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Practical guidance for implementing SSARS 8 : how to understand and apply the amendments to SSARS 1; Compilation and review alert;Audit risk alerts

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COMPILATION AND REVIEW ALERT

Practical Guidance for Implementing SSARS 8

How to Understand and Apply the Amendments to SSARS 1, *Compilation and Review of Financial Statements*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Alert, *Practical Guidance for Implementing SSARS 8: How to Understand and Apply the Amendments to SSARS 1*, Compilation and Review of Financial Statements, is intended to provide CPAs with an update on recent changes to Statements on Standards for Accounting and Review Services (SSARS). The document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

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Practical Guidance for Implementing SSARS 8

Introduction

What is the authority of Practical Guidance for Implementing SSARS 8, *and what does it cover?*

Practical Guidance for Implementing SSARS 8 is a nonauthoritative practice aid designed to help CPAs implement the new Statement on Standards for Accounting and Review Services (SSARS) 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1,* Compilation and Review of Financial Statements (AICPA, *Professional Standards*, vol. 2, AR sec. 800). It clarifies certain existing SSARS, suggests ways of implementing existing and new standards in special circumstances, points out pitfalls that frequently occur in compilation engagements, and provides a series of questions and answers to help implement the changes in SSARS 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100).

On December 31, 1999, the Accounting and Review Services Committee (ARSC) issued an exposure draft that sought to make fundamental changes to the way in which we view the compilation engagement. The comment period ended on June 9, 2000, and ARSC received approximately eighty comment letters. During this process, many issues were identified that warranted further discussion and explanation. This Alert covers issues primarily related to the amendments to SSARS 1.

Overview of the Changes

Amendment to SSARS 1—The Management-Use Only Compilation Engagement and Other Changes

Why was a change made to SSARS 1? What specific changes were made?

One of the goals of SSARS 1 was to establish a minimum level of service for unaudited financial statements of nonpublic entities.

To accomplish this, SSARS 1 contained a "trigger." SSARS 1, AR Section 100.07, states the following.

The 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. Submission of financial statements is defined as presenting to a client or others financial statements that the accountant has (*a*) *generated,* either manually or through the use of computer software, or (*b*) *modified,* by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements. [*Emphasis added*]

EXHIBIT 1

Applicability of SSARS 1 Prior to the Amendments

Your client asks you to help find a problem in an income statement that he or she has just printed (net income doesn't "look right"). You sit down and begin to review the prior month's entries in the client's computerized accounting database and notice that four checks (totaling $15,000, a material amount) were coded incorrectly. Each of these checks was coded as "Repairs and Maintenance." Nevertheless, based on your close association with the client and your knowledge of the prior month's activities, you know that these four checks should have been coded as "Leasehold Improvements," so you simply change the account classifications and log out of the software.

Did you just submit the financial statements? In the author's opinion, you did, because you *materially modified* the client's financial statement by changing account classifications. (See SSARS 1.)

Did you *intend* to compile the financial statements? Probably not.

Must you now *compile* the client's financial statements? According to SSARS 1, you must.

What if, instead of going to the client's office, you made the same modifications on a disk in your office or by modem? In the author's opinion, the answer would be the same—you submitted financial statements and now you must compile those statements.

Although initially this trigger was effective and served its purpose, in the years since SSARS 1 was issued, circumstances have changed, including the profession, the competitive environment, and technology. These changes have progressively led to problems for practitioners that can be summarized as problems of applicability and market-driven problems.

Deciding when SSARS applies is one of the difficulties that has resulted. See exhibit 1, "Applicability of SSARS 1 Prior to the Amendments."

The other problem is related to market influences. As our profession has changed and as our relationships with our clients have changed, many practitioners believe that they are constrained by the requirements in SSARS 1. For example, a client may need financial statements solely for management purposes. Yet SSARS 1 requires the accountant to perform a compilation engagement and issue a report on the financial statements. This is the case even if neither the client nor the accountant believes that compiled financial statements are needed.

The major changes in SSARS 1 can be summarized as follows.

- The definition of *submission of financial statements* is changed to include only the "preparation of financial statements."
- A provision for a special management-use-only compilation engagement is created (when the financial statements are not expected to be used by a third party).

Submission of Financial Statements

When is SSARS 1 applicable? Can I modify a client's accounting database and not report on the financial statements?

SSARS 1 is applicable whenever you submit unaudited financial statements of a nonpublic entity to your client or third parties. SSARS 8 modifies the definition of *submission*. *Submission of financial statements* is now defined as follows:

> Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

Although some in the profession will argue that this change in the definition of submission will create a loophole for those who want to avoid performing a compilation, ARSC believes that this modification was the best way to address today's technological environment, while still retaining the trigger (thereby ensuring a minimum level of service on financial statements that are *prepared* by the accountant and *presented* to the client).

Note that the following two actions are necessary in order to submit financial statements.

- *Prepare* financial statements, either manually or through the use of computer software.
- *Present* the financial statements to a client or third party.

Absent either of these actions, the financial statements have not been submitted, and SSARS 1 is not applicable.

The term *prepared* is not defined by SSARS 8. Rather, you must use your professional judgment to determine if you have prepared a financial statement. In making this judgment, you should consider the difference between mere bookkeeping services (for example, adjustments, corrections, and accruals) and preparation of financial statements. To prepare financial statements, you must use your knowledge, education, and experience to create financial statements that would not have existed otherwise. In other words, if the financial statements prepared by your client's bookkeeper are pretty good to begin with and all you do is "tweak a couple of things," then you probably haven't prepared the financial statements. On the other hand, if the client gives you an unadjusted trial balance and you make all of the adjustments necessary to convert the information into financial statements, then you probably have prepared the financial statements.

The term *presenting* is also not defined in SSARS 1. Again, you will have to use your professional judgment to determine if you have presented financial statements to a client. Obviously, physically presenting printed financial statements would meet the definition used here. Other situations, especially those involving electronic presentation (for example, via e-mail) should be carefully considered.

The following table may be helpful in determining if you have submitted financial statements:

No.	*Scenario*	*Submission of Financial Statements?*	*Reasoning*
1.	Using client information, the CPA prepares financial statements in the CPA's office for use in preparing a corporate income tax return and the financial statements are not given to the client.	No.	The financial statements are not presented to the client and the information contained in a tax return is not considered a financial statement.
2.	Same scenario as number 1, except that a copy of the financial statements is given to the client, along with the income tax return.	Yes.	The financial statements are prepared by the accountant and presented to the client.
3.	Same scenario as number 1, except that a copy of the adjusting journal entries and trial balance is given to the client, along with the income tax return.	No.	A trial balance is not a financial statement.
4.	At a client's office, the CPA makes material adjustments to the client's accounting database, prints the adjusted financial statements, and takes the financial statements with him or her.	No.	The accountant is providing bookkeeping services, but the accountant is not "preparing" financial statements. Material modifications no longer constitute a submission of financial statements. In addition, the accountant did not "present" the financial statements to the client.*
5.	Same scenario as number 4, except that the CPA also prints a copy of the financial statements and presents them to the client.	No.	The accountant is providing bookkeeping services, but the accountant is not "preparing" financial statements. Material modifications no longer constitute a submission of financial statements. Although the financial statements were presented to the client, they were not prepared by the accountant.*
6.	The client sends the CPA a disk containing information from the client's accounting database. The CPA makes adjustments to the disk and returns it to the client.	No.	The accountant is providing bookkeeping services, but the accountant is not "preparing" financial statements. Material modifications no longer constitute a submission of financial statements.*

(continued)

No.	Scenario	Submission of Financial Statements?	Reasoning
7.	The CPA accesses the client's accounting database by modem and makes material modifications to the accounting database.	No.	The accountant is providing bookkeeping services, but the accountant is not "preparing" financial statements. Material modifications no longer constitute a submission of financial statements.*

* Note that, in each of these scenarios, a certain amount of professional judgment is involved. If you believe that in making these material adjustments you have, in fact, prepared financial statements (by using your knowledge, experience, and education) and have gone beyond mere bookkeeping services, and you believe that you have presented them to the client or others, you should comply with SSARS 1.

The Management-Use Only Compilation

What is a compilation? *What is the difference between the existing compilation and the new* management-use-only compilation?

SSARS 1 defines a *compilation* as follows.

> Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements.

Note that this definition does not require you to test, verify, or corroborate information supplied by management, but simply to place the information into the form of financial statements.

SSARS 1, as amended, states that in all compilation engagements, the performance standards in AR Sections 100.05 and 100.07–.10 should be followed. These performance standards consist of the following.

