financial statements in final form, accompanied by an appropriate compilation or review report. As long as the accountant intends to submit the financial statements in final form and labels each page of the draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Changes," or "Working Draft," the accountant is not required to comply with the reporting provisions of SSARS No. 1 for the draft financial statements. Based on this interpretation, the accountant would not be required to report on the draft financial statements and would only be required to report on the final financial statements.

8. The CPA meets with the client's bookkeeper to discuss client-prepared financial statements. The CPA notes a problem in the statements and communicates the required adjusting entries to the bookkeeper, either orally or in writing, but not directly on the client-prepared financial statements. The bookkeeper enters the adjusting entries into the computer, prints the revised financial statements, and shows them to the CPA. The CPA reads the financial statements and informs the bookkeeper that no further adjustments are required. The bookkeeper gives the CPA and the client a copy of the financial statements, which the CPA discusses with the client.

   Conclusion: SSARSs is not applicable to this engagement. Based on paragraph 7 of SSARS No. 1, none of the procedures performed by the CPA constitutes a submission of financial statements.

9. The client sends the CPA a computer disk that contains client-prepared financial statements. The CPA adjusts the financial statements on the disk resulting in revised financial statements. The CPA returns the disk to the client.

   Conclusion: SSARS is applicable to this engagement because the CPA has materially modified client-prepared financial statements and generated revised financial statements.

Using Staff in a Compilation or Review Engagement

Many practitioners are uncertain about whether they may delegate to a staff person, including a paraprofessional, the performance of a compilation or review engagement. Interpretation No. 5, of SSARS No. 1, "Planning and Supervision," (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.16–.17) notes that SSARSs is silent on this topic and that Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides guidance on the use of staff in an audit engagement and on the auditor's responsibility for supervising staff. The Interpretation states that an accountant is not required to follow the guidance in SAS No. 22 when performing a compilation or review engagement However, the Interpretation also states that an accountant may wish to consider SAS No. 22 or other reference sources, such as textbooks and articles, as sources of information about planning and supervising a compilation or review engagement.

The Interpretation's reference to SAS No. 22 as a source of information about planning and supervising a compilation or review engagement, and the fact that SSARSs does not preclude a CPA from delegating the performance of such engagements to a staff person causes the authors of this Alert to conclude that a CPA may delegate the performance of a compilation or review engagement to staff persons, including paraprofessionals, as long as the staff person is qualified to perform the work. In all cases, the owners, partners, or shareholders of the accounting firm retain responsibility for the engagement and the representations in the compilation or review report.

Legends on Compiled or Reviewed Financial Statements

Paragraphs 16 and 34 of SSARS No. 1 require that each page of compiled (reviewed) financial statements bear the legend, "See Accountant's Compilation (Review) Report." The following are questions that are frequently asked about the use of legends in compiled and reviewed financial statements and suggestions for implementing this requirement.

1. *Question.* Must the legend, "See Accountant's Compilation (Review) Report" be placed on pages of the financial statements that contain footnote disclosures?

   Answer. Paragraph 4 of SSARS No. 1 defines a financial statement as a presentation of financial data, including accompanying notes. Since the accompanying notes are part of the financial statements, the legend should be placed on those pages as well. However, if each page of the financial statements contains a statement indicating that the footnotes to the financial statements are an integral part of the statements, it may not be necessary to include the reference to the accountant's report on the footnote pages.

2. *Question.* Should the legend, "See Accountant's Compilation (Review) Report" be placed on pages of the financial-statement package that contain supplementary information?

   Answer. Yes. Although the paragraph 4 definition of a financial statement referred to above does not include supplementary information as a component of a financial statement, the authors of this Alert believe that the pages containing supplementary information should bear the legend as well. Paragraph 43 of SSARS No. 1 states that if the basic financial statements are accompanied by supplementary information, the accountant should clearly indicate the degree of responsibility he or she is taking for that information. Since the accountant's compilation or review report must identify the level of service that has been performed on the supplementary information, the most effective way of communicating that information to the user is to refer the user to the accountant's report.

3. *Question.* How should the legend on the financial statements be worded in the event of either of the following?

   a. The financial statements have been reviewed and the supplementary information has been compiled.

   b. Comparative financial statements are being presented and one year has been reviewed and the other year has been compiled.

   Answer. The legend on the pages of such financial statements may read, "See Accountant's Report." Although this approach is less precise because it does not identify the level of service in the legend, it does refer the reader to the report that will clearly state the level of service performed on each component of the financial statements and each year presented.

Compiling Pro Forma Financial Information

A client who is considering entering into an important transaction, such as acquiring another entity, may find it helpful to have a CPA compile pro forma financial information related to that transaction. The objective of pro forma financial information is to present historical financial information as if a proposed or consummated transaction had occurred at the date of the historical financial information. The pro forma financial information may consist of financial statements or selected elements of a financial statement. Pro forma financial information is prepared by making pro forma adjustments to the historical financial information. The adjustments are based on management's assumptions and should reflect all of the significant effects that would be directly attributable to the proposed transaction or event. For example, in 1996, Company A may be considering acquiring Company B and would like to determine what the December 31, 1995, financial statements would have looked like had that acquisition occurred during 1995. The client, with the assistance of the CPA, would prepare pro forma financial statements that reflect all of the significant factors that would have affected the historical financial statements, such as increased labor costs if the acquisition involves the use of employees covered by a collective bargaining agreement, or the tax effects of operating in a new locality. Other situations for which pro forma financial information may be useful are to show the effects of transactions such as the following:

- The disposition of a significant portion of a business, such as the sale of a division
- A change in the form of a business organization, such as the incorporation of a sole proprietorship
- The sale of securities and the application of the proceeds, such as the issuance of debt or equity securities and the use of the proceeds to purchase additional manufacturing equipment

Statement on Standards for Attestation Engagements (SSAE) No. 1, *Reporting on Pro Forma Financial Information* (AICPA, *Professional Standards,* vol. 1, AT sec. 300), establishes standards for examining or reviewing pro forma financial information. However, that standard does not apply to the compilation of pro forma financial information. In Technical Practice Aid (TPA) No. 9, "Compilation of Pro Forma Information" (AICPA, *AICPA Technical Practice Aids,* sec. 9900.09), an inquiry is made as to whether an accountant may compile pro forma financial information if the related historical financial statements have been compiled. The TPA states that an accountant may compile pro forma financial information because AT section 300 does not proscribe such a service. Although there is no authoritative guidance for compiling such information, the authors of this Alert recommend that CPAs who compile such information

- Obtain a general understanding of the underlying transaction or event that created the need for the pro forma financial information.
- Consider whether management's assumptions underlying the pro forma adjustments are disclosed in the notes to the pro forma financial information and whether the pro forma adjustments ap-

pear to be consistent with each other and with the data used to develop them.

If the historical financial statements have been compiled, the pro forma financial information may be presented as supplementary information accompanying the historical financial statements and the accountant may report on the pro forma financial information in accordance with the guidance on supplementary information presented in paragraph 43 of SSARS No. 1.

Use of Emphasis and Going-Concern Paragraphs in Compilation and Review Reports

Practitioners frequently ask whether they may add a paragraph to a compilation or review report to emphasize a matter regarding the financial statements, especially if they are concerned about an entity's ability to continue as a going concern. The second line in footnote 18 of SSARS No. 1 states, "Nothing in this statement is intended to preclude an accountant from emphasizing in a separate paragraph of his or her report a matter regarding the financial statements." Although SSARS No. 1 does not discuss the use of emphasis paragraphs, the important rule to remember about such paragraphs is that they should not introduce new information to the reader of the financial statements. They should only highlight or emphasize a matter disclosed in the financial statements. If a CPA believes that certain information should be disclosed in the financial statements to conform with the basis of accounting used, and the client refuses to disclose that information, the accountant is required to state, in a separate paragraph of the report, that the disclosure has been omitted and that the omission represents a departure from the basis of accounting used. This kind of paragraph is different from an emphasis paragraph because its purpose is to make the reader aware of a deficiency in the financial statements—it lets the reader know there is something wrong with the statements. Whereas, the tone and purpose of an emphasis paragraph is nonjudgmental; the paragraph simply points to information that is already disclosed in the financial statements. The financial statements are management's statements, not the accountant's, and it is management's responsibility to disclose the appropriate information in the statements. It is the accountant's responsibility to function as a referee and to report problems noted in the financial statements.

