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Financial Statements: Problems Related to Unaudited Statements for the Small Practitioner

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Introduction

In 1968, eighty-eight percent of the corporations filing federal income tax returns had assets of under $500,000; and over 10 million non-corporate businesses filed partnership and proprietorship returns. These statistics indicate the astounding market for the members of the accounting profession serving the small business firms. Neither annual audits nor elaborate unaudited financial statements are a prerequisite to the successful operation of these businesses.[1] The owners of these businesses are primarily interested in pretax income and minimizing tax liabilities. The small business person is not interested in information which may be of little value, which must be developed so that unaudited statements conform to Generally Accepted Accounting Principles (GAAP), and which may cost hundreds of dollars in professional fees. Most Certified Public Accountants (CPAs) will agree that one set of accounting principles and disclosure requirements must apply to all size businesses, but the problems of client misunderstandings of unaudited statements, liability suits, unneeded information disclosures for closely held corporations, etc. cannot be ignored.

Historical Background of Unaudited Statements

In 1968, the Committee on Auditing Procedures of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Procedure No. 38 *Unaudited Financial Statements*, to clarify reporting requirements of a Certified Public Accountant in connection with unaudited financial statements. This statement was incorporated in Statement on Auditing Standards (SAS) No. 1 as Section 516. This section states the following:

> Although the CPA may have prepared, or assisted in preparing, unaudited financial statements, the statements are representations of management, and the fairness of their representation is management's responsibility. The CPA has no responsibility to apply any auditing procedures to unaudited financial statements.[2]

Although the above statement was believed to relieve the CPA of legal liability, the *1136 Tenants' Corp. v. Max Rothenberg and Company* case proved otherwise.[3] This as an action against the Rothenberg firm of CPAs to recover for the firm's alleged failure to uncover defalcations of the plaintiff's funds by its managing agent. The defalcations were hidden by reporting unpaid bills as having been paid. The accountants' defense was that they were retained merely to perform a write-up with no independent verifications undertaken, i.e., unaudited financial statements. The plaintiff was awarded damages equal to three hundred times the fee charged by the CPA. The court held that the defendant had in fact undertaken to perform an audit. The court further stated that even *if* the accountants had been engaged for *only* write-up work or to prepare unaudited financial statements, they (the accountants) were obligated to perform auditing procedures sufficient to uncover defalcations like those in the case.

Assuming that other courts will take a similar stand that the independent CPA, particularly the small practitioner doing mostly write-up work, must follow minimum procedures to uncover defalcations like those in the *1136 Tenants'* case, what then must the CPAs do to protect themselves? An *engagement letter* is a must for all examinations of limited scope and/or write-up work. This is a letter to or an agreement with the client, signed by the client, which outlines the description of services to be performed and the type of report to be issued. A study by Dan M. Guy and Alan J. Winters, surveyed the use of engagement letters when unaudited statements are issued and sought to determine if there was a correlation between familiarity with the *1136 Tenants'* case and the use of engagement letters.[4] The study revealed that only 11% of the respondents always used engagement letters for unaudited financial statements. Forty-six percent of the respondents who indicated they were "very" or "somewhat familiar" with the *1136 Tenants'* case, never employed engagement letters.

Dan M. Guy and Herschel Mann proposed that certain minimum review procedures be applied in all unaudited financial statement engagements.[5] Such minimum review procedures would aid in proving that the accountants exercised due professional care and would aid in providing a satisfactory level of service; such procedures would help guard against being associated with substandard financial statements. One of the suggested procedures is that of scanning the accounts for unusual aspects (i.e., unusual entries and their relationships). This scanning procedure possibly could have helped the accountant in the *1136 Tenants'* case, since missing invoices allegedly paid by the plaintiff's managing agent could have been noted as being unusual by their absence.

Special Problems of the Small Practitioner

Small practitioners face problems not met by the larger firms. Among these is the problem of *independence,* since many small CPA practices consist almost entirely of keeping client's books and preparation of unaudited financial statements and income tax returns based entirely thereon. These clients may be too small to afford a qualified in-house accountant-employee and may rely on the CPA to provide a full service accounting and tax program. Can a CPA who acts as a comptroller for several small businesses really be thought of as an independent professional? Could such a person who has almost complete control of all accounting functions avoid spotting almost any possible defalcation? Even if an engagement letter states that the accountant is not responsible for detecting frauds, would this be adequate evidence in a court case?