- *Establish an understanding with the entity.* This means that you should have an understanding with the entity about the nature and limitations of the services to be performed and a description of the report, if a report is to be issued. The understanding should also provide (*a*) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (*b*) that you will inform the appropriate level of management of any material errors that come to your attention and any fraud or illegal acts that come to your attention, unless they are clearly inconsequential. This understanding should preferably be in writing. However, if the engagement is to compile financial statements for management's use only, a *written* communication is required. See the illustrative engagement letter in appendix C, "Compilation of Financial Statements Not Intended for Third-Party Use—Illustrative Engagement Letter."

- *Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.* This means that you should have a sufficient understanding of the industry to know what the financial statements for an entity in that industry should look like and be aware of any accounting principles or practices that are unique to that industry. You do not have to be an industry expert, and you can obtain this general understanding if you do not already possess it (for example, through AICPA Guides, nonauthoritative industry guides, trade publications).

- *Have or obtain a general understanding of the client's business.* This means that you should have a general understanding of the client's business transactions, form of its accounting records, stated qualifications of accounting personnel, basis of accounting on which the financial statements are to be presented, and form and content of the financial statements. The purpose of this general understanding is to determine how much reliance you (the accountant) can place on the information supplied by the client and to determine the extent of additional accounting procedures (such as bookkeeping and adjustments) that will be necessary in order to compile the financial statements.

- *Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory for the intended use of the financial statements.*

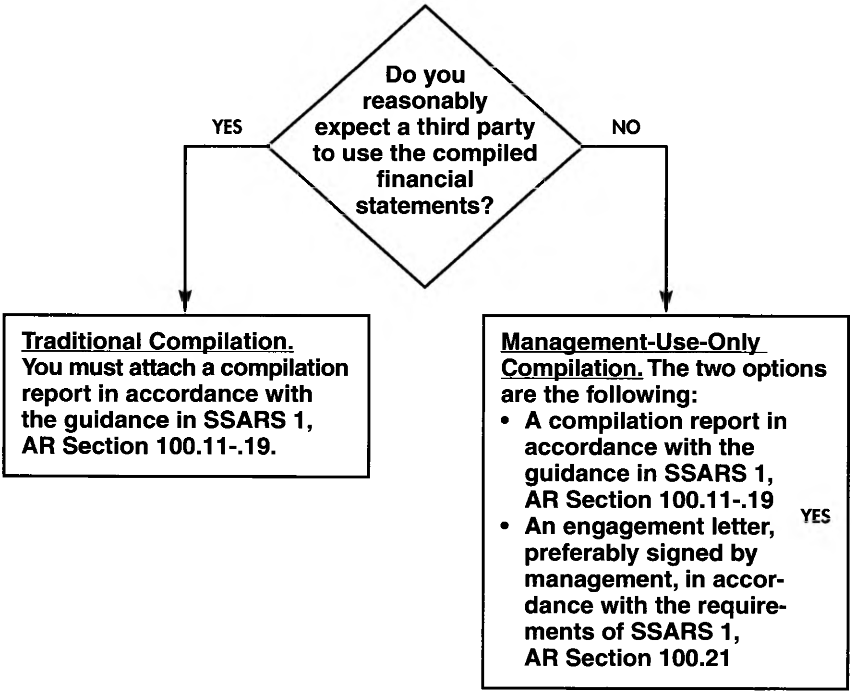
This requirement has different meanings depending upon the intended use of the financial statements. For example, if the financial statements will be used by a third party (or if you reasonably expect that they might be used by a third party), any information that appears to be incomplete, incorrect, or unsatisfactory for use by that third party (for example, missing disclosures or measurement departures) should be obtained from or corrected by the client. On the other hand, if the financial statements are not intended to be used by third parties, that same information may be appropriate for management because they have the requisite knowledge of the business to put the information in the proper context.

- *Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material error.* This is the final reading of the financial statements (sometimes called the "smell test"). The primary purpose of this requirement is to look for mathematical, clerical, or presentation errors (for example, incorrect titles on the financial statements), and others. SSARS 1, as amended, now provides for the following two kinds of compilations.

  1. A *compilation* with a *report* is required when you have been engaged to compile and report on the financial statements or when you reasonably expect the financial statements may be used by a third party. This might be referred to as a *traditional compilation.*
  2. A *compilation* without a *report* is available when you do not reasonably expect the financial statements to be used by a third party. This might be referred to as a *management-use-only compilation.*

Note that in either case, the engagement is a compilation. In either case, you must comply with the performance requirements above. The difference is in the form of communication used. Exhibit 2 illustrates the two kinds of compilation engagements.

EXHIBIT 2



The following table illustrates how the new management-use-only compilation engagement fits into the three existing levels of service on financial statements.

Type of Engagement	*Assurance Provided*
Audit • Unqualified • Qualified • Adverse • Disclaimer	Providing an opinion on the financial statements taken as a whole that they are fairly presented in accordance with generally accepted accounting principles (GAAP)
Review	Providing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with GAAP
Compilation • With report • With communication (no report)	Providing no opinion or any other form of assurance on the financial statements

Executive Summary—Overview of the Changes

- SSARS 1 was amended because of applicability problems and market-driven problems.
- As our profession has changed and as our relationships with our clients have changed, many practitioners believe they are constrained by the requirements in SSARS 1.
- The definition of *submission of financial statements* is changed to include only the "preparation of financial statements."
- A provision for a special management-use-only compilation engagement is created (when the financial statements are not expected to be used by a third party).

Engagement Administration Issues

Third Parties

What is a third party *and what is meant by* reasonable expectation*?*

SSARS 8 states that financial statements may be submitted to a client (management-use-only financial statements) if the financial statements "are not reasonably expected to be used by a third party." In deciding whether the financial statements are or reasonably might be expected to be used by a third party, you may rely on management's representation without further inquiry, unless information comes to your attention that contradicts management's representation.

SSARS 8 defines *third parties* as follows.

> All parties except for members of management who are generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

Note that this is a definition by exception. In other words, the starting point for determining who is a third party is that *all* parties are third parties, with the exception of *certain* members of management. Those certain members of management would be those members who are knowledgeable enough about the business to be able to put the information in the proper context. ARSC chose not to define "third parties," but instead to define who is *not* a third party. In order to not be considered a third party, the person or persons must meet the following two requirements.

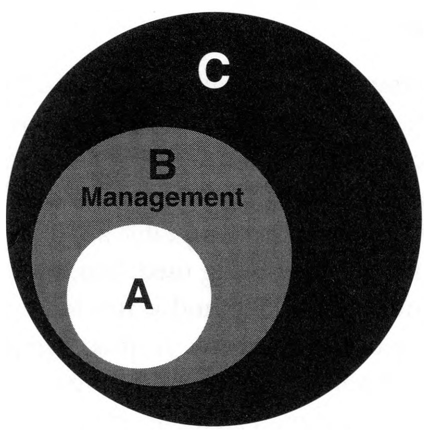
1. He or she is a member of management.
2. He or she is knowledgeable enough about the business to put the information in the proper context.

For guidance on determining whether or not a person is a member of management, you may refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Parties*, which includes the following definition.

> Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.

In Exhibit 3, Circle C represents all potential users of an entity's financial statements (banks, bonding companies, creditors, shareholders, vendors, customers, and so on), and Circle B represents all members of management. All users in Circle C would be considered third parties. In addition, members of management in Circle B—

EXHIBIT 3



those without the requisite knowledge of the client's business that would allow them to place the information contained in the financial statements in the proper context—would also be considered third parties. Compiled financial statements which do not include a report should be restricted to those parties in Circle A (those members of management that have the requisite knowledge of the business).

Does this mean that you will have to make judgments about management's knowledge of their own business? Although some judgment will be involved in making this determination, you may rely on management's representation to you that they have the necessary knowledge of the business to put the information in the proper context (see the illustrative engagement letter in appendix C).

The following are examples of third parties.

- ABC Company is a small, closely held business, owned and managed by its sole shareholder, John. In this situation, absent evidence to the contrary, John has the requisite knowledge of his business and would not be considered a third party.
- KLM Company is a small, closely held business, managed by one of its ten shareholders, Jane (the other nine shareholders live out of state and are not involved in the management of the business). In this situation, absent evidence to the contrary, Jane has the requisite knowledge of the business and would not be considered a third party. The other nine shareholders, however, would be considered third parties.
- XYZ Company is a small, closely held business. The management team consists of a president, Joe; controller, Mary; operations manager, Sue; and sales manager, Jim. Joe, Mary, and Sue are all involved in the financial operation of the company and are knowledgeable about the accounting principles and practices being used. Jim, on the other hand, has no finance background and is not involved in the financial operation of the company. In this example, Joe, Mary, and Sue would not be considered third parties. Jim, although he is a member of management, does not have the requisite

knowledge of the accounting practices of the business and would be considered a third party.

