Theory & Practice

AudSEC Pronouncements and Changes

Editors:

Carol S. DeHaven, CPA
Donald L. DeHaven, CPA
DeHaven and DeHaven, Springfield, Missouri

The Auditing Standards Executive Committee (AudSEC) is a senior technical committee of the American Institute of Certified Public Accountants (AICPA). As such, this committee is the authorative body responsible for issuing standards related to the expression of an opinion on the financial statements, more commonly referred to as "auditing standards." Until recently, AudSEC was also responsible for standards related to *unaudited* financial statements.

The move to separate standards setting for unaudited statements may be traced back to 1974 when the Accounting Standards Division of the AICPA began a study of the application of generally accepted accounting principles (GAAP) to smaller and/or closely held businesses. Among the conclusions and recommendations from this study were that AudSEC, then still the appropriate senior committee, reconsider (1) the unaudited report, especially the "internal use only" disclaimer, (2) the presentation of financial information on prescribed forms and (3) interim financial statements of small and/or closely held businesses.

New Senior Committee

In 1975 the AICPA established an Accounting and Review Services Committee to reconsider all aspects of AICPA pronouncements regarding a CPA's association with unaudited financial information. In September of 1977, this committee was designated a senior technical committee with authority to develop procedures and standards of reporting on accounting and review services that a CPA may render in connection with unaudited financial information of a nonpublic entity. For this purpose, a nonpublic entity is one which is not required to file financial statements with a regulatory agency in connection with the sale or trading of its securities in a public market.

One effect of this designation was to structurally separate the authority for issuing pronouncements relating to unaudited engagements from that for audit engagements. Therefore, as the Accounting and Review Services Committee adopts its own standards, certain sections of the Statements of Auditing Standards (SASs) will no longer be applicable to nonpublic entities.

As the subject matter of its first pronouncement, the Accounting and Review Services Committee chose to address the issue of a CPA's involvement with unaudited financial statements. In January of 1978, the committee released an exposure draft of its first statement, "Compilation and Review of Financial Statements." Among the committee's objectives in issuing the exposure draft were the following:

- to reconsider and define different levels of service that a CPA may perform with respect to unaudited statements;
- to specify minimum procedures for these levels of service;
- to eliminate the "internal use only" disclaimer; and
- to provide reports which would better communicate the CPA's relationship to and responsibility for the information contained in the unaudited statements.

The proposed statement provides that a CPA may render two levels of service in conjunction with unaudited annual or interim financial statements: compilation and review. A compilation service involves the presentation, in the form of financial statements, information supplied by the client without achieving any assurance as to whether there are material modifications that should be made to the statements in order for them to conform to GAAP or another comprehensive basis of accounting, if it is applicable. If a client requests, the CPA would be permitted to compile financial statements that omit required disclosures so long as the omissions are noted in the accountant's report; furthermore, no restriction would be placed on the right of the client to distribute such statements to third parties.

A review service enables the CPA to achieve, through inquiry and analytic procedures, limited assurance that there are no material modifications that should be made to the financial statements in order for them to conform to GAAP or another appropriate basis of accounting. The CPA's report resulting from a review service would express a level of assurance while disclaiming an opinion (meaning an audit opinion) as to the fairness of the financial statements taken as a whole.

Because the exposure draft represents a significant departure from past practice, the AICPA, in cooperation with state societies of CPAs, held member discussion forums throughout the spring and early summer of 1978. At the request of several state societies and due to the high degree of member interest, the committee extended the deadline for comments on the draft from June 30 to August 31, 1978.

It is important to remember that,

until the proposed statement or a modified statement is approved, the current AICPA pronouncements relating to unaudited financial statements will remain in effect.

In contrast, the following summaries are of approved Statements on Auditing Standards issued by AudSEC and are effective at the date of issuance unless another date is specified.

Special Reports

SAS No. 14, "Special Reports," applies (1) to auditor's reports issued in connection with financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, (2) to reports on specified elements, accounts or items of a financial statement, (3) to reports on compliance with aspects of a contractual agreement or regulatory requirement related to audited financial statements and (4) to reports on financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report. These four types of reports are collectively referred to as *special* or *special purpose* reports. This statement is applicable to reports covering periods beginning after December 31, 1976.

