

# Proposed Statements on Standards for Accounting and Review Services



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# Overview



- Review of current SSARS and requirements
- Review of current independence requirements
- Internal control services
- Current accounting environment
- New proposed standards from ARSC

# Current Standards



- **Statements on Accounting and Review Services from the AICPA Accounting and Review Services Committee**
- **There are a total of 17 current SSARS, dating back to December, 1978. Last standard is SSARS no. 17 issued in 2008.**
- **These standards relate to what constitutes a compilation and review, what the requirements are, the separation of reviewed statements from an issuer and non-issuer**

# Current Standards



- **Internal use compiled financial statements and when they can be used**
- **Limited assurance definitions**
- **Independence required for all work except for a compilation where it is disclosed as a line**
  - “we are not independent with respect to this engagement”
  - No explanation of why you are not independent is allowed.

# Independence



- What is independence? Code of Professional Conduct, ET Section 100.01—Conceptual Framework for AICPA Independence Standards
- Professional Standards (AICPA)
  - “This conceptual framework describes the risk-based approach to analyzing independence matters that is used by the Professional Ethics Executive Committee (PEEC) of the AICPA when it develops independence standards. Under that approach, a member's relationship with a client is evaluated to determine *whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client.* Key to that evaluation is identifying and assessing the extent to which a threat to the member's independence exists and, if it does, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, whether it can be effectively mitigated or eliminated. Under the risk-based approach, steps are taken to prevent circumstances that threaten independence from compromising the professional judgments required in the performance of an attest engagement.”

# Independence



- **Definition:**

*Independence is defined as:*

- a. Independence of mind—The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.*
- b. Independence in appearance—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards<sup>2</sup> applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.*

# Independence



- *Safeguards—Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity.<sup>5</sup> To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.*

# Independence



## Type of Nonattest Service

### Bookkeeping

## Independence Would Not Be Impaired

Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger

Prepare financial statements based on information in the trial balance.

Post client-approved entries to a client's trial balance.

## Independence Would be Impaired

Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval.

# Independence



## Type of Nonattest Service

## Independence Would Not Be Impaired

## Independence Would Be Impaired

Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements

Prepare source documents.

Make changes to source documents without client approval.

# Independence



- While not specifically related in these standards, the SAS 112 (originally issued) discussed significant and material internal control weaknesses. One of the items mentioned was that a client's inability to prepare its own financial statements, with footnotes, was at least a significant deficiency, and probably a material weakness.
- If this is a material weakness in internal control because client cannot do these statements, and we are preparing the footnotes and financial statements, then are we independent?

# Internal control



- What is internal control – ‘a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations.
- COSO says the elements are Risk Assessment, Control Environment, Control Activities, Information and Communication, and Monitoring.

# Internal control



- **Internal control services impair a practitioner's independence.**
- **Procedures performed as part of an internal control service have a different intent from those performed as part of an attest engagement.**
- **When performing procedures for internal control services, such procedures are performed for management and results are used by management.**
- **Performing procedures for attestation have as their purpose to support the basis of the opinion in their report.**

# Internal control



- **Types of internal control services:**
  - Approval, authorization and verification
    - ✦ Approval means that either manual or electronic approval is needed before an action can be completed.
    - ✦ Authorization is either general or specific. General authorization example is spending limit authorization; specific is that a particular transaction must be authorized.
      - Example – if the accountant approves the account classifications for trial balance posting, an internal control function of approval has been performed – impairing independence.

# Internal control



- **Security of Assets and Records**
  - Security over assets must be maintained as well as the accounting records underlying it.
  - An accountant could perform this function if he designs a control that establishes password protection or locks to assets.

# Internal control



- **Segregation of duties**
  - Just to summarize, duties should be segregated so that an individual does not have incompatible duties – e.g. that would put an individual in the position of being able to commit an irregularity and then conceal it.
  - Incompatibility would be authorize a transaction; record the transaction, and maintain custody of the assets.

# Internal control



- **A practitioner may perform procedures that relate to segregation of duties such as:**
  - Establishing a control that the person who opens the mail and prepares the listing of checks is not the same person who makes the deposit.
  - Practitioner performs cash reconciliations to segregate that duty from the person who has custody of the checks.

# Internal control



- **Analytical review is an important control activity for management and must be done for consistency and reasonableness.**
  - Practitioner designs a control that compares information about current performance to budgets or other benchmarks on a monthly basis.
  - Practitioner performs the monthly analytical review by comparing internal financial information with other financial or nonfinancial information.

# Internal control



- **Information systems have two types of controls:**
  - General and application controls
  - General controls are over software acquisition and maintenance, security, and application system development
  - Application controls are those such as computer matching and edit checks.
  - Practitioner designs a disaster recovery plan that includes specific file backup policies and procedures.
  - Practitioner performs the periodic backup of files.

