Your AUD materials have undergone some extensive changes due to pronouncements that become testable on July 1, 2015. Instead of producing a change document that details every edit, which would be quite extensive and possibly confusing, we have reproduced the edited subunits in their entirety in this book update. Please see below for a summary of the changes, and then use the rest of this pdf to replace the relevant pages in your book. These pages include the changes for outlines, questions, and simulations.

We have updated Study Unit 4, Subunit 1, to reflect the changes caused by AU-C 610, *Using the Work of Internal Auditors*. This clarified pronouncement adds the requirement that the external auditor consider whether the internal audit function used a systematic and disciplined approach in their work when deciding whether to use the work of the internal auditor.

We have updated and renamed Study Unit 19 to reflect SSARS 21. This clarified pronouncement includes AR-C 60, AR-C 70, AR-C 80, and AR-C 90. Note that the updated study unit includes two new subunits and a subsequent shifting of the old subunits. Thus, Subunits 5-8 of the current material are the same as Subunits 4-7 in your book. We did not reproduce these subunits in this update because the only changes were to the subunit numbers. If you have already studied these subunits, you do not need to study them again now.
This study unit considers issues that are fundamental to planning an audit. Questions about the internal audit function, related parties, and accounting estimates can be expected on the exam. Moreover, most of the issues considered in this study unit have an effect on other facets of the audit, including evidence collection and reporting. We cover the additional matters here to provide comprehensive and coherent coverage.

4.1 USING THE WORK OF INTERNAL AUDITORS (AU-C 610)

1. Internal auditors
   a. Perform assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management, and internal control processes. This may include evaluation of internal control, examination of financial and operating information, review of compliance with laws and regulations, and the assessment of fraud risk.
   b. Are part of the organization’s internal control. The knowledge and experience of the internal audit function can inform the external auditor’s understanding of the entity and its environment and identification and assessment of risks of material misstatement.
   c. Are not independent in the same manner as the external auditor (although they may be objective and unbiased).

2. The external auditor’s use of the work of internal auditors includes using
   a. The work of the internal audit function to obtain audit evidence and
   b. Internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.

3. The external auditor may be able to use the work of the internal audit function to obtain audit evidence in a constructive and complementary manner depending on
   a. The objectivity of the internal auditors;
   b. The level of competence of the internal audit function; and
   c. Whether the function applies a systematic and disciplined approach, including quality control.

4. Objectivity, the ability to perform tasks without bias, is judged by the function’s organizational status and relevant policies and procedures that support objectivity.
   a. For example, objectivity is promoted when the internal auditors (1) report to those charged with governance rather than management, (2) are free of any conflicting responsibilities, (3) work without constraints, and (4) are members of professional organizations that obligate them to be objective.
5. **Competence** is the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and with the appropriate level of quality. Factors that may affect the external auditor’s determination about competence include whether
   a. The internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
   b. Appropriate policies for hiring, training, and assigning internal auditors to internal audit engagements exist.
   c. The internal auditors have adequate technical training and proficiency in auditing.
   d. The internal auditors are members of relevant professional bodies or have certifications that require them to comply with the relevant professional standards, including continuing professional education requirements.
   e. The internal auditors have the required knowledge or experience relating to the entity’s financial reporting and the applicable financial reporting framework.
   f. The internal audit function has the necessary skills (for example, industry-specific knowledge) to perform work related to the entity’s financial statements.

6. Objectivity and competence are a continuum from low to high. But a high level of one attribute cannot compensate for a low level of the other.

7. **The external auditor has sole responsibility for the audit opinion.** That responsibility is not reduced by
   a. The external auditor’s use of the work of the internal audit function to obtain audit evidence or
   b. Use of internal auditors to provide direct assistance on the engagement.

8. The function may perform audit procedures similar to those performed by the external auditor. But neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements.

9. In judging whether to use the internal auditors to obtain audit evidence, the external auditor should evaluate the internal auditors’ objectivity, competence, and use of a systematic and disciplined approach.
   a. Attributes of objectivity and competence to be evaluated are addressed in items 4. and 5. above and on the previous page.