Note that these financial statements are intended to be restricted to *management use*, not *internal use*. Internal use implies that anyone who is internal to the client might be the intended user of the financial statements (for example, all employees). SSARS 1, as amended, requires that these financial statements be restricted to management use.

Also note that those members of management that are considered third parties, Jim (in the preceding example) could be "brought into the loop" or removed from third-party status. This would be accomplished by educating those members of management about the accounting principles and practices of the business, thereby allowing them to place the information in the proper context. This education could be accomplished by other members of management or by the accountant.

Management-Use Only Financial Statements Distributed to Third Parties

What should I do if financial statements restricted for management's use only are subsequently distributed to third parties?

SSARS 8 states the following.

> If the accountant becomes aware that the financial statements have been distributed to third parties, the accountant should discuss the situation with the client and request that the client have the statements returned. If the client does not comply with this request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third party use, preferably in consultation with his or her attorney.

If you determine that the financial statements were given to a third party unintentionally (for example, the client made a mistake or forgot about the restricted nature of the financial statements), then you should remind the client of the restricted nature of the statements and request that he or she retrieve all copies from third parties. If the client complies, then no further action would be necessary.

However, if you discover that the client intentionally disregarded the restriction placed on the use of the financial statements and refuses to retrieve the financial statements, then you should notify known third parties that the financial statements are not intended for third-party use. Because this action involves legal matters beyond the scope of this publication, you should consult with an attorney before taking any action. This action on the part of your client because it bears on the integrity of management, should also be considered before performing any further services for that client.

In order to minimize the risk of a client distributing management-use-only financial statements to third parties, you may want to include language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third party use, you can provide that service separately (see the illustrative engagement letter in appendix C).

Change in Kind of Engagement

What if I am engaged to perform the management-use-only compilation, but subsequently, the client needs compiled or reviewed financial statements for use by a third party?

If the client needs financial statements for third-party use, you may compile (or review) financial statements for that client and comply with the reporting requirements in SSARS 1, AR Section 100.11 - .19 (or follow requirements for a review engagement). Note that you may do this even if you have previously compiled the financial statements for management's use only. This would, however, be a different engagement. You may want to include language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third-party use, you can provide that service separately (see the illustrative engagement letter in appendix C).

Independence and Client Services

What impact does independence have on compilation and review engagements? Where can I get more guidance on independence issues?

SSARS 1 requires that you identify a lack of independence in a compilation engagement and prohibits you from reviewing financial statements if you are not independent. The lack of independence is noted either in the compilation report or in the engagement letter if the financial statements are restricted to management's use and not intended to be used by third parties. The following sentence is added to the appropriate communication.

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

Guidance for determining independence can be found in Rule 101, the Interpretations of Rule 101, and the related independence rulings of the AICPA Code of Professional Conduct. You should also consult the independence rules of your state board of accountancy, your state CPA society, and any applicable regulatory agency.

Independence is a difficult area; it is easy to define but difficult to apply. Consequently, the AICPA developed a new user-friendly Audit Risk Alert to understanding the subject of independence, *The ABCs of Independence* (Product No. 022271kk).

Client and Engagement Selection

Is a management-use-only compilation engagement appropriate for every client? What should I consider in making this decision?

Engagements to compile financial statements for management's use only are not appropriate for every client. As a result of the unique nature of these financial statements and the fact that they are restricted for management's use only, there may be situations in which this engagement is not appropriate. Just as practitioners make decisions every day about client and engagement selection, they will also have to make decisions about when management-use-only compilations are appropriate.

Key issues to consider in determining whether or not to perform this engagement include the following:

- *Needs of third parties.* Does a third party (for example, a bank) need compiled financial statements on a regular basis?
- *Information that might bear on the integrity of management.* Has information come to your attention that gives you reason to doubt the integrity of management?

- *Past experience with management.* Have past experiences on other engagements been positive?
- *Independence considerations.* You may have to consider carefully the independence implications of being closely involved with management-use-only financial statements. For further guidance, see the new Audit Risk Alert, *The ABCs of Independence.*
- *Cost/benefit considerations.* Can you perform the engagement at a reasonable cost to the client versus the benefit over a traditional compilation engagement?
- *Risk management considerations.* Some practitioners may perceive this engagement as more risky than a traditional compilation (which offers the additional protection of the compilation report).

Executive Summary—Engagement Administration Issues

- The definition of *third parties* includes all parties except for members of management who are generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.
- Under this definition, some members of management may be considered third parties.
- If you become aware that the financial statements have been distributed to third parties, you should discuss the situation with the client and request that the client have the statements returned.
- If the client does not comply with this request within a reasonable period of time, you should notify known third parties that the financial statements are not intended for third-party use, preferably in consultation with your attorney.
- Compiling financial statements for management's use only does not preclude you from compiling financial statements for the same period for use by third parties.
- For guidance in the area of independence, you may want to consult the new AICPA Audit Risk Alert, *The ABCs of Independence.*
- You should carefully consider the implications of compiling financial statements for management's use only in making client selection and engagement decisions.

Accounting and Reporting Issues

Communicating With the Financial Statement User

What's the difference between a report *and a* communication*?*

If you submit financial statements to a client that will be used by a third party (or if you reasonably expect that they might be used by a third party), you must comply with the reporting requirements in SSARS 1, AR Section 100.11-.19. These paragraphs contain the following requirements:

1. Standards for the form of a standard compilation report
2. Standards for reporting on financial statements that omit substantially all disclosures
3. Standards for reporting when the accountant is not independent
4. Standards for reporting when there are departures from GAAP or an other comprehensive basis of accounting (OCBOA)

If the financial statements are for management's use only (and you do not reasonably expect them to be used by a third party), there is an additional communication option: a written engagement letter (preferably signed by management). This engagement letter must contain the following elements:

- A description of the nature and limitations of the services to be provided
- A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management
- A statement that the financial statements have not been audited or reviewed
- A statement that no opinion or any other form of assurance on the financial statements will be provided
- An acknowledgment that management has knowledge about the nature of the procedures applied and the basis of

accounting and assumptions used in the preparation of the financial statements

- An acknowledgment of management's representation and agreement that the financial statements will not be used by third parties
- A statement that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts

The engagement letter should also include the following additional matters, if applicable:

- A statement that material departures from GAAP or OCBOA may exist and the effects of those departures on the financial statements may not be disclosed
- A statement that substantially all disclosures (and the statement of comprehensive income and statement of cash flows, if applicable) required by GAAP or OCBOA may be omitted
- A statement that the accountant is not independent
- A reference to any supplementary information that may be included

An example of this communication can be found in appendix C.

The Engagement Letter in a Management-Use Only Compilation

Can an engagement letter in a management-use-only compilation cover multiple periods? Can this engagement letter cover multiple services? Is management required to sign the engagement letter? How should I document this engagement letter?

In an engagement to compile financial statements for management's use only, a written engagement letter is required (note that in all compilation and review engagements an *understanding with the client* is required). This engagement letter must address certain matters (see the "Communicating With the Financial Statement User" section of this Alert). It is permissible to issue one engagement letter to cover multiple periods and/or multiple services. However, it is recommended that this engagement letter be updated at least annually. This is attributable to the fact that client relationships change over time, and it is especially important in this kind of engagement to ensure that there is a good understanding between the CPA and the client (restricted nature of the statements, limitations of the financial statements).

In addition, care should be exercised in adding additional services to the engagement letter. Although it is common to address additional services such as bookkeeping, tax, payroll, and consulting in this engagement letter, it is not advisable to include both the management-use compilation and traditional (unrestricted) compilation engagements in the same engagement letter. Should the client need compiled financial statements for third-party use, it is recommended that a separate engagement letter be issued in order to reduce the risk of misunderstanding and confusion about the two kinds of engagements.

Management is not required to sign the engagement letter, but it is preferable and highly advisable. Obtaining management's signature on the engagement letter helps to ensure that management has read and understands the letter and the engagement. If the engagement letter is mailed to the client, it may be advisable to send the letter by certified mail or another means that will provide proof of receipt. In any case, a copy of the engagement letter should be included in your working papers.

Basis of Accounting in a Management-Use Only Compilation

Are management-use financial statements required to be presented in accordance with GAAP (or OCBOA)?

In SSARS 1, AR Section 100.04, a financial statement is defined as the following.