In general all special reports require the auditor to apply the general standards and the standards of field work. The standards of reporting apply to the first type of report listed above and are modified for the remaining three types of special reports.

There are four recognized comprehensive bases of accounting which permit issuance of a special report. They are described as (1) the basis of accounting used to comply with a governmental regulatory agency, (2) the tax basis, (3) the cash receipts and disbursements basis and its modifications having substantial support and (4) a definite set of criteria having substantial support, such as that of APB No. 3 for the price-level basis of accounting.

The standard short form report, modified as appropriate according to SAS No. 2, is used if the basis of accounting does not meet any one of the above descriptions.. When the special report is applicable, the auditor's report is similar to a short form report in that the opening paragraph should identify the financial statements examined and state whether the examination was made in accordance with generally accepted auditing standards (GAAS). A middle paragraph is required to state, or preferably refer to a footnote that states, the basis of presentation on which the auditor is reporting and that the financial statements are not intended to be presented in conformity with GAAP. Also, this middle paragraph should refer to a footnote that described how the basis of presentation differs from GAAP, although the monetary effect of such differences need not be stated. The last paragraph is the opinion paragraph and should express the auditor's opinion, or disclaimer of opinion, on whether the financial statements are presented fairly in conformity with the basis of accounting described and whether that basis has been applied in a manner consistent with that of the preceding period. Reasons for disclaiming or modifying an opinion are the same as otherwise specified in SASs and require similar modifying language and a reference to the explanatory material.

When expressing an opinion on a regulatory-basis form of a comprehensive basis of accounting, the auditor may use the special report form described above only if the financial statements are intended solely for filing with such regulatory agency or if the additional distribution is recognized as appropriate by an AICPA accounting or audit guide or auditing interpretation.

Care should be taken in all special reports to consider whether the financial statement are suitably titled and to modify the auditor's report to disclose reservations, if any. For example, terms such as "balance sheet" or similar unmodified titles are generally understood to apply with GAAP; consequently, a cash-basis financial statement might be titled "statement of assets and liabilities arising from cash transactions."

Use of the second type of special report to report on specified elements, accounts, or items of a financial statement depends upon the nature of the engagement. The auditor may be requested to express an opinion on a limited number of elements, accounts or items or on applying certain agreed-upon procedures to a limited number of elements, accounts or items.

When reporting on a limited number of elements, accounts or items, the auditor may conduct a separate examination or one in conjunction with an examination of the financial statements taken as a whole. In either instance, the engagement should be planned toward the objectives encompassed by the special report and, therefore, the measurement of materiality must be related to the individual specified elements, accounts or items. This usually results in a more extensive examination than if the information were being considered in conjunction with an examination of the financial statements taken as a whole. Inasmuch as many elements, accounts or items are interrelated (such as sales and receivables), the auditor should be satisfied that the interrelationship has been given appropriate consideration.

Caution should be exercised to limit the number of elements, accounts or items covered by the auditor's report so that issuance of a piecemeal opinion is avoided. This is particularly important if the special report is issued in conjunction with an adverse opinion or a disclaimer of opinion on the financial statements taken as a whole.

The special report should not be attached to or accompany the financial statements of the entity. It should follow the general reporting format and include (a) a description of the elements, accounts or items examined; (b) a statement that the examination was made in accordance with GAAS and, if applicable, in conjunction with an examination of the financial statements (any modification to that audit report should be included in the special report); (c) the basis on which the specified elements, accounts or items are presented and a description of any related agreements or significant interpretations of agreements and (d) an indication whether the specified elements, accounts or items are presented fairly on the basis described and, if applicable, in a manner consistent with that of the preceding period.

The special report relating to the application of agreed-upon procedures is appropriate only if (a) the parties involved have a clear understanding of the procedures to be performed, (b) distribution of the report is to be restricted to named parties involved and (c) financial statements of the entity are not to accompany the report.

The second and third standards of field work and the standards of reporting do not apply to this type of engagement. As a result, the auditor's report may take several forms and should (a) indicate the specified elements, accounts or items to which the agreed-upon procedures were applied, (b) indicate the intended distribution of the report, (c) enumerate the procedures performed, (d) state the accountant's findings, (e) disclaim an opinion with respect to the specified elements, accounts or items and (f) state that the report should not be associated with the financial statements of the entity. A negative assurance (such as "no matters came to our attention that caused us to believe that adjustments should be made") may be used. The report may also contain additional qualifying language indicating that, if an examination in accordance with GAAS had been performed, matters might have come to the auditor's attention that would have been reported.