Emphasis paragraphs should never contain information about procedures the accountant has or has not performed or about the CPA's conclusions or opinions concerning the entity's status as a going concern. Footnote 18 of SSARS No. 1 points out that paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provide guidance on evaluating the adequacy of going-concern disclosures in financial statements. The disclosure guidance in those paragraphs applies to compiled, reviewed, and audited financial statements. The following are examples of information related to going concern that might need to be disclosed in the financial statements:

- Pertinent conditions and events giving rise to the going-concern matter
- The possible effects of such condition.
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

If full-disclosure financial statements need the going-concern disclosure required by SAS No. 59 and the disclosure has been omitted, the accountant should add a paragraph to the report describing the departure from GAAP, as required by paragraphs 39 and 40 of SSARS No. 1. If financial statements include appropriate disclosure about a going-concern matter, the accountant is *not* required to modify the standard compilation or review report. However, the accountant may add an emphasis paragraph highlighting the disclosures in the financial statements. Interpretation No. 11 of SSARS No. 1, "Reporting on Uncertainties," (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.33–.40) suggests the following sample paragraph as one that might be used to emphasize going-concern disclosure included in compiled or reviewed financial statements.

> As discussed in Note X, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments to the financial statements that might be necessary should the Company be unable to continue as a going concern.

SAS No. 59 requires that the terms *substantial doubt* and *going concern* be used in the explanatory paragraph if the auditor concludes that substantial doubt exists. The auditor determines that there is substantial doubt on the basis of evidence obtained from procedures performed in an audit, not from compilation or review procedures. Accordingly, the phrase "substantial doubt about the entity's ability to continue as a going concern" is reserved for audit reports and should not be used in an emphasis paragraph of a compilation or review report.

Incomplete Information

Paragraphs 39 and 40 of SSARS No. 1 note that an accountant who is engaged to compile or review financial statements may become aware of a departure from GAAP, or an other comprehensive basis of accounting (OCBOA), that is material to the financial statements. Paragraph 12 of SSARS No. 1 indicates some of the ways in which potential financial-statement misstatements may come to the accountant's attention, such as through inquiries the accountant may have made, procedures the accountant may have performed, knowledge gained from prior engagements, and the appearance of the financial statements on their face. Paragraph 12 states that an accountant is not required to make inquiries or perform other procedures in a compilation engagement to verify, corroborate, or review information supplied by the entity. However, it also states that if information comes to the accountant's attention that causes him or her to conclude that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, the accountant is required to obtain additional or revised information. Practitioners have asked about the extent of their responsibility in a compilation engagement for determining the existence of potential suspected financial statement misstatements if not all of the information needed to make such a determination is available. How much work must a CPA perform in a compilation engagement to discharge his or her responsibility for identifying financial statement misstatements?

Consider the following situation. A CPA who is compiling financial statements for a client notes that the client's cash disbursements journal shows monthly disbursements for several pieces of leased equipment. When the CPA asks the client whether the equipment is rented or whether the client is making payments on purchased equipment, the client indicates that he is uncertain. The client does not have documentation concerning the leased equipment, and telephone calls to the lessor do not readily elucidate the matter. This is the first year of the engagement and the CPA does not have information from prior years. Paragraph 12 of SSARS No. 1 directs the accountant to obtain additional information if the accountant concludes that information supplied by the entity is incomplete.

In this situation, the CPA should explain to the client why the information is needed and request that the client contact the lessor to obtain copies of the lease agreements. Making the client aware of the reason why the information is needed is important because a compilation is defined as presenting in the form of financial statements information that is the representation of management, and management must take responsibility for the representations in the financial statements.

As a practical solution, for the current financial statements that the CPA is compiling, the CPA has several options. Interpretation No. 17 of SSARS No. 1 permits the accountant to prepare the financial statements with the existing information and not to report on them as long as the CPA marks the statements with words such as "Draft—Subject to Change," and intends to submit final financial statements, with an appropriate compilation report, when the information needed to complete the compilation becomes available. Another alternative is to prepare the financial statements using the cash basis of accounting, if that meets the client's temporary needs, until the required information is obtained.

A CPA should *not* issue a compilation report indicating that management has not determined the appropriateness of the accounting treatment used in the financial statements and that any potential departures from GAAP have not been determined. The use of such language is inappropriate because it permits the accountant to evade his or her responsibility for identifying material departures from the basis of accounting used.

Deciding When to Use OCBOA Financial Statements

The article, "Practice Problems Identified in Comment Letters on the Assembly Exposure Draft," in this Alert, recommends that practitioners consider preparing OCBOA financial statements for their clients as a cost-effective alternative when GAAP financial statements are not needed or required. SAS No. 62, *Special Reports* (AICPA, *Professional Standards,* vol. 1, AU sec. 623), defines an OCBOA as one of the following four:

1. A basis of accounting used to comply with the requirements of a governmental regulatory agency, such as a basis of accounting used by insurance companies to comply with the rules of a state insurance commission[1]

[1] An accountant's report on financial statements prepared using a basis of accounting that complies with the requirements of a governmental regulatory agency should include a paragraph restricting distribution of the report to those within the entity and to the regulatory agency.

2. A basis of accounting that the entity uses to file its income tax return
3. The cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes
4. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level-basis of accounting.

Preparing OCBOA financial statements is generally less costly than preparing GAAP financial statements because OCBOA financial statements generally do not require the extensive disclosures required by GAAP. It should be noted that the use of an OCBOA does not necessarily eliminate the need for disclosures in financial statements,[2] unless the CPA prepares financial statements that omit substantially all disclosures, as provided for in paragraphs 19 through 21 of SSARS No. 1.

In determining whether OCBOA financial statements are appropriate for a client, a CPA should consider who the users of the financial statements will be and whether the client is bound by contractual agreement or regulatory provisions to prepare GAAP financial statements. Characteristics of entities that generally are good candidates for cash or tax-basis financial statements are the following.

- The entity has no third-party users of the financial statements, for example, the entity is a small closely held business with no third-party debt.
- The entity only has secured debt rather than unsecured debt.
- Creditors of the entity do not require GAAP financial statements.
- The entity's cost of complying with GAAP would exceed the benefits, for example, a small construction contractor who would be required to account for long-term contracts using the percentage-of-completion method and would be required to compute deferred taxes.
- The business is owned by a manager who is closely involved in the day-to-day operations of the business and carries in his or her mind a fairly accurate picture of the entity's financial position.
- The owners of the entity are primarily interested in cash flows, for example, a professional corporation of physicians that distributes

[2] Footnote 4 of SSARS No. 1 indicates that the source of guidance for evaluating the adequacy of disclosure in OCBOA financial statements is paragraphs 9 and 10 of SAS No. 62.

its cash-basis earnings through salaries, bonuses, and retirement plan contributions.

- The owners of the entity are primarily interested in the tax implications of transactions, for example, partners in a partnership who are concerned about the tax effects of transactions that will be reflected on their personal tax returns.
- Capital expenditures and long-term financing are not significant to the entity.
- The entity is not subject to Internal Revenue Code rules that would require the entity to prepare its tax return on the accrual basis of accounting, for example, the entity does not have inventory that is material to the business or does not have average annual gross receipts that exceed $5 million for the prior three tax years.

Obtaining a Representation Letter for All Periods Covered by a Review Report

Paragraph 28 of SSARS No. 1 requires that a client provide a CPA with a representation letter in a review engagement. According to Interpretation No. 2, of SAS No. 19, "Management Representations When Current Management Was Not Present During the Period Under Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9333.05–.06), representation letters should cover all periods covered by the auditor's report and should be signed by the current owner/manager. Although the Interpretation only addresses audit engagements, the authors of this Alert believe that this requirement also is applicable to review engagements. If a CPA is reviewing comparative financial statements (financial statements covering two or more periods), the CPA should obtain a representation letter that covers all periods covered by the review report.