> A presentation of data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles (GAAP) or a comprehensive basis of accounting other than GAAP (OCBOA).

Theoretically, to be considered financial statements, these management-use financial statements should be prepared using GAAP or OCBOA. However, as with any compiled or reviewed financial statements, there may be departures from that basis (measurement or disclosure). Financial statements that are, or might reasonably be expected to be, used by a third party include a report identifying these departures. Management-use-only financial statements will not include a report. However, the engagement letter may identify departures. The fact that departures may exist in these financial statements does not mean that the financial statements are not prepared using GAAP or OCBOA. As a result of the restricted nature of the financial statements, however, there is no need to identify the particular basis of accounting being used. This is attributable to the fact that management was involved in designing the financial statements to provide the best information available for managing his or her business. He or she is already aware of the limitations of the financial statements, including the fact that they may not be prepared in strict conformity with GAAP or OCBOA.

In addition, titles such as "Income Statement" or "Balance Sheet" should be used only on GAAP financial statements. Appropriate titles for OCBOA financial statements include "Statement of Assets," "Liabilities, and Equity—Income Tax Basis," or "Statement of Revenues and Expenses—Cash Basis." However, as a result of the restricted nature of these financial statements, strict adherence to proper titles is not always necessary. Management should understand and be able to use the financial statements. Therefore, any reasonable title that management understands would be appropriate.

Legend on Each Page of the Financial Statements

Do financial statements restricted to management use only have to contain a legend or reference to a report?

SSARS 8 requires that you place a legend on each page of the financial statements restricted to management's use only indicating the restricted nature of the presentation (meaning, restricted to management use), such as "Restricted for Management's Use Only" or "Solely for the information and use of the management of XYZ Company and is not intended to be and should not be used by any other party." Although a legend is required, you do not have to use either of these two examples (as long as you indicate the restricted nature of the financial statements). Some practitioners may choose more descriptive legends, such as the following.

> These financial statements are for use by management only and should not be relied upon by others. These statements may contain material departures from generally accepted accounting principles and the effects of those departures, if any, are not disclosed.
>
> Restricted for Management-Use Only—Not for External Distribution

This legend may be placed on the financial statements by installing footers in financial statement software, by using a rubber stamp, by manually writing the legend, or any other method that is practical for the accountant.

Because the financial statements are intended to be restricted to management's use, the use of the words *Internal use* should be avoided.

Restricting to Specific Members of Management

Can the financial statements be restricted to specific members of management?

As an option, you may choose to further limit the use of management-use-only financial statements to specified members of management. To accomplish this, an optional paragraph may be added to the engagement letter, as follows.

> The financial statements are intended solely for the information and use of John Doe, Jane Doe, and Jim Smith, and are not intended to be and should not be used by any other party.

Executive Summary—Accounting and Reporting Issues

- The kind of communication (report or engagement letter) used in a compilation engagement depends upon the intended user of the financial statements.
- More flexibility is allowed for management-use-only financial statements in the areas of presentation, measurement, and disclosure, as a result of the restricted nature of the financial statements.

- A legend must be placed on each page of the financial statements restricted to management's use only.
- Financial statements restricted to management's use only may be restricted to specific members of management by adding appropriate language to the engagement letter.

Other Implementation Issues

Correlation With Other Professional Services

Can management-use-only financial statements be used in other than traditional business situations? Can a personal financial statement be considered management use only? Can management-use-only financial statements be used in ElderCare services? Can management-use-only financial statements be provided to a not-for-profit or governmental entity? What about trusts and estates?

According to SSARS 8 financial statements may be compiled for management's use only as long as the financial statements are not expected to be used by third parties. In business entities, this determination is not difficult to apply. However, if the client is an individual, not-for-profit, or governmental entity, then care should be exercised. The following table may be helpful in making these judgments.

Engagement	*Management-Use Only Compilation Allowed?*	*Other Options*
Personal financial statements	Yes, as long as the financial statements are restricted to management use only. In this context, only the individual whose financial statements are presented would be considered management. Note that the individual's advisers (for example, attorney, financial planner, banker) would be considered third parties.	SSARS 6 provides for an exemption from SSARS 1 for personal financial statements included in personal financial plans. Under SSARS 6, the personal financial plan may be used by the individual's advisers to assist in implementing the plan.
ElderCare services	Yes, as long as the financial statements are restricted to management use only. In this context, whomever is responsible for achieving the objectives of the individual and has the authority to establish policies and make decisions by which those objectives are to be pursued would be considered management.	

Engagement	*Management-Use Only Compilation Allowed?*	*Other Options*
Not-for-profit organizations	Yes, as long as the financial statements can be restricted to management use only. However, if the organization's financial information is subject to public examination, then management use-only financial statements would not be appropriate because management cannot legally agree to restrict the financial statements to management's use only.	
Trusts or estates	Yes, as long as the financial statements are restricted to management use only. In this context, whomever is responsible for achieving the objectives of the trust or estate and has the authority to establish policies and make decisions by which those objectives are to be pursued would be considered management. Generally, this would be the trustee or executor, but not the beneficiaries.	
Governmental entities	No, because a governmental entity's financial information is subject to public examination, management-use-only financial statements would not be appropriate because management cannot legally agree to restrict the financial statements to management's use only.	

Peer Review Implications

Will these management-use-only compilation engagements be subject to peer review?

In general, in order to maintain membership in the AICPA, any firm or individual who performs engagements resulting in a report being issued under the professional standards must be enrolled in an approved practice monitoring program. Historically, this has meant that any firm or individual who performs audits, reviews, compilations, or other attestation engagements was subject to peer review. Nevertheless, financial statements compiled for management's use only do not include a report, theoretically putting them outside the purview of peer review.

The Peer Review Board has determined that if a compilation for management's use is issued with an engagement letter, not with a report, and is the only accounting and auditing service performed by the firm, the firm would *not* be required by the AICPA to enroll in an Institute-approved Practice Monitoring Program. If a firm is already enrolled in such a program, and performs these engagements, this engagement *would* be included in the definition of a firm's accounting and auditing practice and *would* be within the scope of peer review.

You should consult with your state CPA society (or other organization responsible for conducting peer review) to determine the appropriate course of action in your own state.

Effective Date

When are the changes effective? When will financial statements compiled for management use only be available to my clients?

SSARS 8 is effective for financial statements submitted after December 31, 2000. Therefore, the new definition of submission becomes operable on January 1, 2001. Financial statements restricted for management's use only (compiled without a report) may be provided to clients starting on that date.

Note that the effective date is connected to the submission of the financial statements, not the date of or period covered by the financial statements. Therefore, the new management-use-only financial statements may be for a prior period (for example, December 31, 2000, or the year then ended).

Executive Summary—Other Implementation Issues

- Financial statements compiled for management's use only may be used in other kinds of engagements (personal financial statements, ElderCare, not-for-profits, and so on) as long as the financial statements can actually be restricted to management's use only.
- Management-use-only financial statements should not be provided to governmental entities.

- You should consult with your state CPA society (or other organization responsible for conducting peer review) to determine whether these management-use-only engagements will be subject to peer review.
- The two major changes (the definitions of *submission* and *management-use-only compilations*) will become effective for financial statements submitted after December 31, 2000.

APPENDIX A
Implementation Questions & Answers

These Q&As have been included to concisely cover some of the most frequently asked questions about Statement on Standards for Accounting and Review Services (SSARS) 8.

During the two years of discussions, debates, and comment letters, the ARSC continuously stressed the need for educating practitioners about the changes that were being proposed. As questions arose, the ARSC documented these along with the answers that they agreed upon. The result is the following list of the most frequently asked questions about SSARS 8.

1. What are the communication options in a compilation engagement?

   The kind of communication you use depends upon the intended use of the financial statements. If the financial statements will be used by a third party (or if you reasonably expect that they might be used by a third party), then a compilation report is the only appropriate communication. If you do not reasonably expect a third party to use the compiled financial statements, then you can choose either of the following two options.

   a. Issue a compilation report (in other words you may choose to perform a traditional compilation).
   b. Document your understanding with the client in an engagement letter, preferably signed by management.

   See the "Accounting and Reporting Issues" section of this Alert for a discussion of what must be included in the engagement letter and see appendix C, "Compilation of Financial Statements Not Intended for Third-Party Use—Illustrative Engagement Letter," for an illustrative engagement letter.

2. Have either or both the performance and reporting standards for review engagements been affected?

No. The performance and reporting standards for review engagements have not changed.

3. Can I make a statement that the financial statements are "not presented in conformity with generally accepted accounting principles (GAAP) or other comprehensive bases of accounting (OCBOA)?"