The third type of special report, on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements, must be issued only in conjunction with an examination of the financial statements and may be either part of the auditor's report on the statements or a separate report. If a separate report is used, it must state that it is being given in connection with an examination of the financial statements. Whether a separate report or combined report is used, a negative assurance may be given. If the auditor wishes, the report may also contain language to indicate that the examination was not primarily directed toward obtaining knowledge regarding compliance.

The fourth type of special report occurs when the auditor is requested to express an opinion in prescribed words or on preprinted forms. Many such forms are not acceptable to independent auditors because the prescribed wording or form of the auditor's report does not conform to the applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditor that are not consistent with an independent auditor's function or responsibility.

Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a preprinted report form calls upon an independent auditor to make an assertion that the auditor believes is not justified, the form should be reworded or a separate report attached. In wording the report, attached or separate, the reporting provisions of the first type of special report relating to other comprehensive bases of accounting may be applicable.

Comparative Statements

SAS No. 15, "Reports on Comparative Financial Statements," modifies the manner in which reports are presented for comparative statements. It provides guidance for auditors in updating a prior-period report, in reporting when another CPA audited prior-period statements and in reporting when audited and unaudited statements are presented together. The statement was issued in December of 1976 but is effective for reports on periods ending after June 30, 1977.

The major change resulting from SAS No. 15 is that the fourth standard of reporting related to a clear expression of opinion on the financial statements taken as a whole is now to be considered to apply both to the current-period statements and to those of prior periods presented on a comparative basis.

One effect of the change is to permit issuance of a report with differing opinions on various portions of the comparative statements. An auditor may modify or disclaim an opinion with respect to one or more financial statements for one or more periods, while expressing an unqualified opinion on the other financial statements presented.

Another effect of this change is to cause the auditor to update the report on the prior-period statements. The updating involves consideration of additional information relating to the prior-period statements that is disclosed to the auditor during the examination of the current period.

Three types of circumstances or events would ordinarily cause the auditor to express an updated opinion different from that originally expressed on the prior-period statements. They arise (1) when a previously-known uncertainty is resolved, (2) when a previously-unknown uncertainty is discovered or (3) when the financial statements are subsequently restated to conform with GAAP. In these cases the updated report should include a separate paragraph which includes the date of the original report, the type of opinion previously expressed, the events or circumstances causing the change and an indication that the updated opinion is different from the one previously expressed.

A special problem arises when the prior-period statements were audited by another CPA. In this case, either the report of the predecessor auditor is reissued with the statements or the successor auditor must note in the current-period report that the statements were audited by other auditors, the date of their report, the type of opinion it contained and the substantive reasons for any departure from an unqualified report.

If the predecessor auditor's report on the prior period is to be presented, it must be updated. However, the procedures to accomplish the updating differ from those previously described because the predecessor auditor has no continuing relationship with the client. The predecessor is responsible for reading the financial statements of the current period, comparing the prior-period statements on which the report was issued with the financial statements presented for comparative purposes and obtaining a letter of representations from the successor auditor. This letter should state whether the successor's examination revealed any matters that, in the opinion of the successor, might have a material effect on, or require disclosure in, the financial statements of the prior period. If these procedures reveal any matters having a material effect on the financial statements previously reported on, the predecessor auditor must consider whether the opinion should be changed. If so, the updated report will contain a separate paragraph to explain the revisions.

Another type of problem occurs when audited statements are presented on a comparative basis with unaudited statements. When it is the prior-period statements that are unaudited, they should be clearly marked as such and a disclaimer of opinion regarding those statements should be included in the report. If the current-period statements are unaudited, the CPA should indicate in a separate paragraph to the disclaimer (a) that the audited prior-period statements are presented for comparative purposes only, (b) that the prior-period statements were previously examined, (c) the date of the audit report, (d) the type of opinion expressed, (e) the substantive reasons for other than an unqualified report and (f) that the auditor has not performed any auditing procedures since the date of the previous report. This statement does not apply to documents containing unaudited information that are required to be presented on a comparative basis in filings with the Securities and Exchange Commission.