10. The application of a **systematic and disciplined approach** to (a) planning, (b) performing, (c) supervising, (d) reviewing, and (e) documenting internal audit activities distinguishes it from other monitoring control activities. When evaluating whether a systematic and disciplined approach is applied, the external auditor should consider
   a. The existence, adequacy, and use of documented internal audit procedures or guidance for such matters as (1) risk assessments, (2) work programs, (3) documentation, and (4) reporting. The nature and extent of this documentation should be proportionate to the nature and size of the internal audit function relative to the complexity of the entity.
   b. Whether the internal audit function has (1) appropriate quality control policies and procedures (for example, those relating to leadership, human resources, and engagement performance) or (2) quality control requirements in standards set by relevant professional bodies. Such bodies also may establish other appropriate requirements, such as conducting periodic external quality assessments.

This standard establishes the concept of a **systematic and disciplined approach**. It is consistent with ISA 610 and requires that the external auditor evaluate the application by the internal audit function of a systematic and disciplined approach, including quality control. This approach is required for use of the work of the internal audit function. This issue likely will be tested on subsequent exams.
11. The external auditor should not use the work of the internal audit function to obtain audit evidence if the external auditor determines that
   a. The function’s organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
   b. The function lacks sufficient competence; or
   c. The function does not apply a systematic and disciplined approach, including quality control.

12. Internal Audit Work Used to Obtain Audit Evidence
   a. The external auditor should consider the nature, timing, and extent of the work performed or planned by the function and its relevance to the overall audit strategy and audit plan.
   b. The external auditor should make all significant judgments, including when using the work of the internal audit function to obtain audit evidence. Significant judgments include, but are not limited to, the following:
      1) Assessing the risks of material misstatement
      2) Evaluating the sufficiency of tests performed
      3) Evaluating the appropriateness of management’s use of the going concern assumption and whether substantial doubt exists about the entity’s ability to continue as a going concern
      4) Evaluating significant accounting estimates
      5) Evaluating the adequacy of disclosures in the financial statements and other matters affecting the auditor’s report
   c. To prevent undue use of the internal audit function to obtain audit evidence, less of the work should be used
      1) The more judgment is required to plan and perform audit procedures or evaluate the audit evidence.
      2) The higher the assessed risk of material misstatement at the assertion level (with special consideration given to significant risks).
      3) The less the objectivity of the internal audit function.
      4) The lower the competence of the internal audit function.

13. The external auditor should evaluate whether, in the aggregate, using (1) the work of the internal audit function to obtain audit evidence and (2) internal auditors to provide direct assistance results in too little involvement of the external auditor in the audit.

14. When using the work of the internal audit function to obtain audit evidence, the external auditor should
   a. Discuss the planned use of the work with the function as a basis for coordinating their activities.
   b. Read the relevant reports of the internal audit function.
   c. Perform sufficient audit procedures on the work of the function as a whole that the external auditor plans to use. The objective is to determine its adequacy for purposes of the audit, including evaluating whether
      1) Work was properly planned, performed, supervised, reviewed, and documented;
      2) Sufficient appropriate evidence was obtained to draw reasonable conclusions; and
      3) Conclusions reached were appropriate, and the reports prepared were consistent with the work performed.
15. The nature and extent of the external auditor’s audit procedures should respond to the evaluation of
   a. The extent of judgment involved to perform procedures and evaluate evidence,
   b. The assessed risk of material misstatement,
   c. The objectivity of the internal auditors, and
   d. The function’s competence.

16. The external auditor also should reperform some of the work of the function that the external auditor intends to use.

17. Before the conclusion of the audit, the external auditor should make an overall assessment of the usefulness of the internal auditors’ work to obtain evidence.