Paragraph 28 of SSARS No. 1 requires that the representation letter in a review engagement be obtained from members of management "whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter." Because a representation letter must cover all periods covered by the review report, a problem may arise if ownership/management of the entity has changed during the period covered by the report. For example, there may have been a different owner/manager in the first year of the two-year period for which comparative financial statements are presented or a new owner/manager may have joined the entity in the latter part of a single year under review. In these circumstances, the new owner/manager may be reluctant to sign the representation letter because he or she is not sufficiently familiar with the events that occurred during the period prior to his or her tenancy.

In such circumstances, it may be possible to obtain a representation letter from the previous owner/manager; however, this is highly unlikely. The accountant may point out to the client that the sample representation letter for a review engagement, presented in appendix D of SSARS No. 1, limits the confirmant's response to his or her "best knowledge or belief" concerning the representations in the representation letter. If the current owner/manager refuses to sign a representation letter, the review will be considered incomplete and is not an adequate basis for issuing a review report. Paragraph 47 of SSARS No. 1 states that if, in an audit or review engagement, a client does not provide the accountant with a signed representation letter, the accountant is precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements. Thus, the client would not be able to step down to a compilation engagement.

How an On-Site Peer Review Differs from an Off-Site Peer Review

Firms that perform even one compilation, review, or audit of historical financial statements, or compilation or examination of prospective financial statements are required to undergo peer review; however, the type of peer review the firm receives depends on the types of engagements the firm performs. Firms that perform audit engagements or examinations of prospective financial statements (even one such engagement) are required to have an *on-site* peer review.[3] In an on-site peer review, a cross section of the firm's accounting and auditing engagements are reviewed to evaluate the adequacy of the firm's quality control system. Procedures performed during an on-site peer review include reviewing the reports, financial statements, and working papers for specified engagements; interviewing firm personnel, and testing the administrative files. The objective of an on-site peer review is to report on whether the firm's system of quality control for its accounting and auditing practice met the objectives of the quality control standards established by the AICPA and was complied with during the period under review to provide the firm with reasonable assurance of conforming with professional standards.

[3] In certain circumstances, sole practitioners who perform audit engagements are permitted to have their on-site review at a location other than their office.

If a firm performs no audit engagements or examinations of prospective financial statements, and only performs compilations or reviews, the firm may have an *off-site* peer review.[4] Prior to an off-site peer review, the reviewed firm completes a form that requests information about the types of engagements the firm performs, such as the number and nature of the compilation and review clients served, and the industries in which those clients operate. Based on that information, the administering entity or the assigned reviewer advises the reviewed firm as to the types of engagements that will be selected for review. For each engagement selected, the reviewed firm submits a copy of the financial statements and accountant's report as well as a completed engagement questionnaire. The engagement questionnaire requests information about the client as well as information about accounting matters that may have arisen during the engagement. During the off-site peer review, the reviewer reads the accountant's compilation or review report, the related financial statements, and the engagement questionnaire for the engagements selected for review. The objective of an off-site peer review is to provide the reviewer with a reasonable basis for expressing limited assurance that the engagements submitted for review do not materially depart from the requirements of professional standards. An off-site peer review does *not* include a review of working papers, tests of the firm's administrative and personnel files, or interviews with firm personnel. In certain circumstances, if a firm has relinquished its audit clients, the firm may be able to change from an on-site peer review to an off-site peer review. In such situations, the firm should call or write to the entity administering its peer review to determine whether it qualifies for such a change.

Responding to Peer Review Letters of Comments

During fieldwork in an on-site peer review, the reviewer will inform the reviewed firm of any deficiencies noted during the peer review, and generally will note those deficiencies on a form entitled, "Matter for Further Consideration" (MFC). The reviewed firm will have the opportunity to discuss the identified deficiencies during the peer review and to respond in writing concerning the deficiencies on the response section of the MFC form. In an off-site peer review, any identified deficiencies are communicated to the reviewed firm either

[4] The SEC Practice Section Peer Review Program has certain requirements that are different from those of the AICPA Peer Review Program and does not offer off-site peer reviews. For additional information about peer review, call (201)938-3030.

by telephone or in writing on the MFC form. Because peer review is a subjective process, there may be differences of opinion between the reviewer and the reviewed firm as to whether a deficiency exists that are not resolved to the reviewed firm's satisfaction. In such circumstances, the reviewed firm should ask the reviewer to cite the applicable section of the professional standards (or the reviewed firm's policy for on-site reviews) that supports the reviewer's conclusion that a deficiency exists. Ordinarily, such matters are resolved by the exit conference in an on-site peer review and before the peer review report and letter of comments are issued in an off-site peer review. If the reviewed firm is still dissatisfied with the reviewer's conclusions, the reviewer or reviewed firm should consult with the entity administering the peer review.[5] If the matter is not resolved through consultation, the reviewed firm should respond to the reviewer's letter of comments by addressing each deficiency noted and citing the section of the professional standards that supports the reviewed firm's view. The state CPA society peer review committee will then attempt to resolve the disagreement.

Many professional standards require the use of professional judgment; accordingly, a reviewed firm should not assume that the reviewer's interpretation is always the correct one. If a reviewer identifies deficiencies in an engagement, it is in the reviewed firm's best interest to read the applicable section of the standards to broaden his or her knowledge of the subject and to verify that the comment is applicable to that particular situation.

Recurring Deficiencies Noted in Compilation and Review Engagements

Certain deficiencies in compilation and review engagements recur frequently and are noted by peer reviewers in letters of comments on those engagements. The following is a list of some of those deficiencies and, where applicable, a reference to the appropriate professional standard.

Common Reporting Deficiencies

The accountant's report—

- Departs from the revised report wording established in SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Serv-*

[5] This guidance is applicable to firms enrolled in the AICPA Peer Review Program. If a firm is a member of the SEC Practice Section, it should contact the staff of the SEC Peer Review Committee at the AICPA by calling (201) 938-3030.

ices. SSARS No. 7 revised the wording of the SSARSs compilation and review reports to indicate that the standards referred to in these reports are the SSARSs. Guidance on the appropriate wording for compilation and review reports is presented in paragraphs 14 and 32 of SSARS No. 1, respectively.

- Does not disclose the accountant's lack of independence in a compilation engagement when the prior year's accounting fees were not paid. Ethics Ruling No. 52, "Unpaid Fees," (AICPA, *Professional Standards*, vol. 2, ET sec. 191.103–.104) states that a firm's independence is impaired if, when the report on the client's current year is issued, fees remain unpaid, whether billed or unbilled, for any professional services provided more than one year prior to the date of the report.

- Does not disclose the basis of accounting used when the financial statements are prepared using a comprehensive basis of accounting other than GAAP and the financial statements do not disclose the basis, as required by paragraph 20 of SSARS No. 1.

- Does not refer to all periods presented in the financial statements. Paragraph 2 of SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200), requires that the accountant's report cover each period presented if comparative financial statements are presented.

- Does not indicate that substantially all disclosures have been omitted from the financial statements. Paragraph 21 of SSARS No. 1 provides an example of a paragraph that should be added to the accountant's report if management has elected to omit substantially all of the disclosures required by GAAP.

- For GAAP-basis financial statements, does not indicate that a statement of cash flows has been omitted. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*, requires a statement of cash flows as part of a full set of financial statements for all business enterprises.

- Does not refer to the accompanying supplementary information. Paragraph 43 of SSARS No. 1 requires that the accountant clearly indicate in his or her report the degree of responsibility he or she is taking with respect to supplementary information accompanying the financial statements.

- Contains financial-statement titles that are not the same as the titles in the financial statements presented.

- Is not dated. Paragraph 15 of SSARS No. 1 states that the date of completion of the compilation should be used as the date of the accountant's compilation report, and paragraph 33 of SSARS No. 1 indicates that the date of the completion of the accountant's inquiry and analytical procedures should be used as the date of the accountant's review report.