   No. Including such a statement in a compilation report would be tantamount to expressing an adverse opinion on the financial statements taken as a whole.

   If the financial statements are accompanied by a report, then each known departure that would have a material effect on the financial statements must be either corrected or identified, along with the effect of the departure on the financial statements (if the effect is known).

   If the financial statements are for management's use only, then a statement can be made in the engagement letter that "material departures from GAAP or OCBOA may exist and the effects of these departures, if any, on the financial statements may not be disclosed."

4. Do I have to identify each and every measurement departure from GAAP or OCBOA?

   If the financial statements are accompanied by a report, then each known departure that would have a material effect on the financial statements must be either corrected or identified, along with the effect of the departure on the financial statements (if the effect is known).

   If the financial statements are for management's use only, then a statement can be made in the engagement letter that "material departures from GAAP or OCBOA may exist and the effects of these departures, if any, on the financial statements may not be disclosed."

5. Can I perform a compilation if I am not independent?

   Yes, as long as the lack of independence is disclosed. If the financial statements are accompanied by a report, then a paragraph is added to the compilation report. If the financial statements are for management use only, then a statement is added to the engagement letter. In either case, the disclosure should read as follows:

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

6. How do I determine whether I am independent?

   Refer to Rule 101 of the AICPA Code of Professional Conduct, along with the related Interpretations of Rule 101 and independence rulings for guidance for determining independence. You may also consult the AICPA's new Audit Risk Alert, *The ABCs of Independence*.

7. What kind of legend is required on compiled financial statements?

   If the financial statements are accompanied by a report, then each page of the financial statements should include a reference to the report, such as the following:

   > See accountant's compilation report.

   If the financial statements are for management's use only, then each page of the financial statements should include a reference to the restricted nature of the financial statements, such as either of the following.

   > Restricted for Management's Use Only
   >
   > Solely for the information of and use by the management of XYZ Company and not intended to be and should not be used by any other party

8. May I issue a standard compilation report on financial statements that have previously been compiled for management's use only?

   Yes. However, you would have to comply with the reporting requirements in SSARS 1 before issuing the compilation report.

9. May I compile interim financial statements (for example, monthly or quarterly) that are restricted to management's use only and then issue a standard compilation report on the year-end financial statements?

Yes. However, the compilation of the year-end financial statements would be considered a separate engagement and would be subject to both the performance standards and reporting standards in SSARS 1.

10. What should I do if I discover that financial statements that were restricted to management's use only have been distributed to third parties?

    The first step should be to discuss the situation with the client and remind him or her of the restricted nature of the financial statements. You should also request that the client retrieve any copies of the financial statements that have been distributed to third parties. If the client complies with this request, then no further action is necessary.

    If the client does not comply with this request within a reasonable period of time, you should attempt to notify known third parties that the financial statements are not intended for third-party use. Because this action will involve complex legal issues, you should consult with an attorney before proceeding.

11. May I submit drafts of management-use-only financial statements?

    Yes. As long as you have complied with all performance requirements in SSARS 1, AR Section 100.05 and 100.07-.10. These draft management-use-only financial statements should still contain the legend indicating the restricted nature of the financial statements (in order to minimize the risk of misunderstanding about the intended users of the financial statements).

12. May I use the new communication option (engagement letter) for a prescribed form under SSARS 3?

    No. SSARS 3 provides guidance for reporting on financial statements contained in certain prescribed forms. Because the intended user of these financial statements is generally a third party (for example, a bank or an industry association), the new communication option would not be appropriate.

13. May I issue a standard compilation report on comparative statements when the prior period financial statements were restricted to management's use only?

Yes. However, you will have to comply with the SSARS 1 reporting requirements for both periods before issuing the report on the comparative statements. In other words, the reporting requirements in AR Section 100.11-.19 would apply to both periods.

14. May I issue management-use-only financial statements for an individual (that is, personal financial statements)?

    Yes. You can do this as long as the financial statements are restricted to management's use only. In this context, only the individual whose financial statements are presented would be considered to be management.

15. May I include supplementary information with management-use-only financial statements?

    Yes. Supplementary information (which may include charts, graphs, tables, details of financial statement line items) may be included with the financial statements. You should include a statement in the engagement letter indicating your level of responsibility with respect to the supplementary information, such as the following.

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

16. Is it possible for someone who is a third party to become a non-third party?

    Yes, it is possible as long as that party is a member of management. In order to not be considered a third party, the person must meet the following two tests.

    a. He or she is a member of management.
    b. He or she is knowledgeable enough about the business to put the information in the proper context.

    If the person is not generally knowledgeable about and does not understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements, then he or she can be educated and "brought into the loop." This education can be done by other members of management or by the accountant.

17. If I am engaged to perform a standard compilation, may I change the engagement to a management-use-only engagement?

    Yes. However, as with any situation involving a change in the kind of engagement, you should carefully consider the reason for a request for a change in the engagement. You may compile financial statements restricted to management's use only if you do not reasonably expect that they will be used by a third party.

18. If I am engaged to perform a management-use-only compilation engagement, may I change the engagement to a standard compilation?

    Yes.

19. Can I issue one engagement letter to cover multiple periods?

    Yes. Engagement letters that cover an entire year are very common and may address multiple services. However, it is recommended that engagement letters be updated at least annually.

20. If a client has bank debt, can I ever reasonably expect that the financial statements will not be used by a third party?

    Yes. The mere fact that a client has bank debt will not preclude you from compiling financial statements for management's use only. You should, however, explain to the client that management-use-only financial statements are not intended to be used by the bank (or any other third party). If and when the client needs financial statements for distribution to the bank or others, you may discuss with him or her the requested level of service. You would not be precluded from compiling financial statements with a report when requested to do so.

21. Can I omit the statement of cash flows from financial statements restricted for management's use only?

Yes. The engagement letter should contain a statement such as the following.

> Substantially all disclosures (and the statement of comprehensive income and statement of cash flows) required by generally accepted accounting principles (or an other comprehensive basis of accounting) may be omitted.

22. Do compiled financial statements have to contain footnotes?

In general, financial statements should include appropriate footnote disclosures. However, compiled financial statements may omit those disclosures as long as that omission is disclosed and as long as the accountant is not aware of any intention to mislead the user of the financial statements.

This omission is disclosed either in the compilation report or in the engagement letter (for financial statements restricted to management's use only).

In the compilation report, the omission is disclosed as follows.

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

In the engagement letter (for financial statements restricted to management's use only), the disclosure would be as follows.

> Substantially all disclosures (and the statement of comprehensive income and statement of cash flows) required by generally accepted accounting principles (or an other comprehensive basis of accounting) may be omitted.