18. Direct Assistance to the External Auditor
   a. The external auditor should not use an internal auditor to provide direct assistance if (s)he lacks the necessary objectivity or competence.
   b. Prior to using internal auditors to provide direct assistance, the external auditor should obtain written acknowledgment (e.g., in the audit engagement letter) from management or those charged with governance, as appropriate, that
      1) Internal auditors can follow the external auditor’s instructions and
      2) The entity will not intervene in the work.
   c. To determine the work that may be assigned to internal auditors, the external auditor should
      1) Evaluate threats to the internal auditors’ objectivity, the effectiveness of the safeguards applied to reduce or eliminate the threats, and the competence of the internal auditors who will be providing such assistance;
      2) Consider the assessed risk of material misstatement; and
      3) Consider the judgment involved in (a) performing relevant audit procedures and (b) evaluating audit evidence.
   d. The external auditor should direct, supervise, and review the work performed by internal auditors on the engagement.
   e. The internal auditor should not be used to perform critical procedures.
      1) For example, internal auditors should not (a) perform inquiries of entity personnel or those charged with governance related to identifying fraud risks and determining the procedures to respond to such risks or (b) determine the use of unpredictable audit procedures.
      2) Internal auditors often perform less critical procedures, such as preparing schedules and compiling documentation.
   f. The direction, supervision, and review by the external auditor of the audit procedures performed by the internal auditors should be adequate to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions based on that work.
   g. The external auditor should evaluate whether, in the aggregate, using (1) the work of the internal audit function to obtain audit evidence and (2) internal auditors to provide direct assistance results in too little involvement of the external auditor in the audit.

19. Communicating with Those Charged with Governance
   a. The external auditor should communicate how (s)he plans to use the work of the internal audit function to (1) obtain audit evidence and (2) provide direct assistance.
20. **Documentation**

a. If the external auditor uses the work of the internal audit function to **obtain audit evidence**, the following should be documented:

1) The results of the evaluation of
   a) The function’s organizational status and relevant policies and procedures to adequately support the objectivity of the internal auditors;
   b) The competence of the function; and
   c) The application by the function of a systematic and disciplined approach, including quality control.
2) The nature and extent of the work used (including the period covered by, and the results of, such work)
3) The audit procedures performed by the external auditor to evaluate the adequacy of the work used, including reperformance of some of the work of the internal audit function to obtain audit evidence

b. If the external auditor uses internal auditors to **provide direct assistance**, the following should be documented:

1) The evaluation of the existence and significance of threats to the objectivity of the internal auditors and any safeguards applied to reduce or eliminate the threats
2) The competence of the internal auditors used to provide direct assistance
3) The basis for the decision about the nature and extent of the work performed by the internal auditors
4) The nature and extent of the external auditor’s review of the internal auditors’ work (including the testing, by the external auditor, of some of the work performed by the internal auditors)
5) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement

c. The external auditor should document the evaluation of whether (s)he was sufficiently involved in the audit to take sole responsibility for the audit opinion expressed.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 1 through 8 beginning on page 140.
QUESTIONS

4.1 Using the Work of Internal Auditors (AU-C 610)

1. In assessing the competence and objectivity of an entity’s internal auditor, an independent auditor would least likely consider information obtained from

   A. Discussions with management personnel.
   B. External quality reviews of the internal auditor’s activities.
   C. Previous experience with the internal auditor.
   D. The results of analytical procedures.

   Answer (D) is correct.

   REQUIRED: The least likely procedure in assessing the competence and objectivity of an entity’s internal auditor.

   DISCUSSION: Analytical procedures are evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data, using models that range from simple to complex. They are substantive procedures used by the auditor to gather evidence about the fairness of the financial statements.

   Answer (A) is incorrect. Discussion with management is a procedure appropriate for assessing the competence and objectivity of an internal auditor. Answer (B) is incorrect. A quality review is a procedure appropriate for assessing the competence and objectivity of an internal auditor. Answer (C) is incorrect. Consideration of previous experience is a procedure appropriate for assessing the competence and objectivity of an internal auditor.

2. For which of the following judgments may an independent auditor share responsibility with an entity’s internal auditor who is assessed to be both competent and objective?

<table>
<thead>
<tr>
<th>Materiality of Misstatements</th>
<th>Evaluation of Significant Accounting Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Yes</td>
<td>No</td>
</tr>
<tr>
<td>B. No</td>
<td>Yes</td>
</tr>
<tr>
<td>C. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>D. No</td>
<td>No</td>
</tr>
</tbody>
</table>

   Answer (D) is correct.

   REQUIRED: The judgment(s) for which an auditor may share responsibility with an internal auditor.