Small practitioners serve cash-basis clients, who do not understand that since income tax returns have been properly prepared on the cash basis, omission of accruals and deferrals may have a material effect on financial statements and/or results of operation. Therefore, it is inappropriate to use the terms balance sheet and statement of income with respect to a cash-basis statement or mention GAAP in expressing an opinion on them. If earnings per share are computed on the cash basis, and the statement is then converted to reflect GAAP, two widely different earnings per share amounts would be obtained which may seem to be inconsistent to many clients.

Problems with *disclosures* often arise with small business persons. Many disclosures of non-conformity with GAAP, with the effect thereof on the statements, can be so confusing as to render the statements meaningless. Some clients refuse to accept statements with necessary qualifications; they send copies of their income tax returns to interested third parties.

Further problems arise with *"for internal use only"* statements. Clients may not fully understand the limitations attached to them even though it's thoroughly explained. Men and women sophisticated in their own businesses are not always so when it comes to unaudited financial statements prepared by CPAs. Without prior warning, the client is apt to give one of the unaudited monthlies, quarterlies or annuals to a banker, a creditor or another third party.

Guide for Preparing Unaudited Financial Statements

In March, 1974, the Exposure Draft of the *Guide for Engagements of CPAs to Prepare Unaudited Financial Statements,* was published.[6] It sought to clarify requirements for, and aid in the preparation of, unaudited statements. (Until the final SAS is issued, the accountant should follow the exposure draft.) Since performing an audit requires extensive tests and examinations of the records, unaudited financial statements are prepared for many small firms. The purpose of the engagement must be made clear to the client. If the client is only concerned with obtaining assistance in preparing the financial statements, and is not concerned with the CPA's expression of an opinion on the statements, an audit presumably is neither necessary nor contemplated. The CPA should advise the client as to the type of professional services performed so that the statements serve the client's needs.

Association and Disclosures

When an accountant has prepared or assisted in the preparation of financial statements, an "association" with the statements is presumed. Since the CPA is "associated" with the statements, a disclaimer of opinion should accompany unaudited financial statements. The opinion of an unaudited statement should state that the CPA has not applied auditing procedures to the financial statements and cannot express an opinion concerning them. The *association* exists even though the CPA does not sign the financial statement or uses "plain paper" rather than firm stationery. When an accountant is performing ancillary services for a client, such as typing or reproducing, the client should be informed that the service is an accommodation and that it should not be construed as an accounting or auditing service.

Engagement Letters

The purpose of the engagement letter is to provide a written record of the agreement with the client stating the services to be provided. An engagement letter should state clearly the nature and limitations of the services to be performed. It should include a statement of (1) the limitations of the services (i.e., that the service will not constitute an examination in accordance with GAAP); (2) the reasons why a disclaimer would be issued; (3) why the procedures specified clearly do not constitute an examination of the financial statements and (4) the limitations as to possibility of detecting fraud and defalcations.

Professional Care

Since the CPA has not performed an audit, she or he cannot be expected to determine if the unaudited statements are in conformity with GAAP (which include adequate disclosure). However, awareness of GAAP may enable the CPA to spot statements that are not in conformity. When fraud or defalcations are uncovered or suspected, it is obligatory that the CPA bring any unusual or suspicious matters to the attention of the client. But the CPA has no obligation to apply procedures whose purpose is to bring to light indications that a fraud or defalcation may have occurred.

The *Guide* presents several pages of check lists to lend assurance against oversight and to provide a record of procedures performed. (Refer to *Guide* for complete list.) These should never be referred to as auditing procedures, only as checklists or minimum review procedures.

Disclaimers

The disclaimer of opinion was discussed earlier in this report and in this column in the previous issue. Each page, including the cover, should be marked "unaudited." Procedures performed by the CPA during an unaudited-statement engagement should not be described in the disclaimer of opinion; this might mislead the reader to believe that the statements might have been audited. Sections 516.04, .06 and .07 of SAS No. 1 describe the wording for disclaimers.

Internal Use Statements and Lack of Independence

Unaudited financial statements that do not include adequate disclosure can be given to the client for *internal use only*. The report must state that the financial statements are restricted for use solely by the company's management. Each page is to be labeled, "For Internal Use Only". The Statement of Changes in Financial Position may be omitted in "Internal Use Only" statements.

Independence, as discussed here, refers to a CPA having an interest in the client's business or being otherwise related to the client. A CPA who is not independent with respect to unaudited financial statements with which he or she is associated should mention this lack of independence in a disclaimer of opinion, but a statement on why independence is not present is not necessary.