Common Financial-Statement Deficiencies

- OCBOA financial statements contain unmodified GAAP-basis titles such as "Balance Sheet" and "Income Statement." Footnote 6 of SSARS No. 1 refers the reader to paragraph 7 of SAS No. 62, *Special Reports,* for guidance on suitable titles for OCBOA financial statements.
- Each page of compiled or reviewed financial statements does not include a reference to the accountant's report. Paragraphs 16 and 43, respectively, of SSARS No. 1, require that each page of compiled or reviewed financial statements include a reference such as, "See Accountant's Compilation (Review) Report."
- Interim GAAP-basis financial statements omit a provision for income taxes and the accountant's compilation or review report does not identify the omission.
- The notes to financial statements containing only selected disclosures are not appropriately labeled. Paragraph 19 of SSARS No. 1 states, "When the entity wishes to include disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled, "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."

Common Financial-Statement Disclosure Deficiencies

Financial-statement disclosures concerning the following matters are missing or incomplete:

- Leases
- Concentrations of credit risk
- Off-balance-sheet risk
- Long-term debt commitments for the five years following the date of the latest balance sheet
- Related-party transactions

- Disclosures for each of the periods presented, if comparative financial statements are presented
- Accounting policies

Other Deficiencies

- The accountant fails to report on financial statements that he or she has submitted to a client, as required by paragraph 7 of SSARS No. 1.
- In a review engagement, the accountant's working papers do not include information about matters covered in the accountant's inquiry and analytical procedures or about unusual matters that the accountant considered during the performance of the review, including their disposition, as required by paragraph 31 of SSARS No. 1.
- The accountant fails to obtain a representation letter from the client in a review engagement, as required by paragraph 28 of SSARS No. 1.
- The accountant submits draft financial statements to a client without submitting final financial statements and reporting on them accordingly, as required by Interpretation No. 17 of SSARS No. 1.

Performance Measurement Engagements—An Engagement Expansion Opportunity

A CPA who compiles or reviews financial statements for a client on a monthly or quarterly basis is in a strategic position to provide other services to that client as well. The CPA's regular visits to a client's office and discussions with management enable the CPA to develop a thorough knowledge of the client's business and its personnel. Also, by performing financial-statement services for many clients, a CPA develops a broad knowledge of business practices, including the use of technology, financial services, and outsourcing organizations, such as payroll services. The CPA's wide network of clients enables him to her to observe, first hand, what works for businesses and what does not.

The AICPA's Special Committee on Assurance Services, which was created in 1994, reports that the market for traditional accounting and auditing services is flat, and that the future will hold even greater challenges to the profession it if is unwilling to embrace new services. The Special Committee on Assurance Services has been focusing on developing new engagement opportunities for CPAs, such as CPA association with information that may be useful to clients and unavailable or unreliable without that association. One such engagement that may be especially suited to CPAs performing compilation and review engagements is providing clients with information about their businesses in the form of performance measures that tell management whether it is achieving its objectives and enable it to monitor its progress toward achieving those objectives. Performance measures are specific quantifiable operational or financial measures that individuals can control and work to improve. For example, an objective that a company might establish is to reduce accounts receivable collection time from an average of 90 days to 60 days by selling only to customers who meet certain specified criteria. The performance measure would be the number of days required to collect accounts receivable.

In a performance measurement engagement, the client must determine what its current performance measures are and whether they are consistent with its overall business strategy and primary objectives. The CPA may have to help the client to articulate its business strategy and primary objectives. For example, management must decide whether its primary objective is to maximize cash flows and current earnings or to build the value of the entity through the reinvestment of profits. Management may be uncertain about its business strategy and may need help in developing it.

To develop performance measures, the CPA will need to analyze the client's business by identifying all of its processes and focusing on key indicators for that business such as revenue (volume and price), collections, cash flow, quality of the product, customer satisfaction, relationships with suppliers, product promotion, and financing. The CPA also will have to develop an understanding of the entity's strengths, weaknesses, opportunities, and threats. After a thorough analysis of the business, the CPA assists management in developing an action plan for achieving its objectives that includes the required actions needed, the individuals responsible for those actions, the timing of those actions, and the required resources (including outside specialists or advisers). Finally, the CPA helps the client to develop performance measures that are best suited for monitoring the success of the action plan. The data used for the performance measures must be reliable and relevant to the achievement of the entity's goals. CPAs should be particularly alert for measures that are counterproductive in that they encourage actions that actually hinder the achievement of the entity's overall goals and objectives. For example, consider a situation in which salespeople sell by telephone. It would be counterproductive to measure performance by measuring the number of hours salespeople spend on the telephone if the entity's objective is high sales, not high telephone bills. In addition, sales alone would not be a good performance measure if another entity objective is to avoid sales returns because the goods being sold have a high cost and are fragile and subject to breakage when returned through the mail. In those circumstances, management should focus on net sales (sales less returns) as a performance measure, rather than on sales alone. The CPA will also have to determine whether the current accounting system captures the information needed for the performance measure. For example, the accounting system would have to segregate sales returns from gross sales and sales allowances to capture the information needed for the performance measure in the previous example. Finally, the performance measure must reflect actions that the specified individual can control. If management's primary objective is to increase net sales per hour spent on the telephone, management needs to develop information, in the form of customer profiles, about the customers who are best suited to the product being sold. Providing salespeople with relevant data about customers enables salespeople to select customers who are more likely to purchase a product and to decrease the number of unproductive hours spent on the telephone.

Standards Overload

Managing the information overload that results from the large number of standards in existence, the continuous development of new standards, and the amendment of existing standards makes the work of a CPA extremely difficult. In August 1996, the AICPA's Private Companies Practice Section Special Task Force on Standards Overload issued its report containing recommendations as to the actions that should be taken to address the problem of standards overload. The task force was composed of CPAs from small firms who provide financial-statement services primarily to small nonpublic entities. The following are some of the recommendations that were made by the task force.

1. *Increase small-firm input in the standard-setting process.* Standard setters should be made aware of the unique problems certain standards pose for small entities, such as the high cost of capturing and generating certain financial information, and the irrelevancy of certain required financial-statement disclosures to the users of the financial statements of small entities. Small CPA firms are less likely than large firms to be able to allocate resources to the formal consideration of proposed standards and may require assistance in expressing their views on proposed standards. One way to assist small firms in expressing their views is to increase

the effectiveness and visibility of the AICPA's Technical Issues Committee (TIC), which has primary responsibility for communicating the views of small CPA firms and their clients to standard setters. The task force recommends that the TIC be assigned an additional staff person to serve as a liaison between the TIC and the standard-setting bodies and to assist the TIC in expressing its views on the potential effects of specified standards on small businesses.

The Financial Accounting Foundation should make a concerted effort to recruit and select trustees, FASB members, and FASB staff persons who have experience with and understanding of the needs of small nonpublic entities.

2. *Facilitate access to the professional literature and improve the understandability of that literature.* To help CPAs keep abreast of new standards as they are issued, and understand and apply those standards, the AICPA should—

   - Provide members with all of the relevant codified professional and accounting standards and other important literature, such as Emerging Issues Task Force (EITF) consensuses, and Audit and Accounting Guides, in a single CD-ROM format. The product should be reasonably priced, easy to learn, well-indexed, and contain an effective search capability so that it serves as an effective research tool.[6]

   - Provide members with the option of ordering a minimum library package of professional standards, in soft cover, at the time they renew their annual AICPA memberships. This could be implemented by providing a checkoff option on the annual dues statement.

   - Expand the staff and hours of the AICPA Technical Information Hotline, which provides answers to accounting, auditing, and attestation questions, as well as questions related to com-

[6] Practitioners Publishing Company (PPC) and the AICPA are currently offering on one CD-ROM disk, titled *The Practitioner's Library—Accounting and Auditing,* publications issued by PPC, the AICPA, and the FASB. The disk contains the following publications issued by the FASB: *Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts,* and *FASB Implementation Guides;* and the following publications issued by the AICPA: *Professional Standards, Technical Practice Aids, Audit and Accounting Guides* (available April, 1997), and *Peer Review Program Manual* (available January 1997). The disk also contains 18 PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call (800) 323-8724.

pilation and review engagements. The Technical Information Hotline provides important technical consultation services to CPAs in small firms, and for many CPAs serves as their only contact with the AICPA.