   DISCUSSION: The responsibility to report on financial statements rests solely with the auditor and cannot be shared with internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about (1) assessments of RMMs, (2) materiality of misstatements, (3) sufficiency of tests performed, (4) evaluation of significant accounting estimates, and (5) other matters affecting the auditor’s report always should be those of the auditor.

3. In assessing the competence of an internal auditor, an independent CPA most likely would obtain information about the

   A. Quality of the internal auditor’s documentation.
   B. Organization’s commitment to integrity and ethical values.
   C. Influence of management on the scope of the internal auditor’s duties.
   D. Organizational levels to which the internal auditor reports.

   Answer (A) is correct.

   REQUIRED: The information needed to assess the competence of an internal auditor.

   DISCUSSION: In assessing the competence of an internal auditor, the auditor should consider such factors as (1) educational level and professional experience; (2) professional certification and continuing education; (3) audit policies, programs, and procedures; (4) supervision and review of the internal auditor’s activities; (5) practices regarding assignments; (6) quality of documentation, reports, and recommendations; and (7) evaluation of the internal auditor’s performance.

   Answer (B) is incorrect. The organization’s commitment to integrity and ethical values relates to objectivity rather than competence. Answer (C) is incorrect. The influence of management on the scope of the internal auditor’s duties relates to objectivity rather than competence. Answer (D) is incorrect. The organizational levels to which the internal auditor reports relate to objectivity rather than competence.

4. For which of the following judgments may an independent auditor share responsibility with an entity’s internal auditor who is assessed to be both competent and objective?

<table>
<thead>
<tr>
<th>Assessment of Inherent Risk</th>
<th>Assessment of Control Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>B. Yes</td>
<td>No</td>
</tr>
<tr>
<td>C. No</td>
<td>Yes</td>
</tr>
<tr>
<td>D. No</td>
<td>No</td>
</tr>
</tbody>
</table>

   Answer (D) is correct.

   REQUIRED: The judgment(s) that an auditor may share with an entity’s internal auditor.

   DISCUSSION: The auditor may use the internal auditor to provide direct assistance in the audit as long as the auditor supervises, reviews, evaluates, and tests the work of the internal auditor. However, an internal auditor, regardless of his or her competence and objectivity, should never make judgments about the audit work being conducted. All judgments, including assessments of the risks of material misstatement (inherent and control risk), should be made by the auditor.
5. In assessing the objectivity of internal auditors, an independent auditor should

- Evaluate the quality control program in effect for the internal auditors.
- Examine documentary evidence of the work performed by the internal auditors.
- Test a sample of the transactions and balances that the internal auditors examined.
- Determine the organizational level to which the internal auditors report.

Answer (D) is correct.

**REQUIRED:** The procedure performed to assess an internal auditor’s objectivity.

**DISCUSSION:** If the external auditor plans to use the work of the internal auditors to obtain audit evidence or to provide direct assistance, their competence and objectivity should be evaluated. Objectivity is promoted when the internal auditors (1) report to those charged with governance rather than management, (2) are free of any conflicting responsibilities, (3) work without constraints, and (4) are members of professional organizations that obligate them to be objective. The external auditor should assess each of these factors in evaluating objectivity.

Answer (A) is incorrect. Evaluating quality control pertains to competence, not objectivity. Answer (B) is incorrect. Examining internal auditors’ engagement records (documentation) pertains to competence, not objectivity. Answer (C) is incorrect. Testing details examined by internal auditors pertains to competence, not objectivity.

6. During an audit, an internal auditor may provide direct assistance to an independent CPA in

<table>
<thead>
<tr>
<th>Obtaining an Understanding of Internal Control</th>
<th>Performing Tests of Controls</th>
<th>Performing Substantive Tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>B. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>C. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Answer (D) is correct.

**REQUIRED:** The types of direct assistance an internal auditor may provide to an independent CPA.

**DISCUSSION:** The auditor may request direct assistance from the internal auditor when performing the audit. Thus, the auditor may appropriately request the internal auditor’s assistance in obtaining the understanding of internal control, performing tests of controls, or performing substantive procedures (AU-C 610). The internal auditor may provide assistance in all phases of the audit as long as (1) the internal auditor’s competence and objectivity have been tested, and (2) the independent auditor supervises, reviews, evaluates, and tests the work performed by the internal auditor to the extent appropriate.