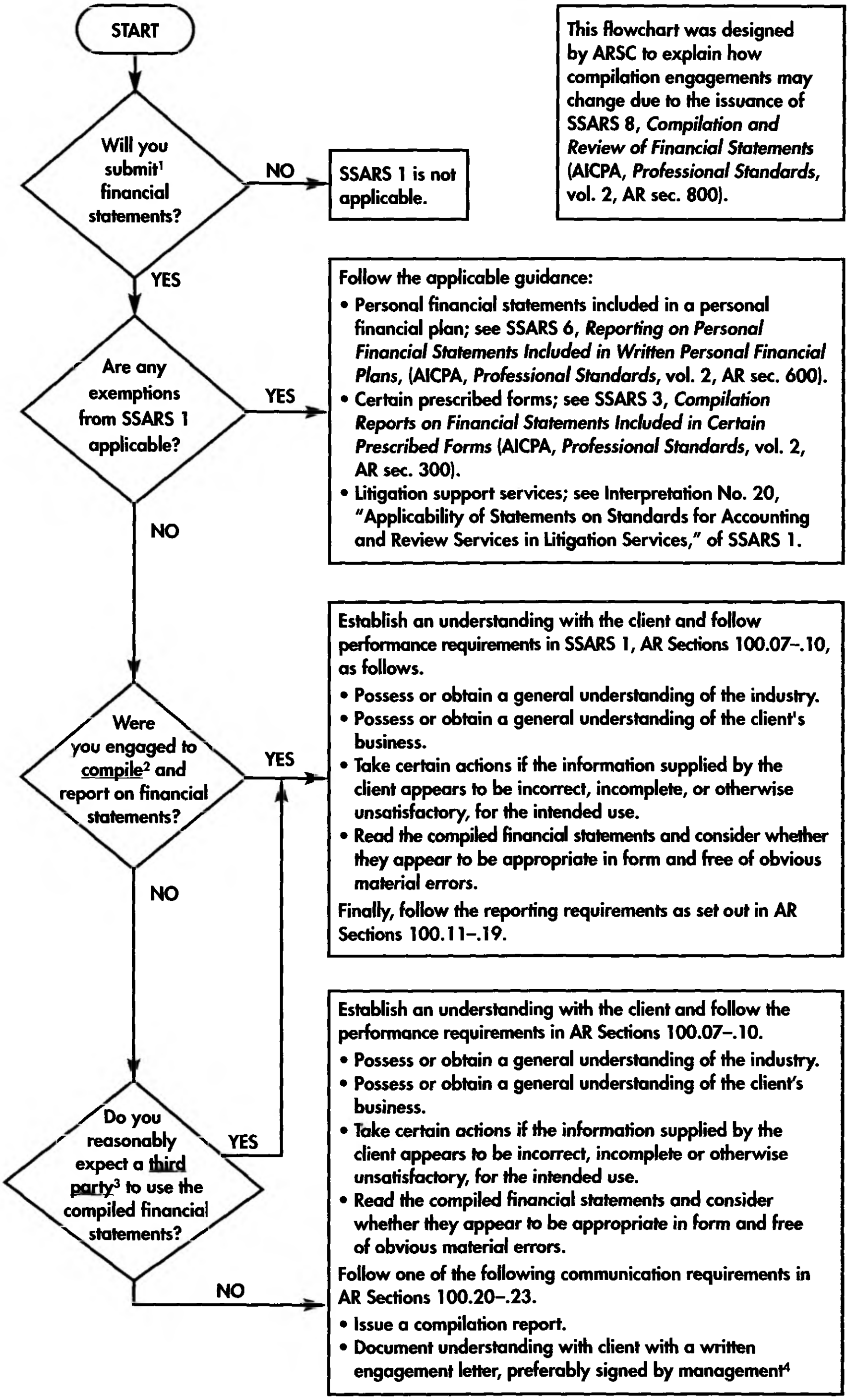
23. What titles should be used on financial statements restricted to management's use only?

In general, titles such as "Income Statement" or "Balance Sheet" should only be used on GAAP financial statements.

Appropriate titles for OCBOA financial statements include "Statement of Assets, Liabilities, and Equity—Income Tax Basis" or "Statement of Revenues and Expenses—Cash Basis." However, as a result of the restricted nature of these financial statements, strict adherence to proper titles is not always necessary. Since these financial statements are designed to meet management's needs in managing their business, you should use titles that management understands.

APPENDIX B
Compilation of Financial Statements

During the initial development of Statement on Standards for Accounting and Review Services (SSARS) 8, the members of ARSC designed a flowchart to help guide their discussion about the proposed changes in SSARS 1. This flowchart is also useful in explaining how compilation engagements may change due to the issuance of SSARS 8.


START
Will you submit[1] financial statements?
NO
SSARS 1 is not applicable.
This flowchart was designed by ARSC to explain how compilation engagements may change due to the issuance of SSARS 8, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 800).
YES
Are any exemptions from SSARS 1 applicable?
YES
Follow the applicable guidance:
• Personal financial statements included in a personal financial plan; see SSARS 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans*, (AICPA, *Professional Standards*, vol. 2, AR sec. 600).
• Certain prescribed forms; see SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300).
• Litigation support services; see Interpretation No. 20, "Applicability of Statements on Standards for Accounting and Review Services in Litigation Services," of SSARS 1.
NO
Were you engaged to compile[2] and report on financial statements?
YES
Establish an understanding with the client and follow performance requirements in SSARS 1, AR Sections 100.07–.10, as follows.
• Possess or obtain a general understanding of the industry.
• Possess or obtain a general understanding of the client's business.
• Take certain actions if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory, for the intended use.
• Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material errors.
Finally, follow the reporting requirements as set out in AR Sections 100.11–.19.
NO
Do you reasonably expect a third party[3] to use the compiled financial statements?
YES
NO
Establish an understanding with the client and follow the performance requirements in AR Sections 100.07–.10.
• Possess or obtain a general understanding of the industry.
• Possess or obtain a general understanding of the client's business.
• Take certain actions if the information supplied by the client appears to be incorrect, incomplete or otherwise unsatisfactory, for the intended use.
• Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material errors.
Follow one of the following communication requirements in AR Sections 100.20–.23.
• Issue a compilation report.
• Document understanding with client with a written engagement letter, preferably signed by management[4]

1. *Submission of financial statements*—Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.
2. *Compilation of financial statements*—Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements.
3. *Third parties*—All parties except for management who are generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.
4. The engagement letter should include the following matters:
   - A description of the nature and limitations of the services to be performed
   - A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management
   - A statement that the financial statements have not been audited or reviewed
   - A statement that no opinion or any other form of assurance on the financial statements will be provided
   - An acknowledgment that management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements
   - An acknowledgment of management's representation and agreement that the financial statements will not be used by third parties
   - A statement that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts

   The engagement letter should also include the following additional matters, if applicable:
   - A statement that material departures from generally accepted accounting principles (GAAP) or other comprehensive bases of accounting (OCBOA) may exist and the effects of those departures on the financial statements may not be disclosed
   - A statement that substantially all disclosures (and the statement of comprehensive income and statement of cash flows, if applicable) required by GAAP or OCBOA may be omitted.
   - A statement that the accountant is not independent
   - A reference to any supplementary information that may be included

APPENDIX C

Compilation of Financial Statements Not Intended for Third-Party Use—Illustrative Engagement Letter

This illustrative engagement letter was designed by the Accounting and Review Services Committee (ARSC) to be used in compilation engagements when the financial statements are not expected to be used by third parties.

Statement on Standards for Accounting and Review Services (SSARS) 8 requires that if financial statements are compiled for management's use only (not expected to be used by third parties) a written engagement letter is required (if a report is not issued). SSARS 8 requires specific items to be documented in this written engagement letter. The following illustrative engagement letter was designed by ARSC to be used in this type of compilation engagement.

[*Appropriate salutation*]

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

We will perform the following services:

1. We will compile, from information you provide, the [*monthly, quarterly, or other frequency*] financial statements of XYZ Company for the year 20XX. A compilation is limited to presenting in the form of financial statements information that is the representation of management. We will not audit or review the financial statements and accordingly, will not express an opinion or any other form of assurance on them. The financial statements will not be accompanied by a report.

Based upon our discussions with you, these financial statements are for management's use only and are not intended for third party use.

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

The financial statements are intended solely for the information and use of [*include list of specified members of management*] and are not intended to be and should not be used by any other party. [*Optional*]

2. We will also [*discussion of other services*]. —[*Optional*]

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless clearly inconsequential.

We are not independent with respect to [*name of entity*]. [*If applicable*]

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

In view of the limitations described above, you agree not to take, or assist in, any action seeking to hold us liable for damages due to any deficiency in the financial statements we prepare and you agree to hold us harmless from any liability and related legal costs arising from any third party use of the financial statements in contravention of the terms of this agreement. [*Optional*]

Our fees for these services .[*Include amounts*].

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

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.*

Sincerely yours,

[*Signature of accountant*]

Accepted and agreed to:

XYZ Company

Title

Date

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing..." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

APPENDIX D

SSARS 8—Amendment to Statement on Standards for Accounting and Review Services 1, *Compilation and Review of Financial Statements*

1. This amendment provides communication and performance requirements for unaudited financial statements submitted to a client that are not expected to be used by a third party. The performance and communication requirements for such engagements would be subject to the Statement on Standards for Accounting and Review Services (SSARS) 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), as amended. This Statement does not preclude an accountant from reporting in compliance with SSARS 1 in such engagements.

.01 This Statement sets forth the performance and communication requirements when an accountant submits unaudited financial statements of a nonpublic entity to his or her client or third parties. The accountant should not submit unaudited financial statements of a nonpublic entity to his or her client or a third party unless, as a minimum, he or she complies with the provisions of this Statement applicable to a compilation engagement.

a. *Compilation of financial statements.*[1] If the accountant performs a compilation, a communication to management is required. The type of communication depends on the following.

1. If the accountant is engaged to report on compiled financial statements or submits financial statements to a client that are or reasonably might be expected to be used

1. See appendix A, "Compilation of Financial Statements," for a flowchart describing the requirements of Statements on Standards for Accounting and Review Services (SSARSs) for a compilation engagement.

by a third party, see SSARS 1, AR sections 100.11–.19 for reporting requirements.

2. If the accountant submits financial statements to a client that are not reasonably expected to be used by a third party, see SSARS 1, AR sections 100.20–.23 for required communications to management.