- Publish articles in the *Journal of Accountancy* that present new accounting standards in a succinct and understandable format and that contain examples and journal entries elucidating the application of the standard to situations that are relevant to small entities. Each article should be followed by a self-study examination on the new standard that may be submitted to the AICPA for CPE credit at a nominal cost.
- Enable CPAs to obtain copies of professional standards and other technical pronouncements for a fee through the AICPA 24-Hour Fax Hotline or via the computer.
- Draft standards using language that is unambiguous and easy to understand, and when accounting matters require a high degree of subjectivity, provide examples of appropriate options. Pivotal terms should always be defined and terminology should be used consistently in all standards.

3. *Sensitize peer reviewers and reviewed firms to standards-overload concerns.* The implementation of peer review has significantly improved the quality of practice. However, in some cases, peer reviewers are more demanding than the standards require and thereby become *de facto* standard setters. The task force believes that representatives of the AICPA's Practice Monitoring Division (Peer Review) should continue to be involved in the examination of the standards-overload problem by ensuring that peer reviewers are well qualified and do not expect firms to exceed professional standards. In addition, reviewed firms should be encouraged to request that peer reviewers cite the applicable section of the professional standards or firm policy that supports peer-reviewer recommendations for changes to the financial statements or accountant's report, or recommendations that additional procedures be performed or provided for in the firm's quality control procedures.
4. *Provide guidance on disclosure in OCBOA presentations.* Because of the complexities of GAAP, many entities elect to present their financial statements using an OCBOA. Paragraph 9 of SAS No. 62, *Special Reports,* indicates that OCBOA financial statements should include "all informative disclosures that are appropriate for the basis of accounting used." However, the guidance in SAS No. 62 is extremely broad and practitioners find they need more specific

guidance concerning disclosures in OCBOA presentations. The task force recommends that standard setters issue such guidance.

5. *Provide guidance concerning materiality and financial-statement disclosures.* A problematic area of practice is the consideration of materiality in determining whether specified financial-statement disclosures are required. Many CPAs believe that the materiality threshold is relatively low for small nonpublic entities. The task force believes that CPAs who make this assumption are overlooking the fact that materiality has a qualitative aspect in addition to a quantitative aspect. Both aspects should be considered in making decisions about the disclosures that should be included in financial statements. The AICPA should provide implementation guidance on the consideration of materiality in applying accounting standards and in making judgments about financial-statement disclosures for small nonpublic entities.

6. *Provide practice guidance concerning compilation engagements.* There is a need to provide CPAs with high-quality, practical, CPE in modules that address problematic areas of practice. For example, comments from focus groups and responses to questionnaires indicate that CPAs need additional information about how to perform cost-effective compilation engagements tailored to their clients' financial-information needs. SSARS No. 1 provides for alternatives to full-disclosure GAAP financial statements, such as financial statements that omit substantially all disclosures, and financial statements prepared in accordance with an OCBOA. These engagements should enable CPAs to provide clients with a timely and cost-effective service; however, many practitioners are unaware of effective ways to use these alternatives. The task force recommends that the AICPA develop a four-hour CPE course to alert CPAs to these options and that the course be designed, coordinated, and staffed by the AICPA to ensure that the course content is technically correct, that there is consistency in the information presented, and that instructors are knowledgeable and effective communicators. This course should be offered in locations nationwide and should be reasonably priced to encourage attendance by as many practitioners as possible. It should also be available in video and, perhaps, CD-ROM format to maximize exposure.

7. *Continue to evaluate the effectiveness and relevance of financial-statement disclosures.* The task force reviewed the FASB Prospectus, *Disclosure Effectiveness,* and is aware that the FASB is currently considering modification of the disclosure requirements in certain specified standards. The task force strongly supports the

FASB's project to reevaluate the information needs of financial statement users.[7]

Modifying Engagements for SOP 94-6

Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* was issued by the Accounting Standards Executive Committee (AcSEC) in December 1994 and is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Pronouncements issued by the AcSEC are in the GAAP hierarchy and are applicable to audited, reviewed, and compiled financial statements. Accordingly, SOP 94-6 must be considered when compiling or reviewing financial statements. The SOP is applicable to all nongovernmental entities that prepare financial statements in conformity with GAAP.[8] The SOP requires disclosure of the following information:

- The nature of an entity's operations
- Its major products or services
- Its principal markets and the locations of those markets
- The relative importance of its operations in each business, and the basis for that determination, if the entity operates in more than one business
- An explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates

The SOP also requires disclosure of information about sensitive estimates in the financial statements if known information available prior

[7] On September 20, 1996, the FASB issued an exposure draft of a proposed Statement entitled *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities.* The proposed Statement would amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for nonpublic entities that (1) have total assets of less than $10 million on the date of the financial statements, and (2) have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments,* during the reporting period.

[8] The applicability of the SOP to financial statements prepared using an OCBOA is not clear. Paragraph B-47 of the SOP indicates that the issue of the SOP's applicability to financial statements prepared using an OCBOA is a pervasive one that goes beyond the scope of the SOP.

to the issuance of the financial statements indicates that (1) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term (within one year of the balance-sheet date) due to one or more future confirming events, and (2) the effect of the change would be material to the financial statements. Examples of such items are recorded amounts or disclosures that are based on estimates particularly sensitive to change in the near term, such as inventory and equipment subject to rapid technological obsolescence, valuation allowances for commercial and real estate loans, litigation-related obligations, and amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits. If the criteria are met, the disclosure must describe the nature of the uncertainty and indicate that it is reasonably possible that the estimate will change in the near term. If the estimate involves a contingency covered by FASB Statement No. 5, *Accounting for Contingencies*, the disclosure also should include an estimate of the possible loss or range of loss, or state that an estimate cannot be made.

The final disclosure requirement of the SOP concerns risks and uncertainties that arise from an entity's current vulnerability due to certain concentrations. An example of a concentration is a manufacturer who depends on a single supplier for materials and whose business would be significantly disrupted by the loss of that supplier. Disclosure of concentrations is required if, based on information known to management prior to the issuance of the financial statements, the following conditions exist.

1. The concentration existed at the date of the financial statements
2. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact (a significant financially disruptive effect on the normal functioning of the entity)
3. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

The content of the disclosure is not generally specified; however, the disclosure should inform users of the nature of the risk involved. For concentrations of labor subject to collective bargaining agreements, and for operations outside an entity's home country, certain specified information must be disclosed.

The following are some additional inquiries that may be added to the list of illustrative inquiries for a review of financial statements, presented in appendix A of SSARS No. 1, to provide for the consideration of SOP 94-6 in a SSARSs review engagement.

- Do the financial statements include estimates that may be subject to a material change within the next year? If such estimates exist, what is the probability that the change will occur within the next year?
- Do individual or group concentrations exist for any of the following?
  — Customers
  — Suppliers
  — Lenders
  — Products or services
  — Sources of labor
  — Sources of material
  — Licenses or other rights
  — Operating areas or markets
  — Grantors, contributors, or fund-raising events (for not-for-profit organizations)
- Do concentrations exist at the date of the financial statements that will make the company vulnerable to the risk of a severe near-term impact?

CPAs also should consider adding the following item to the client representation letter in a review engagement:

> We have no knowledge of concentrations existing at the date of the financial statements that make the company vulnerable to the risk of a near-term severe impact, that have not been properly disclosed in the financial statements. We understand that concentrations include individual or group concentrations of customers, suppliers, lenders, products, services, sources of labor or materials, licenses or other rights, or operating areas or markets. We further understand that severe impact means a significant financially disruptive effect on the normal functioning of the company.

New Statements on Quality Control Standards

In May 1996, the Auditing Standards Board (ASB) issued two new Statements on Quality Control Standards (SQCS), SQCS No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 2, QC sec. 20) and SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 2, QC sec. 30). The new Statements supersede

SQCS No. 1, *System of Quality Control for a CPA Firm* (AICPA, *Professional Standards,* vol. 2, QC sec. 10), and provide guidance for developing a system of quality control for a firm's accounting and auditing practice.