Answer (A) is incorrect. Evaluating quality control pertains to competence, not objectivity.

7. Which approach to planning, performing, supervising, reviewing, and documenting internal audit activities distinguishes it from other monitoring controls that may be performed within the entity?

- An independent approach.
- A balanced approach.
- A fair and honest approach.
- A systematic and disciplined approach.

Answer (D) is correct.

**REQUIRED:** The approach of the internal audit function that distinguishes it from other controls.

**DISCUSSION:** The application of a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting internal audit activities distinguishes it from other monitoring controls that may be performed within the entity.

Answer (A) is incorrect. Internal auditors can be objective. But they are not independent in the same sense as the external auditor. Answer (B) is incorrect. Internal auditors are not distinguished by using a balanced approach. Answer (C) is incorrect. Internal auditors may take a fair and honest approach to their work, but it does not distinguish the function from other controls.

8. Miller Retailing, Inc., maintains a staff of three full-time internal auditors. The independent auditor has found that they are competent and objective. Moreover, the work of the internal auditors is relevant to the audit, and it is efficient to consider how that work may affect the audit. The independent auditor most likely will

- Nevertheless need to make direct tests of assertions about material financial statement amounts for which the risks of material misstatement are high.
- Decrease the extent of the tests of controls needed to restrict audit risk to the acceptable level.
- Increase the extent of the procedures needed to reduce control risk to an acceptable level.
- Not evaluate and test the work performed by the internal auditors.

Answer (A) is correct.

**REQUIRED:** The true statement about the effect of the work of the internal auditors.

**DISCUSSION:** The auditor has the sole reporting responsibility and makes all judgments about matters affecting the report. When amounts are material and the risks of material misstatement are high or the evaluation of the evidence is highly subjective, the consideration of the internal auditors’ work cannot alone reduce audit risk to an acceptable level. Thus, direct testing of those assertions by the auditor cannot be eliminated (AU-C 610).

Answer (B) is incorrect. The auditor performs substantive procedures, not tests of controls, to restrict detection risk to the acceptable level. Answer (C) is incorrect. Control risk can be assessed but not restricted by the auditor. Answer (D) is incorrect. The auditor should evaluate the quality and effectiveness of the work of the internal auditors that significantly affects the nature, timing, and extent of the audit procedures.
The external auditor plans to use the work of the internal auditors to obtain audit evidence and to provide direct assistance in the audit. Thus, the independent auditor should assess both the competence and objectivity of the internal auditors. For each of the following procedures, select from the list provided to show whether it is appropriate for assessing competence, objectivity, both, or neither. Each choice may be used once, more than once, or not at all.

<table>
<thead>
<tr>
<th>Procedures</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Update or obtain information about the supervision and review of internal auditors’ work.</td>
<td></td>
</tr>
<tr>
<td>2. Update or obtain information about the policies regarding the employment of relatives of internal auditors in audit-sensitive positions.</td>
<td></td>
</tr>
<tr>
<td>3. Evaluate evidence from a recent external quality review of the internal auditors.</td>
<td></td>
</tr>
<tr>
<td>4. Update or obtain information about the audit plans and procedures used by the internal auditors.</td>
<td></td>
</tr>
<tr>
<td>5. Evaluate the personal financial statements of the internal auditors.</td>
<td></td>
</tr>
<tr>
<td>6. Determine whether the internal auditors have direct access to the board of directors.</td>
<td></td>
</tr>
<tr>
<td>7. Update or obtain information about the professional certification of the internal auditors.</td>
<td></td>
</tr>
<tr>
<td>8. Update or obtain information about the continuing education programs provided to the internal auditors.</td>
<td></td>
</tr>
<tr>
<td>9. Consider information obtained in previous audits about the activities of internal auditors.</td>
<td></td>
</tr>
<tr>
<td>10. Consider whether the internal auditors are well paid.</td>
<td></td>
</tr>
</tbody>
</table>

**Choices**

A) The independent auditor should perform this procedure to test the competence and objectivity of the internal auditors.

B) The independent auditor should perform this procedure to test the competence but not the objectivity of the internal auditors.