In deciding whether the financial statements are or reasonably might be expected to be used by a third party, the accountant may rely on management's representation without further inquiry, unless information comes to his or her attention that contradicts management's representation.

In each of the above circumstances, the performance requirements in AR sections 100.05 and 100.07–.10 apply.

b. *Review of financial statements.*[2] If the accountant performs a review, see AR sections 100.05 and 100.24–.39 for performance and reporting requirements.

.02 If the accountant performs more than one service (for example, a compilation and an audit), the accountant should issue the report that is appropriate for the highest level of service rendered.[3]

.03 An accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity unless (*a*) the accountant has compiled or reviewed the financial statements and a report accompanies them or (*b*) the financial statements are accompanied by an indication that the accountant has not compiled or re-

2. Statements on Auditing Standards (SASs) provide guidance to the accountant who performs services in connection with the unaudited financial statements of a public entity. However, if a public entity does not have its annual financial statements audited, an accountant may review the entity's annual or interim financial statements in accordance with SSARSs as permitted by footnote 4 of SAS No. 26, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 504.05).

3. SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300), permits an accountant who has reviewed the financial statements of a nonpublic entity to issue a compilation report on financial statements for the same period that are included in a prescribed form that calls for departure from generally accepted accounting principles (GAAP).

viewed the financial statements and that the accountant assumes no responsibility for them. If an accountant becomes aware that his or her name has been used improperly in any client-prepared document containing unaudited financial statements, the accountant should advise the client that the use of his or her name is inappropriate and should consider what other actions might be appropriate, including consultation with his or her attorney.

Definitions

.04 Certain terms are defined for purposes of this Statement as follows.

Submission of financial statements. Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

Third party. All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.[4]

Nonpublic entity. Any entity other than (*a*) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (*b*) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (*c*) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (*a*) or (*b*). (See SSARS 2, *Reporting on Comparative Financial Statements* [AICPA, *Professional Standards*, vol. 2, AR sec. 200].)

Financial statement. A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accor-

4. The accountant may wish to specify those members of management. See appendix D, "Compilation of Financial Statements Not Intended for Third-Party Use—Illustrative Engagement Letter."

dance with generally accepted accounting principles (GAAP)[5] or a comprehensive basis of accounting other than GAAP.[6] Financial forecasts, projections and similar presentations,[7] and financial presentations included in tax returns are not financial statements for purposes of this Statement. The following financial presentations are examples of financial statements:[8]

- Balance sheet
- Statement of income
- Statement of comprehensive income
- Statement of retained earnings
- Statement of cash flows
- Statement of changes in owners' equity
- Statement of assets and liabilities (with or without owners' equity accounts)
- Statement of revenue and expenses
- Statement of financial position
- Statement of activities
- Summary of operations
- Statement of operations by product lines
- Statement of cash receipts and disbursements

5. The definition of GAAP and the hierarchy of established accounting principles 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.
6. The term *comprehensive basis of accounting other than generally accepted accounting principles* is defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). Hereafter, reference to GAAP in this Statement includes, where applicable, an other comprehensive basis of accounting (OCBOA). SAS No. 62, AU section 623.09 and .10, provides guidance on evaluating the adequacy of disclosure in financial statements prepared in conformity with OCBOA.
7. Statement on Standards for Attestation Engagements No. 1, *Financial Forecasts and Projections* (AICPA, *Professional Standards*, vol. 1, AT sec. 200), as well as the AICPA *Guide for Prospective Financial Information*, provide guidance on preparing and reporting on financial forecasts, projections, and similar presentations.
8. SAS No. 62, AU section 623.07, provides guidance with respect to suitable titles for financial statements that are prepared in conformity with OCBOA other than GAAP.

A financial statement may be, for example, that of a corporation, a consolidated group of corporations, a combined group of affiliated entities, a not-for-profit organization, a governmental entity, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual. The method of preparation (for example, manual or computer preparation) is not relevant to the definition of a financial statement.

Compilation of financial statements. Presenting in the form of financial statements[9] information that is the representation of management (owners) without undertaking to express any assurance on the statements. (The accountant might consider it necessary to perform other accounting services to compile the financial statements. See AR section 100.08.)

Review of financial statements. Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with an other comprehensive basis of accounting (OCBOA). (The accountant might consider it necessary to compile the financial statements or to perform other accounting services to enable him or her to perform a review. See AR section 100.30.)

The objective of a review differs significantly from the objective of a compilation. The inquiry and analytical procedures performed in a review should provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements. No expression of assurance is contemplated in a compilation.

The objective of a review also differs significantly from the objective of an audit of financial statements in accordance with generally accepted auditing standards (GAAS). The objective of an audit is to provide a reasonable basis for expressing an opinion re-

9. AR sections 100.16-.18 of this Statement provide guidance to the accountant engaged to compile financial statements that omit substantially all the disclosures required by GAAP or OCBOA.

garding the financial statements taken as a whole. A review does not provide a basis for the expression of such an opinion because a review does not contemplate obtaining an understanding of internal control or assessing control risk; tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmation; and certain other procedures ordinarily performed during an audit. A review may bring to the accountant's attention significant matters affecting the financial statements, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit.

Understanding With the Entity

.05 The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. However, if the engagement is to compile financial statements not expected to be used by a third party, a written communication is required. (See AR sections 100.20-.21.) The understanding should include a description of the nature and limitations of the services to be performed and a description of the report, if a report is to be issued. The understanding should also provide (*a*) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (*b*) that the accountant will inform the appropriate level of management[10] of any material errors that come to his or her attention and any fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential. Examples of engagement letters are presented in appendixes C, D, and E.

Compilation of Financial Statements

.06 AR sections 100.07–.10 are applicable to a compilation of financial statements, whenever the accountant—

- Is engaged to report on compiled financial statements.

10. When a fraud or illegal act involves senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the manager (owner) or the board of directors.

- Submits financial statements to a client that are or reasonably might be expected to be used by a third party.
- Submits financial statements to a client that are not expected to be used by a third party.

Compilation Performance Requirements

.07 The accountant should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable him or her to compile financial statements that are appropriate in form for an entity operating in that industry.[11] This standard does not prevent an accountant from accepting a compilation engagement for an entity in an industry with which the accountant has no previous experience. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, or individuals knowledgeable about the industry.

.08 To compile financial statements, the accountant should possess a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel. On the basis of that understanding, the accountant should consider whether it will be necessary to perform other accounting services, such as assist in adjusting the books of account or consult on accounting matters, when he or she compiles financial statements.

11. For purposes of this Statement, the term *industry* includes governmental and not-for-profit activities.

.09 The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have made inquiries or performed other procedures. The results of such inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory. In such circumstances, the accountant should obtain additional or revised information. If the entity refuses to provide additional or revised information, the accountant should withdraw from the engagement. (However, see AR sections 100.16–.18 for guidance when management elects to omit substantially all the disclosures required by GAAP and see AR sections 100.40–.42 for the accountant's reporting responsibilities when he or she is aware of other departures from GAAP.)

.10 Before submission, the accountant should read the financial statements and consider whether such financial statements appear to be appropriate in form and free from obvious material errors. In this context, the term *error* refers to mistakes in the compilation of financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure.

Reporting on the Financial Statements

.11 When the accountant is engaged to report on compiled financial statements or submits financial statements that are reasonably expected to be used by a third party, the financial statements should be accompanied by a report stating that—

a. A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

b. A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners).

c. The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

Any other procedures that the accountant might have performed before or during the compilation engagement should not be described in the report.

.12 The date of completion of the compilation should be used as the date of the accountant's report.

.13 Each page of the financial statements compiled by the accountant should include a reference, such as "See Accountant's Compilation Report."

.14 The following form of standard report is appropriate for a compilation:

> I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

.15 An accountant may be asked to issue a compilation report on one financial statement, such as a balance sheet, and not on other related financial statements, such as the statements of income, retained earnings, and cash flows. This Statement does not preclude the accountant from doing so. Also, an accountant may be asked to compile financial statements included in a prescribed form that calls for departure from GAAP. SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300), provides additional guidance, including an alternative form of standard report, applicable to such compilation engagements.

Reporting on Financial Statements That Omit Substantially All Disclosures

.16 An entity may request an accountant to compile financial statements that omit substantially all the disclosures required by GAAP, including disclosures that might appear in the body of the financial statements.[12] (As previously noted, reference to GAAP in this Statement includes, where applicable, OCBOA.) The accountant may compile such financial statements provided the omission of substantially all disclosures is clearly indicated in the report and is not, to his or her knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. 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."