SQCS No. 2 redefines a firm's accounting and auditing practice to include all audit, attest, and accounting and review services for which professional standards have been established by the ASB or the ARSC under rules 201 and 202 of the AICPA Code of Professional Conduct, and any other professional standards that may be issued by the aforementioned standard setters in the future. Prior to the issuance of SQCS No. 2, attestation services were not specifically addressed in the quality control standards because Statements on Standards for Attestation Engagements had not been issued when SQCS No. 1 was promulgated. The revised definition now makes it clear that attestation services must be included in a firm's quality control system.

SQCS No. 2 replaces the nine elements of quality control presented in SQCS No. 1 with five broad elements of quality control. It does not establish any new elements but instead combines and renames the previous elements as shown in the following table.

Old *Nine Elements of SQCS No. 1*	*Change*	*New* *Five Elements of SQCS No. 2*
Independence	The independence element is expanded to include integrity and objectivity. Firms are now required to establish policies and procedures assuring that personnel perform all professional responsibilities with integrity, and maintain objectivity while performing those responsibilities.	Independence, integrity, and objectivity
• Hiring • Advancement • Assigning personnel to engagements • Professional development	These four elements are combined into a single element.	Personnel management
Acceptance and continuance of clients	The name of this element has been modified because SQCS No. 2 requires that firms con-	Acceptance and continuance of clients and engagements

(continued)

Old *Nine Elements of SQCS No. 1*	*Change*	*New* *Five Elements of SQCS No. 2*
	sider the acceptance of client engagements in addition to considering client relationships. SQCS No. 2 also requires a firm to establish policies and procedures that provide reasonable assurance that a firm will accept only those engagements it can complete with due professional competence. Firms also must have policies and procedures in place requiring them to obtain an understanding with their client of the nature, scope, and limitations of the services they will perform.	
• Supervision • Consultation	These two elements are combined and referred to as activities within the new element of engagement performance.	Engagement performance
Inspection	Inspection becomes subsumed under the new element of monitoring. SQCS No. 3 provides guidance on how a CPA firm can monitor its accounting and auditing practice.	Monitoring

SQCS Nos. 2 and 3 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997. To help firms implement the new standards, a booklet entitled *Guide for Establishing and Maintaining a System of Quality Control for an CPA Firm's Accounting and Auditing Practice* has been issued by the AICPA. The guide includes illustrative examples of four hypothetical firms and the suggested policies and procedures for the design and maintenance of a quality control system that is appropriate for each firm's accounting and auditing practice. One of the hypothetical firms is a sole owner without any professional staff who occasionally hires per diem professionals. Her accounting practice consists of only engagements subject to SSARSs. A firm's policies and procedures should be sufficient for it to obtain reasonable assurance of complying with the requirements of SQCS Nos. 2 and 3, and the illustrative examples depict various types of policies and procedures that a firm may consider for each of the elements of quality control.

GAAP for Compiled and Reviewed Financial Statements

Although there are different reporting and performance standards for compilation, review, and audit engagements, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements.

An exception to that rule is found in SSARS No. 1, which permits an accountant to compile financial statements that omit substantially all of the disclosures required by GAAP. If the accountant compiles such financial statements, a special compilation report is issued that alerts readers to the fact that the disclosures have been omitted.

Footnote 3 of SSARS No. 1 states that the GAAP hierarchy presented in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411), is also applicable to compilations and reviews of financial statements performed under SSARSs. A summarization of the GAAP hierarchy is reproduced in the following table.

Nongovernmental Entities	*State and Local Governments*
Established Accounting Principles	
a. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	*a.* GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation
b. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	*b.* ASB Technical Bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position

(continued)

Nongovernmental Entities	*State and Local Governments*
Established Accounting Principles	
c. Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	*c.* Consensus positions of the GASB Emerging Issues Task Force* and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA
d. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	*d.* "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent
Other Accounting Literature†	
Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles	Other accounting literature, including GASB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aides*; and accounting textbooks, handbooks, and articles

*As of the date of this section, the GASB had not organized such a group.

†In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

Because several standard-setting bodies establish GAAP, there is no single publication that contains all of the GAAP pronouncements. Each of the following publications contains certain pronouncements included in levels *a* through *d* of the GAAP hierarchy (must know GAAP).

FASB Original Pronouncements—Accounting Standards

This two-volume set contains the original text of accounting pronouncements. It includes FASB Statements of Financial Accounting Standards and Interpretations, APB Opinions, AICPA Accounting Research Bulletins, FASB Technical Bulletins, and AICPA Accounting Interpretations. The pronouncements are arranged chronologically and the text includes a topical index (available from the AICPA).

AICPA Technical Practice Aids (Including Statements of Position)

Statements of Position and Practice Bulletins issued by the AcSEC are included in this text. This publication also contains a selection of nonauthoritative audit, review, compilation, and accounting questions answered by the AICPA's Technical Information Service (available from the AICPA).

FASB Emerging Issues Task Force Abstracts

This text contains a summary of the proceedings of the FASB's EITF. Each abstract summarizes the accounting issues involved and the results of the discussion, including any consensus reached on the issue (available from the FASB).

FASB Implementation Guides (Qs and As)

Implementation guides are published by the FASB staff and provide guidance, in the form of questions and answers, on the implementation of FASB Statements. The following implementation guides are available from the FASB.

- *A Guide to the Implementation of Statement 87 on Employers' Accounting for Pensions*
- *A Guide to the Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- *A Guide to the Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *A Guide to the Implementation of Statement 96 on Accounting for Income Taxes*
- *A Guide to the Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits other than Pensions*
- *A Guide to the Implementation of Statement 109 on Accounting for Income Taxes*
- *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*

Codification of Governmental Accounting and Financial Reporting Standards

Practitioners who compile or review the financial statements of state and local governmental entities should supplement their professional libraries with the *Codification of Governmental Accounting and Financial Reporting Standards*. This text contains current authoritative accounting and financial reporting standards for state and local governmental entities. GASB Statements, Interpretations, and Technical Bulletins are included (available from the FASB).

AICPA Audit and Accounting Guides

Audit and Accounting Guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. The accounting guidance included in AICPA Audit and Accounting Guides is in the GAAP hierarchy as authoritative GAAP. When an accountant compiles or reviews the financial statements of an entity, SSARS No. 1 requires that the accountant have or acquire a level of knowledge of the accounting principles and practices of the industry in which the entity operates. Although the audit guidance included in the Audit and Accounting Guides may not be relevant to practitioners performing compilation and review engagements, the accounting guidance, illustrative financial statements, and industry background that is provided should help accountants to acquire knowledge of a specific industry. The following industry Audit and Accounting Guides are available from the AICPA:

Agricultural Producers and Cooperatives

Airlines

Banks and Savings Institutions

Brokers and Dealers in Securities

Casinos

Certain Nonprofit Organizations

Colleges and Universities

Common Interest Realty Associations (CIRAs) (This Audit and Accounting Guide contains a chapter on compilations and reviews of CIRAs.)

Construction Contractors

Credit Unions

Employee Benefit Plans

Entities With Oil and Gas Producing Activities

Federal Government Contractors
Finance Companies
Health Care Organizations
Investment Companies
Not-for-Profit Organizations
Property and Liability Insurance Companies
State and Local Governmental Units
Stock Life Insurance Companies
Voluntary Health and Welfare Organizations

The following general Audit and Accounting Guides also may be of interest to CPAs performing compilation and review engagements:

Personal Financial Statements
Prospective Financial Information
Use of Real Estate Appraisal Information

Ordering Information

To order FASB products, call (203) 847-0700, ext. 10.

To order AICPA products, call: (800) 862-4272 (menu selection #1); write: AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; fax: (800) 362-5066.

Recent GAAP Pronouncements

Authoritative Accounting Pronouncements Becoming Effective in 1996

As noted on page 39 of this Alert, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements. A number of authoritative accounting pronouncements, issued prior to 1996, have delayed effective dates for certain reporting entities and will be implemented for the first time in 1996 by those entities. Following is a brief overview of some of the pronouncements becoming effective in 1996 that practitioners performing compilation and review engagements should be aware of. When applying these pronouncements, practitioners should refer to the complete professional standard.