# Internal control



- Many of the functions we perform, therefore, by definition are internal control functions.
- What does this mean?

# Current Standards



- **Rule 101-3 of the Ethics addressed, to some extent, what we as practitioners were allowed to do with proper documentation.**

# Current standards



- We had to document that the client was taking full responsibility for any of the work we performed
- That we would not make any management decisions for the client
- And, if we did all that, then we were still independent in fact.

# Current environment



- **But are we?**
- **Let's take some examples:**
  - Depreciation
    - ✦ Decision on lives of property, type of property classification for book or tax – who really makes that decision?
  - Prepaid expenses
  - Accrued liabilities
  - Notes payable – interest and principal allocation

# Current environment



- If your client was under oath, and an attorney asked him, “did you understand the journal entry that your accountant made to capitalize your computer equipment?”, what would he really say?
- 101-3 provided us a way to do all of the work we need to do for our clients in small companies, but it always seemed to be a “wink and a nod.”

# New standards proposed



- The new exposure draft came as a result of understanding that much of what we as accountants do for our clients is very valuable to assist them in preparing quality financial statements.
- However, because of the complexity of the accounting standards many of these businesses just do not have the technical expertise to understand all of those requirements.

# New standards proposed



- The activities, though, that we perform are really a part of a client's internal control system, and they are not part of any attest function.
- With this thought in mind, independence is therefore impaired in many of the engagements we do when taken with a strict reading of the standards.

# New standards proposed



- **If independence is impaired, then we cannot do a review engagement, and a compilation must have the one line disclosure in it that we are not independent.**

# New standards proposed



- So, what can be done?
- The Accounting and Review Services Committee began to ask questions of practitioners, their clients, and third party users on the need for independence when performing many of these functions. The survey received 4,300 answers from various organizations.

# New standards proposed



- **The result was that third party users advised that they do not perceive that an accountant's involvement with financial statements as negative. In fact, they believe that the financial statements are better, and that they improve the quality of the financial reporting.**

# New standards proposed



- ARSC decided that a complete change should be made for the SSARS, and a new framework has been adopted.
- The new framework takes into account what accountants generally do for their smaller clients, it separates the compilation services from the review services, and it allows both compilations and reviews to be performed when a practitioner is not independent.
- There are three new proposed standards:

# New standards proposed



- **Framework and Objectives for Performing and Reporting on Compilation and Review Engagements.**
- **Compilation of Financial Statements**
- **Review of Financial Statements**
  - The old standards – SSARS #1 dealt with independence, and was issued in December, 1978. It has not changed since that time. It established that you could do a compilation if you were not independent, but not a review.
  - AICPA's Professional Ethics Executive Committee promulgates independence standards, and these are included in Rule 101 of the AICPA Code of Professional Conduct.

# Other changes



- An important change was to modify the language for a review engagement. “the objective of a review engagement is to express limited assurance...”
- It now states that the objective of a review is to obtain “moderate” assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework.

## Other changes



- You will note that this language is more consistent with Attest Engagement language, as well as the International Accounting Standards equivalent that is to be in accordance with ISRE which uses “moderate” assurance.
- Notice the desire to again begin conformity with international standards even in this arena.

## Other changes



- The new proposed SSARS introduces “review evidence”. It is defined as that evidence which is used by the accountant to provide a reasonable basis for obtaining moderate assurance. It does state that generally this evidence can be obtained through analytical procedures and inquiries.

# Other changes



- It introduces the term “review risk.” This is the risk that an accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated.
- It includes a discussion of materiality in the context of a review engagement. Remember we have always considered materiality in reviews, since we say “I am not aware of any material modifications that should be made....”

# Other changes



- **For compiled financial statements**
  - It requires that an understanding be obtained with management through a written engagement letter. While it was always preferred to have a written engagement letter, it was not required.
  - There are enhanced documentation requirements for compilations.
    - ✦ Engagement letter
    - ✦ Any findings that financial statements may be materially misstated
    - ✦ Questions accountant had during the compilation and how they were resolved
    - ✦ Communications with management on any fraud.

# Other changes



- **Non-attest services performed for a client (internal control services) are not covered by SSARS, but they may affect the accountants' independence.**
- **Procedures performed as a part of an internal control services, there is a different intent than those performed as part of a compilation service (para 17). Those performed for internal control purposes are performed for management; those for the compilation are performed for the purpose of the accountants' compilation engagement.**

# Other changes



- **Internal control services list**
  - Reconciliations of accounts
  - Bookkeeping services
  - Investigating unreconciled differences in accounts and details
- **These types of services impair independence.**

# Reporting



- If financial statements are to be given to a third party, a report should be issued.
- The standard report will have:
  - Title “Accountant’s Compilation Report”
  - A statement that the financial statements are the responsibility of management of the entity
  - A statement that the compilation was conducted in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants

## Reporting (continued)



- A statement that the objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements.