Application to Tax Returns

Obviously, when a CPA prepares a tax return, Section 516 of SAS No. 1 does not apply. If, however, the CPA knows when preparing the tax return that a copy of the tax return is to be submitted to a third party, in lieu of a financial statement, such copy is considered as being used as a financial statement and a disclaimer opinion with footnotes for disclosures should be used.

Cash-Basis Statements

As discussed earlier in this report, cash basis reporting does not follow GAAP. The disclaimer of opinion could be clearly explained by stating that, due to the omission of accounts receivable and accounts payable, the financial statements do not present the financial position or results of operations of the company. This may not help with the problem of explaining to the client that cash-basis accounting does not objectively measure income or reflect a true balance sheet, but it does permit the use of cash-basis accounting when the client requests it.

Conclusion

The past seven years have seen a change in the attitude of responsibility for unaudited statements go from "anything goes" to carefully developed procedures to avoid liability. Now, even though the final AICPA's *Guide for Engagements of CPAs To Prepare Unaudited Financial Statements* has not been issued, the broader question of responsibility has been brought to the forefront. On October 7, 1974, a Commission on Auditor Responsibility was appointed by the AICPA to study the question of (among others) "Should Auditors be Responsible for Corporation Information Other than Audited Financial Statements, as Interim Statements?"[7] In the interim, the above mentioned *Guide* will provide some guidance for the small practitioners who seek to protect themselves from liability suits.

Footnotes

[1]Betty McGill and Peter Arnstein, "Unaudited Financial Statements — A Cloud of Dissent?" *Journal of Accountancy* 134 (December 1972):81.

[2]American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 1.* (New York: AICPA Inc., 1973), 88-92.

[3]Irvin Schneiderman. "1136 Tenants' Corporation v. Max Rothenberg & Co. — Some Legal Considerations." *The CPA Journal* 42 (June 1972): 465-466.

[4]Dan M. Guy and Herschel Mann. "A Practical Guide for Reporting on Limited Examinations of Financial Statements." *The CPA Journal* 43 (July 1973): 556, 557.

[5]Dan M. Guy and Alan J. Winters. "Unaudited Financial Statements: A Survey." *The Journal of Accountancy* 133 (December 1972): 52.

[6]Task Force on Unaudited Financial Statements of the Auditing Standards Division of the American Institute of Certified Public Accountants. *Guide for Engagements of Certified Public Accountants to Prepare Unaudited Financial Statements – Exposure Draft.* (New York: AICPA Inc., March, 1974).

[7]Staff. "Seven Basic Issues". *Forbes* v. 114, November 1, 1974, 76.

Education
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General Accounting Office.–Travel away from home varies from region to region. As of October 24, 1973, the following percentages applied to the regions indicated:

GAO TRAVEL REQUIREMENTS
APPROXIMATE PERCENTAGE OF TRAVEL REQUIRED

Regional Office	First 3 Years	Overall
Atlanta	75%	50%
Boston	15%	26%
Chicago	20%	20%
Cincinnati	90%	75%
Dallas	70%	50%
Denver	58%	36%
Detroit	15%	15%
Kansas City	50%	40%
Los Angeles	21%	31%
New York	10%	12%
Norfolk	29%	26%
Philadelphia	20%	30%
San Francisco	15%	20%
Seattle	30%	20%
Washington Regional Office	5%	8%
Washington Headquarters	5%	10%

Internal Revenue Service.–Travel for the Internal Revenue Agent depends on the post of duty, but — after the initial training period — generally less than 10% of the employee's time will be spent away from home.

South Central Bell.–Travel is insignificant except for occasional training courses.

In general, are there any circumstances or characteristics of women that impede their success with your organization?

Recruiters agree that there are no circumstances or characteristics of women that impede their success. David Stokes, Arthur Andersen & Co., added that promotions are based on demonstrated ability and performance. However, he stated that at AA the turnover rate nationally is higher for women than men. The principal reason for this higher rate is that women sometimes terminate their careers to raise a family or to accompany husbands transferred to locations without an Arthur Andersen & Co. office. Furthermore, women leave for the same reason as men, such as employment offers from clients, inability to progress professionally, or unwillingness to accept and deal effectively with the pressures normally associated with being a professional person.

Conclusion

Recruiters seek qualified personnel interested in a career in accounting. So — armed with technical ability, put on your best smile, believe in yourself, and talk to recruiters as friends (because they are).