- FASB Statement No. 107, *Disclosure about Fair Value of Financial Instruments,* extends existing fair-value disclosure practices for some instruments by requiring all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement requires the disclosure of descriptive information pertinent to estimating the value of a financial instrument. Appendix A of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* provides examples of instruments that are included in and excluded from the definition of a financial instrument. Statement No. 107 is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets. For those entities, the effective date is for fiscal years ending after December 15, 1995.

- FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* are both effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Statement No. 116 establishes accounting standards for contributions and applies to all entities that receive or make contributions. Generally, contributions received, including unconditional promises to give, are recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are recognized when they become unconditional, that is, when the conditions are substantially met. The Statement allows certain exceptions for contributions of services and works of art, historical treasures, and similar assets.

  FASB Statement No. 117 establishes standards for general-purpose external financial statements provided by not-for-profit organizations. It requires that those statements include a statement of financial position, a statement of activities, and a statement of cash flows. It also requires classification of an organization's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. For implementation guidance on FASB Statement Nos. 116 and 117, refer to "Implementing FASB 116 and 117," by Martha L. Benson, Alan S. Glazer, Henry R. Jaenicke, and Kenneth D. Williams, *Journal of Accountancy* (New York: AICPA, September 1995).

- FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,* requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. It also amends FASB Statement Nos. 105 and 107 to require that distinction in certain disclosures required by those Statements. FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995. For additional guidance on derivatives and FASB Statement No. 119, refer to the following:
  - Winograd, Barry N., and Robert H. Herz. "Derivatives: What's an Auditor to Do?" *Journal of Accountancy* (New York: AICPA, June 1995).
  - Molvar, Roger H.D., and James F. Green. "The Question of Derivatives." *Journal of Accountancy* (New York: AICPA, March 1995).
  - *Derivatives—Current Accounting and Auditing Literature,* A Report Prepared by the Financial Instruments Task Force of the Accounting Standards Executive Committee, AICPA.
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* requires that long-lived assets and certain identifiable intangibles (including goodwill) to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The Statement requires that long-lived assets and certain identifiable intangibles to

be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are covered by Accounting Principles Board (APB) Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Assets that are covered by APB Opinion 30 will continue to be reported at the lower of carrying amount or net realizable value. FASB Statement No. 121 is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted. Impairment losses resulting from the application of the Statement should be reported in the period in which the recognition criteria are first applied and met. The initial application of the Statement to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

- FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*, was issued in May 1995 and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, to require that mortgage banking enterprises capitalize the cost of purchased and originated mortgage servicing rights as part of the cost of a mortgage loan and, for mortgage loans sold with servicing rights retained, allocate the cost of the loan between the servicing rights and the loan without the servicing rights based on the relative fair values of each of the components. The gain or loss on the sale of the loan is equal to the sales proceeds less the allocated cost of the mortgage loan; any cost allocated to the mortgage servicing rights is recognized as a separate asset. The Statement also includes guidance on estimating the fair values of the components and accounting for the impairment of the capitalized mortgage serving rights and expands the disclosure requirements of FASB Statement No. 65. The provisions of the Statement are to be applied prospectively in fiscal years beginning after December 15, 1995; special transition provisions apply.

- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to a supplier (an employee or nonemployee) in amounts based on the price of the entity's common stock or other equity instruments. The Statement provides a choice of accounting methods for transactions with employees that are within the scope of APB Opinion 25, *Accounting for Stock Issued to Employees*. It presents a fair-value based method of accounting for employee stock options or similar equity instruments and encourages all entities to adopt that accounting method for all their employee stock compensation plans. Under the fair-value method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Entities having transactions with employees that are within the scope of APB Opinion 25 may continue to measure compensation cost under that standard. However, if they choose that measurement option, they must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair-value based method of accounting presented in FASB Statement No. 123 had been applied. The fair-value method is preferable to the method presented in APB Opinion 25 for purposes of justifying a change in accounting principle under APB Opinion 20, *Accounting Changes.* Equity instruments issued to acquire goods and services from nonemployees should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The Statement is generally effective for fiscal years beginning after December 15, 1995; special transition provisions apply.

- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* establishes standards for accounting for certain investments held by not-for-profit organizations. It requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. The Statement requires disclosures about investments held by not-for-profit organizations and the return on those investments. The Statement also establishes standards for reporting losses on investments held because of a donor's stipulation to invest a gift in perpetuity or for a specified term. The Statement is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The Statement is applied either by restating the financial statements of all prior years presented or by recognizing the cumulative effect of the change in the year of the change. The expiration of restrictions on previously unrecognized net gains may be recognized prospectively.

- FASB Interpretation No. 42, "Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power," interprets paragraph 4 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* Paragraph 4 of Statement No. 116 states, "This Statement does not apply to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee." Interpretation No. 42 clarifies that an organization that receives assets acts as a donee and a donor, rather than as an agent, trustee, or intermediary, if a resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries (variance power). The Interpretation is effective for financial statements issued for fiscal years ending after September 15, 1996. Earlier application is encouraged. The Interpretation may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

- SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations,* amends and makes uniform the guidance on reporting of related entities in the AICPA Audit and Accounting Guides, *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations,* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* SOP 94-3 provides that the decision as to whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) are to be consolidated should be based on the nature of the relationship between the entities. That relationship also affects the disclosures that the reporting organization is required to make. The guidance in SOP 94-3 focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. SOP 94-3 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117 before its effective date, earlier application of the SOP is encouraged.
- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*— See page 34 of this Alert for a discussion of SOP 94-6.
- Practice Bulletin 14,[9] *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships,* provides guidance on applying existing accounting literature to limited liability compa-

[9] SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA practice bulletins as authoritative (meaning, "must know") accounting principles.

nies and limited liability partnerships (hereinafter referred to as limited liabilities companies or LLCs). LLCs combine the limited liability aspect of corporations with the flow-through tax attributes of partnerships. Because an LLC is formed under state law, its characteristics may vary depending on the state in which it is organized. However, LLCs generally have the following characteristics:

— An LLC is an unincorporated association of two or more "persons."

— Its members have limited personal liability for the debts and obligations of the entity.

— It is classified as a partnership for federal income tax purposes and thus lacks at least two of the four corporate characteristics which include limited liability, free transferability of interests, centralized management, and continuity of life.

Practice Bulletin 14 is effective for financial statements issued after May 31, 1995.

Authoritative Accounting Pronouncements Issued in 1996

Following is a list of various authoritative accounting pronouncements issued from January 1, 1996 to October 1, 1996, and their effective dates.

Statements of Financial Accounting Standards and Interpretations Issued by the FASB[10]

Description		*Effective Date*
FASB Statement No. 125	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	For transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996; should be applied prospectively.
FASB Interpretation No. 42	*Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*	For financial statements issued for fiscal years ending after September 15, 1996; earlier application is encouraged.

To order copies, call the FASB at (203) 847-0700, ext. 10.

[10] See the Audit Risk Alert *State and Local Governmental Industry Developments—1996* for recently issued Statements of the Governmental Accounting Standards Board.

EITF Consensus Positions

EITF Issue No.	*Description*	*Effective Date*
96-1	*Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement*	January 18, 1996
96-3	*Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123*	March 21, 1996
96-4	*Accounting for Reorganizations Involving Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*	May 23, 1996
96-5	*Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*	March 21, 1996
96-7	*Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*	May 23, 1996
96-8	*Accounting for a Business Combination When the Issuing Company Has Targeted Stock*	May 23, 1996
96-10	*Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115*	May 23, 1996
96-11	*Accounting for Forward Contracts and Purchased Options to Acquire*	May 23, 1996

EITF Issue No.	*Description*	*Effective Date*
	Securities Covered by FASB Statement No. 115	
96-14	*Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*	July 18, 1996
96-17	*Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms*	September 18–19, 1996
96-21	*Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*	September 18–19, 1996
96-22	*Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*	September 18–19, 1996

To order copies call the FASB at (203) 847-0700, ext. 10.