## Reporting (continued)



- A statement that the accountant has not audited or reviewed the financial statements, and accordingly does not express an opinion or any other conclusion about whether the financial statements are in accordance with the applicable financial reporting framework.
- Manual or printed signature of the accounting firm.
- Date of the compilation report.
- Each page of the financial statements should include “See accountant’s compilation report.”

# Disclosure omission



- **Language is same as previously in our compilation reports in the paragraph after the conclusion paragraph.**

# When Accountant Not Independent



- **When we are not independent, we should include as the last paragraph:**
  - I am not independent with respect to XYZ Company.
  - There is NO requirement that you include why you are not independent, BUT you may include a general description if desired.

# When Accountant Not Independent



- **Examples**

- I am not independent with respect to XYZ Company as during the year ended December 31, 2010, I (or a member of the engagement team) had a direct financial interest in XYZ Company.
- I am not independent with respect to XYZ Company as during the year ended December 31, 2010, an immediate family member of the engagement team was employed by XYZ Company.

# When Accountant Not Independent



- **Examples:**

- In addition to our compilation during the year ended December 31, 2010, management engaged us to perform certain internal control services. Those internal control services involved designing or operating some aspect of management's internal control over financial reporting, the objective of which is to prevent or detect and correct material misstatements in the financial statements. The performance of these internal control services impaired our independence.

# When not independent



- **The accountant is precluded from disclosing a detailed description of the reason independence is impaired. The reasoning for this is that it increases the likelihood that a user will misunderstand or misinterpret the independence impairment.**

## When not to be used by third party



- There is still no requirement to issue a report.
- Reference should be on each page, “Restricted for Management’s Use Only.”
- If statements are released to third party, accountant should request client to notify the third party, then if not done, the accountant should notify the third party (in consultation with your attorney).

# Things that didn't change



- **Emphasis of a matter is still allowed in the report.**
- **Departures from GAAP (or OCBOA) shall still require modification of the standard report in a separate paragraph.**
- **Going concern considerations**
- **Subsequent events**
- **Subsequent discovery of facts existing at date of report.**
- **Change of engagement from audit or review to compilation.**

# Restricted Reports



- Most accountant's reports are general use (meaning they are not just for specified parties).
- However, accountants should restrict reports when the subject matter or presentation is based on measurement or disclosure criteria in contractual agreements.
- Combined (general and restricted) can be issued, but it should be restricted as to users.

# Restricted Reports



- **Restricted reports should contain a separate paragraph at the end of the report that has a statement that the report is intended solely for information and use of the specified parties; the identification of those parties; and a statement that it is not intended to be and should not be used by anyone other than the specified parties.**

# Review of financial statements



- **This standard is for reviews of financial statements UNLESS**
  - The accountant has audited the latest annual financial statements
  - The accountant has been engaged to audit the entity's current annual financial statements, and
  - The client prepares its interim financial information in accordance with the financial reporting framework used to prepare the annual financials.
- **If these three elements are present, the review of interim financial statements shall be done in accordance with AU 722, Interim Financial Information.**
- **The accountant is precluded from performing a review if the accountant's independence is impaired for any reason other than performance of an internal control service.**

# Review of financial statements



- **Written engagement letter**
- **Understanding with management, and those charged with governance, that a review is**
  - To obtain moderate assurance that there are no material modifications to be accordance with the applicable financial reporting framework.
  - Management is responsible for the entity's financial statements and the selection of accounting policies

# Reviews



- Management is responsible for establishing and maintaining effective internal controls over financial reporting;
- Management is responsible for designing and implementing programs and controls to prevent and detect fraud.
- The accountant is responsible for conducting the engagement in accordance with SSARS
- A review consists primarily of inquiries of company personnel and analytical procedures applied to financial data.

# Reviews



- **Reviews are substantially less in scope than an audit, et al. The accountant will not express an opinion regarding the financial statements as a whole.**
- **Engagement cannot be relied upon to disclose errors, fraud or illegal acts but accountant will inform the appropriate level of management of any material errors or any fraud or illegal acts.**

# Reviews



- The performance of a review engagement requires the accountant to accumulate enough review evidence sufficient to restrict review risk to a moderate level.
- The accountant should apply professional judgment in determining the specific nature, timing and extent of review procedures.

# Reviews – things that did not change



- **Understanding of the industry**
  - Generally accepted accounting principles and practices used in that industry
  - May be obtained from AICPA guides, industry publications, financial statements of like companies, etc.
- **Knowledge of the client**
  - Understanding of the client's business and practices used
  - General understanding of the client's organization and related party transactions
  - Revenue recognition policies, estimates, and asset impairment.