.17 Notwithstanding the above, if financial statements compiled in conformity with a comprehensive basis of accounting other than GAAP do not include disclosure of the basis of accounting used, the basis should be disclosed in the accountant's report.

.18 When financial statements that the accountant has compiled omit substantially all disclosures[13], the following form of standard report is appropriate.

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

12. See AR sections 100.40-.42 for the accountant's responsibilities when he or she is aware of other departures from GAAP. However, see SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300), for guidance when such financial statements are included in a prescribed form and the prescribed form or related instructions do not request the disclosures required by GAAP.
13. If the statement of cash flows is omitted, the first and third paragraphs of the report should be modified accordingly.

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

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

Reporting When the Accountant Is Not Independent

.19 An accountant is not precluded from issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent.[14] If the accountant is not independent, he or she should specifically disclose the lack of independence. However, the reason for the lack of independence should not be described. When the accountant is not independent, the following should be included as the last paragraph of the report:

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

Accountant's Communications With the Client When the Compiled Financial Statements Are Not Expected to Be Used by a Third Party

.20 When an accountant submits unaudited financial statements to his or her client that are not expected to be used by a third party, he or she should either—

- Issue a compilation report in accordance with the reporting requirements discussed in AR section 100.11–.19.
- Document an understanding with the entity through the use of an engagement letter, preferably signed by management,

14. In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA *Code of Professional Conduct.*

regarding the services to be performed and the limitations on the use of those financial statements. (Appendix D contains "Compilation of Financial Statements Not Intended for Third-Party Use—Illustrative Engagement Letter.")

.21 The documentation of the understanding should include the following descriptions or statements:

- The nature and limitations of the services to be performed.
- A compilation is limited to presenting in the form of financial statements information that is the representation of management.
- The financial statements will not be audited or reviewed.
- No opinion or any other form of assurance on the financial statements will be provided.
- Management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.
- Acknowledgment of management's representation and agreement that the financial statements are not to be used by third parties.
- The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

The documentation of the understanding should also address the following additional matters if applicable:

- Material departures from GAAP or OCBOA may exist and the effects of those departures, if any, on the financial statements may not be disclosed.
- Substantially all disclosures (and statement of cash flows, if applicable) required by GAAP or OCBOA may be omitted.
- Lack of independence.
- Refer to supplementary information.

Such an understanding reduces the risk that the accountant or the client may misinterpret the needs or expectations of the other party. If the accountant believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

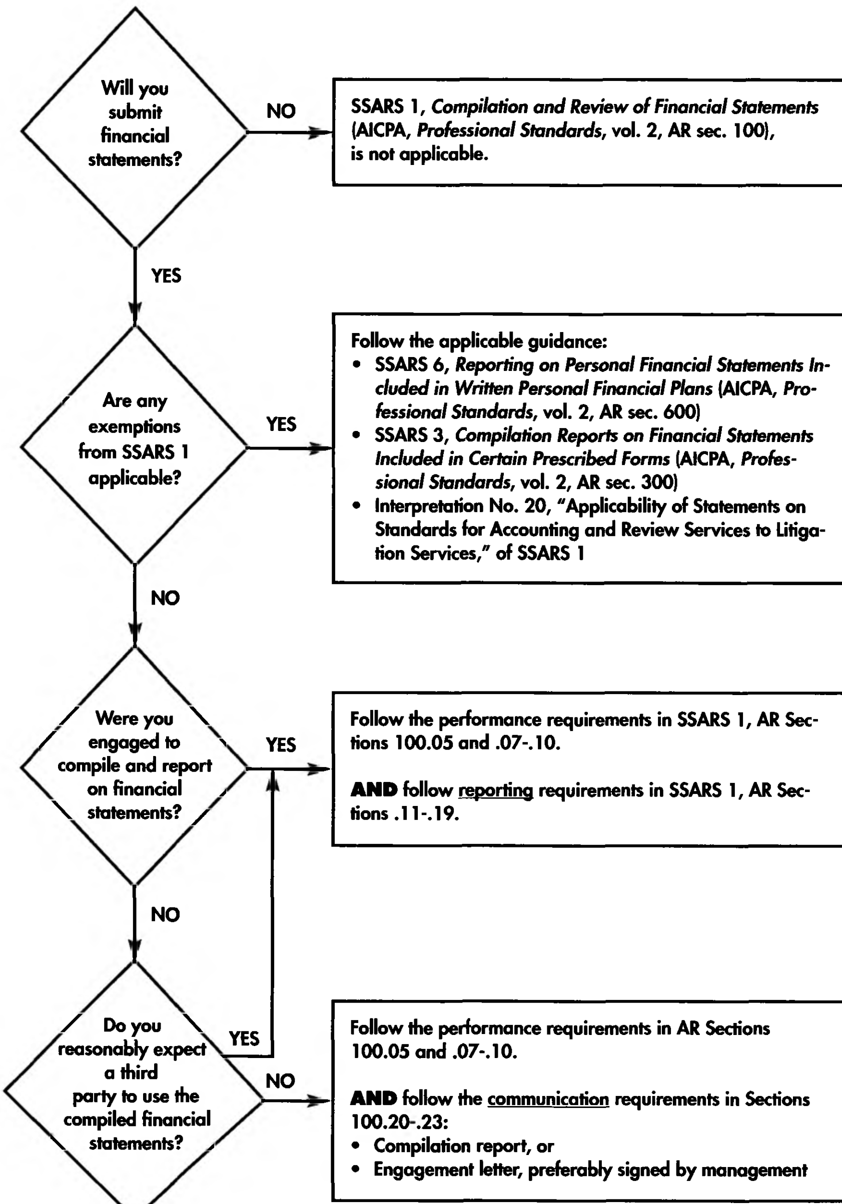
.22 The accountant should include a reference on each page of the financial statements restricting their use such as "Restricted for Management's Use Only," or "Solely for the information and use by the management of [*name of entity*] and not intended to be and should not be used by any other party."

.23 If the accountant becomes aware that the financial statements have been distributed to third parties, the accountant should discuss the situation with the client and request that the client have the statements returned. If the client does not comply with this request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third-party use, preferably in consultation with his or her attorney.

2. This Statement will be in effect for financial statements submitted after December 31, 2000.

APPENDIX A

Compilation of Financial Statements



APPENDIX D

Compilation of Financial Statements Not Intended for Third Party Use—Illustrative Engagement Letter

[*Appropriate Salutation*]

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

We will perform the following services:

1. We will compile, from information you provide, the [*monthly, quarterly, or other frequency*] financial statements of XYZ Company for the year 20XX. A compilation is limited to presenting in the form of financial statements information that is the representation of management. We will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them. The financial statements will not be accompanied by a report.

Based upon our discussions with you, these statements are for management's use only and are not intended for third-party use.

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

The financial statements are intended solely for the information and use of [*include list of specified members of management*] and are not intended to be and should not be used by any other party—[*optional*].

2. We will also [*discussion of other services—optional*].

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless clearly inconsequential.

We are not independent with respect to [*name of entity—if applicable*].

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

In view of the limitations described above, you agree not to take or assist in any action seeking to hold us liable for damages due to any deficiency in the financial statements we prepare and you agree to hold us harmless from any liability and related legal costs arising from any third-party use of the financial statements in contravention of the terms of this agreement. [*optional*]

Our fees for these services [*fill in*].

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

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.*

Sincerely yours,

[*Signature of accountant*]

Accepted and agreed to:

XYZ Company

Title

Date

* Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing..." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement..."

This Statement, titled Amendment to Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements, was adopted by the assenting votes of the seven members of the Accounting and Review Services Committee, of whom one, Mr. Jones, assented with qualification.*

Mr. Jones approves the issuance of this Statement, but qualifies his assent for paragraph .20, which requires the accountant to document an understanding with the entity through the use on an engagement letter, preferably signed by management, for compilations not expected to be used by a third party when a compilation report will not be issued. He believes the Statement should require the engagement letter to be signed by both the accountant and management. The engagement letter documents the accountant's understanding with the entity, and management's representation and agreement that the financial statements are not to be used by third parties. The engagement letter also documents that management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. Mr. Jones believes that an engagement letter signed by both the accountant and management reduces the possibility of a misunderstanding.

Accounting and Review Services Committee (1999–2000)

Diane S. Conant, *Chair*
Rhonda C. Arant
Andrew M. Cohen
Richard A. Jones
J. Russell Madray
Paul J. Murman, Jr.
R. David Smith

Arleen Thomas
Vice President
Professional Standards and Services

Kim Gibson
Technical Manager
Audit and Attest Standards