SOP 96-1, Environmental Remediation Liabilities

In October 1996, the AcSEC issued SOP 96-1, *Environmental Remediation Liabilities,* which provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. The SOP requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5, *Accounting for Contingencies,* are met. The SOP includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5. Examples of such benchmarks are when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. The SOP also requires that the accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort. The measurement of the liability should—

- Include the entity's allocable share of the liability for a specific site, and the entity's share of amounts that will not be paid by other PRPs or the government.
- Be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- Be based on the entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed. The measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or component of the liability and the amount and timing of the cash payments for the liability or component are fixed or reliably determinable.

The SOP also provides guidance on the display of environmental remediation liabilities in financial statements and on the disclosures about environmental-cost-related accounting principles, environmental loss contingencies, and other loss contingency considerations. In addition to the accounting guidance, the document also contains a nonauthoritative section describing major federal legislation dealing with pollution control (responsibility) laws and environmental remediation (cleanup) laws and the need to consider various state and non-U.S. government requirements. The provisions of the SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the SOP should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

Other AICPA Publications Relevant to SSARS Engagements

Codification of Statements on Standards for Accounting and Review Services

Statements on Standards for Accounting and Review Services (SSARSs) are the standards by which compilation and review engagements are performed.

Codification of Statements on Auditing Standards

Codification of Statements on Auditing Standards includes SAS Nos. 1 to 79 and SSAE Nos. 1 to 6. Practitioners performing compilation and review engagements may need to consult the auditing standards because the SASs are the only source of authoritative accounting guidance in areas such as subsequent events and evaluation of the adequacy of going-concern disclosure. In addition, SSARSs sometimes refer the reader to the SASs for amplification of topics mentioned in SSARSs.

AICPA Annual Audit Industry Risk Alerts

AICPA annual Audit Industry Risk Alerts provide information about current economic, regulatory, and professional developments in specified industries. They assist CPAs in planning and performing engagements by highlighting reporting issues, recurring peer review problems, and lessons learned from litigation. The following 1996/97 Audit Risk Alerts are available from the AICPA:

Banks and Savings Institutions

Construction Contractors

Credit Unions

Employee Benefit Plans

Health Care

High Technology

Insurance

Investment Companies

Not-for-Profit Organizations

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Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call: (800) 862-4272 (menu selection #2)

Ethics Hotline

Members of the AICPA's Professional Ethics Division answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call: (800) 862-4272 (menu selection #4)

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This Compilation and Review Alert replaces *Compilation and Review Alert—1995/96.*

Compilation and Review Quiz

Answer each question by circling either *True* or *False*. Answers appear on page 57 of this Alert.

1. SSARS No. 1 requires a "minimum" set of working papers in a compilation engagement.
   True False

2. SSARS No. 1 requires that a CPA perform a compilation only when the financial statements will be submitted to third-party users.
   True False

3. SSARS No. 1 does not require a CPA to perform a compilation if the financial statements are for interim periods.
   True False

4. SSARS No. 1 requires that a compilation report be—
   a. Manually signed.
   True False
   b. Printed on the CPA's letterhead.
   True False

5. A CPA may delegate responsibilities, such as reading the financial statements and signing the compilation report, to a staff person of the accounting firm.
   True False

6. A CPA in public practice who is engaged as a controller (one who is authorized to hire and fire the bookkeeper and sign checks) for a client does not have to attach a compilation report to financial statements that he or she generates.
   True False

7. SSARS No. 1 requires a CPA to perform a compilation if—
   a. The CPA does all of the work necessary to generate the financial statements, but permits the client to actually generate the financial statements on the computer by "pushing the print button."
   True False
   b. The CPA proposes adjustments to the clients books and records, either orally or in writing, that materially change cli-

ent-prepared financial statements, and such adjustments are posted by the client.

True False

c. The CPA makes material changes to the client's financial statements by changing account classifications, amounts, or disclosures directly on the financial statements.

True False

8. A CPA may perform a compilation engagement even though he or she is not independent as long as the CPA discloses his or her lack of independence in the compilation report.
True False

9. A CPA who compiles financial statements using an OCBOA, such as the cash basis or income tax basis, must also disclose all the significant measurement departures from GAAP in the compilation report.
True False

10. Accounting pronouncements issued by the FASB are applicable to audited financial statements but not to compiled or reviewed financial statements.
True False

Answers to the Compilation and Review Quiz

1. SSARS No. 1 requires a "minimum" set of working papers in a compilation engagement.
   False—Paragraph 31 of SSARS No. 1 requires that an accountant prepare working papers for a review engagement but contains no such requirement for a compilation engagement.

2. SSARS No. 1 requires that a CPA perform a compilation only when the financial statements will be submitted to third-party users.
   False—Paragraph 7 of SSARS No. 1 states, "An accountant should not submit unaudited financial statements of a nonpublic entity to his or her client or others unless, as a minimum, he or she complies with the provisions of this statement applicable to a compilation engagement."

3. SSARS No. 1 does not require a CPA to perform a compilation if the financial statements are for interim periods.
   False—The sentence from paragraph 7of SSARS No. 1, cited in item 2, uses no qualifying language as to which types of unaudited financial statements (interim or annual) are meant here. Also, the idea of excluding interim financial statements from the applicability of SSARSs has been considered and rejected by the ARSC several times.

4. SSARS No. 1 requires that a compilation report be—

   a. Manually signed.
      False

   b. Printed on the CPA's letterhead.
      False

   SSARS No. 1 contains no such requirements

5. A CPA may delegate responsibilities, such as reading the financial statements and signing the compilation report to a staff person of the accounting firm.
   True—SSARS No. 1 does not preclude a CPA from delegating responsibilities to staff persons in a compilation or review engagement, as long as the staff person is qualified to perform the procedures.

6. A CPA in public practice who is engaged as a controller (one who is authorized to hire and fire the bookkeeper and sign checks) for a client does not have to attach a compilation report to financial statements that he or she generates.
   True—A compilation report is used by an outside accountant to report on financial statements that are the representations of an-

other party. If an accountant performs services for a client that are equivalent to those performed by management, including making management decisions, the financial statements would be deemed to be the accountant's representations.

7. SSARS No. 1 requires a CPA to perform a compilation if—

   a. The CPA does all of the work necessary to generate the financial statements, but permits the client to actually generate the financial statements on the computer by "pushing the print button."

   True—Paragraph 7 of SSARS No. 1 requires that an accountant compile financial statements if he or she submits them to a client or others. One aspect of submission is generating the financial statements. The term *generating* is not defined in SSARS No. 1 and some accountants believe that if the client "pushes the button," the client has generated the financial statements and the CPA is not required to comply with SSARS No. 1. The authors of this Alert strongly believe that having the client push the button simply to avoid having to compile the financial statements is inappropriate and does not reflect the substance of SSARS No. 1.

   b. The CPA proposes adjustments to the clients books and records, either orally or in writing, that materially change client-prepared financial statements, and such adjustments are posted by the client.

   False—SSARSs is not applicable to this engagement because paragraph 7 of SSARS No. 1 identifies the following service as one that does not constitute a submission of financial statements.

   > Proposing correcting journal entries or disclosures to the financial statements, either orally or in written form, that materiality change client-prepared financial statements, as long as the accountant does not directly modify the client-prepared financial statements

   c. The CPA makes material changes to the client's financial statements by changing account classifications, amounts, or disclosures directly on the financial statements.

   True—See the answer to item 7b.

8. A CPA may perform a compilation engagement even though he or she is not independent as long as the CPA discloses his or her lack of independence in the compilation report.

   True—Paragraph 22 of SSARS No. 1 provides for this type of engagement.

9. A CPA who compiles financial statements using an OCBOA, such as the cash basis or income tax basis, must also disclose all the significant measurement departures from GAAP in the compilation report.
   False—Only departures from the basis of accounting used in the financial statements must be identified in the accountant's compilation report.

10. Accounting pronouncements issued by the FASB are applicable to audited financial statements but not to compiled or reviewed financial statements.
    False—Although there are different reporting and performance standards for compilation, review, and audit engagements, the accounting principles to be followed for compiled or reviewed financial statements are the same as those for audited financial statements.

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