# Reviews



- Procedures must be designed to obtain evidence to restrict review risk to a moderate level
- Analytical procedures are essential in planning and evaluating results, as well as the limitations that the analytics may have.
- Develop expectations on the analytical procedures
- Use relationships with non-financial information
- Analytics can be performed at the financial statement level or detail account level.

# Reviews



- If expectations not met, accountant must follow up with management. Accountant is not required to corroborate management's responses, however. However, he may be required to perform other procedures when management cannot provide an explanation, or when it does not seem adequate based on accountants' other inquiries and review evidence obtained.

# Reviews



- **Inquiries should be made of all members of management who have responsibility for financial and accounting matters**
- **Management representations must be obtained for all periods covered by the accountant's review report.**
- **There are times when an updated management representation must be obtained when there is elapsed time between the inquiries and the issuance of the report.**

# Reviews



- **Documentation requirements in a review**
  - “the accountant should prepare documentation in connection with each review engagement in sufficient detail to provide a clear understanding of the work performed, ...”
  - It should provide the principal support for the representation in the accountant’s review report that the accountant performed the review in accordance with SSARS
  - It provides support for the conclusion that the accountant is not aware of any material modifications that should be made to the financial statements for them to be in accordance with GAAP (or OCBOA).

# Reviews



- **Documentation must include**
  - Engagement letter
  - Analytical procedures, including expectations, results of comparison to expectations, and management responses to procedures.
  - Any additional review procedures performed in response to unexpected differences
  - Significant matters covered in the accountant's inquiry procedures

# Reviews



- Any findings or issues that are significant which could result in a material misstatement in the financial statements and the resolution of those matters
- Any unusual matters that the accountant considered during the performance of the review procedures
- Evidence from the performance of internal control services
- Communications to management on any fraud or illegal acts
- Representation letter

# Internal control services in a review



- **An internal control service is a nonattest service performed by the accountant on behalf of management.**
- **These services provide a valuable tool to management.**
  - Include bookkeeping services
  - Preparation of reconciliations
  - Follow up of unreconciled differences, etc.

# Internal control services-review



- **These services impair independence, requiring a modification of the standard report.**
- **This modification should be discussed with the user of the financial statements BEFORE undertaking the engagement.**

# Reporting - review



- Report shall be “Accountant’s Review Report.”
- A statement that the financial statements identified in the report were reviewed
- A statement that the responsibility for the financial statements is the responsibility of management.
- A statement that the review was conducted in accordance with SSARS

# Reporting - review



- A statement that the standards require the accountant to perform analytical procedures applied to financial data and inquiries of company personnel
- That the accountant's procedures provide a reasonable basis for the conclusions
- That a review is substantially less in scope than an audit
- That the accountant is not aware of any material modifications to be in accordance with GAAP, et al.

# Reporting - review



- **Signature of firm**
- **Date of review (accountant's report should not be dated earlier than the date the accountant concludes he has obtained evidence sufficient to restrict review risk to a moderate level.)**
- **Each page should have "See Accountant's Review Report."**

# Review - reporting



- A review that is incomplete should not result in the issuance of a report.
- An accountant may report on one financial statement as long as the inquiry and analytical procedures have not been restricted.

# Review-reporting



- **When internal control services performed:**
  - A statement that management engaged the accountant to perform internal control services for the period
  - A statement that the internal control services involved designing or operating some aspect of management's internal control over financial reporting.
  - The performance of these internal control services impaired the accountant's independence.
  - Accountant is precluded from elaborating on the specific internal control services performed.

# Review reporting



- **Emphasis of a matter is still allowed**
- **Departures from GAAP or OCBOA will result in a modification of the standard report.**
- **Restricted use can be used on the accountant's report for a specified third party when the measurement or disclosure criteria is based on contractual agreements or regulatory provisions.**
- **Combined reports (general use and restricted) should be restricted to the specified parties**

# Review - reporting



- **Going concern emphasis is still allowed**
- **Subsequent events are evaluated**
- **Subsequent discovery of facts existing at report date may result in additional steps to be taken, although it is presumed that no additional review procedures will be done after issuance.**
- **Supplementary statements should be covered by a report indicating the level of responsibility the accountant is taking.**

# Other matters - review



- **Change in engagement from audit to review may be done after consideration of:**
  - Reason for request, particularly if it is to restrict access
  - Additional effort to complete the audit
  - Additional cost required.

# Effective dates for all



- Upon adoption, these standards will be effective for periods beginning on or after December 15, 2010.
- Early implementation is permitted.

# What happens to 101-3



- Under these standards, it would be possible for an audit client to have the exact same functions performed for them, but justified under 101-3 as management taking responsibility.
- The audit language will have to change to incorporate these changes into the independence rules there.

# Summary



- There is a recognition that what we do for clients is a technical violation of independence.
- That despite that violation the services are valuable to clients and to third party users.
- The problem is what will happen to Rule 101-3 and independence in audits.