C) The independent auditor should perform this procedure to test the objectivity but not the competence of the internal auditors.

D) The auditor would not perform this procedure.
5. Activities (10 Gradable Items)

1. B) The independent auditor should perform this procedure to test the competence but not the objectivity of the internal auditors. The supervision and review of internal auditors’ work relate to their competence.

2. C) The independent auditor should perform this procedure to test the objectivity but not the competence of the internal auditors. The employment of relatives of internal auditors in audit-sensitive positions relates their objectivity.

3. A) The independent auditor should perform this procedure to test the competence and objectivity of the internal auditors. Evidence from a recent external quality review of the internal auditors provides information about both objectivity and competence.

4. B) The independent auditor should perform this procedure to test the competence but not the objectivity of the internal auditors. Evaluating audit plans and procedures used by the internal auditors provides information about their competence.

5. D) The auditor would not perform this procedure. The personal financial statements of the internal auditors would not be evaluated by the auditor.

6. C) The independent auditor should perform this procedure to test the objectivity but not the competence of the internal auditors. Having direct access to the board of directors by the internal auditors relates to their objectivity.

7. B) The independent auditor should perform this procedure to test the competence but not the objectivity of the internal auditors. The professional certification of the internal auditors relates to their competence.

8. B) The independent auditor should perform this procedure to test the competence but not the objectivity of the internal auditors. The continuing education programs provided to the internal auditors relate to their competence.

9. A) The independent auditor should perform this procedure to test the competence and objectivity of the internal auditors. Information from previous audits about the activities of internal auditors relates to both objectivity and competence.

10. D) The auditor would not perform this procedure. Considering whether the internal auditors are well paid would not be performed by the auditor.

Gleim Simulation Grading

<table>
<thead>
<tr>
<th>Task</th>
<th>Correct Responses</th>
<th>Gradable Items</th>
<th>Score per Task</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>+ 5</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>+ 1</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>+ 10</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td>+ 8</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>+ 10</td>
<td></td>
</tr>
</tbody>
</table>

Total of Scores per Task

\[ \text{Total Number of Tasks} = 5 \]

Total Score \( \% \)

Complete more Task-Based Simulations in your online course!
Statements on Standards for Accounting and Review Services (SSARSs) are issued by the AICPA’s Accounting and Review Services Committee (ARSC). SSARSs apply to engagements involving nonissuers, defined as all entities that are not issuers. **Issuers** (also known as public companies) (1) have registered securities under Section 12 of the Securities Exchange Act of 1934, (2) are required to report under Section 15 of that act, or (3) have filed a registration statement under the Securities Act of 1933 that has not become effective. Thus, SSARSs may be applied to all **nonpublic entities**.

The ARSC released Statement on Standards for Accounting and Review Services (Clarified) No. 21 (SSARS No. 21) in October 2014. It includes the following sections:

- AR-C 60: General Principles for Engagements
- AR-C 70: Preparation of Financial Statements
- AR-C 80: Compilation Engagements
- AR-C 90: Review of Financial Statements

SSARS No. 21 supersedes all outstanding SSARSs except SSARS No. 14, *Compilation of Pro Forma Financial Information*, as amended (AR 120). The new, clarified pronouncement is effective for periods ending on or after December 15, 2015, with early implementation permitted. Therefore, these clarified standards are testable on the CPA exam beginning July 1, 2015. SSARS No. 21 is addressed in Subunits 19.1 through 19.4.

Subunits 19.5 through 19.8 cover various **Statements on Standards for Attestation Engagements**. They relate to services performed for a nonissuer that are beyond those for traditional historical financial statements. AT 501, which applies to an examination of internal control integrated with an audit is covered in Study Unit 9.

**19.1 GENERAL PRINCIPLES FOR SSARSs ENGAGEMENTS (AR-C 60)**

1. **Introduction**
   a. For more than 3 decades, the guidance for unaudited financial statements of nonissuers provided for just 2 levels of service, **compilations and reviews**. A third type of service, below the level of a compilation, is now permitted. Accountants may **prepare** financial statements without issuing a report. But the substance of most requirements for compilations and reviews is unchanged (except for the wording of the reports).
b. The following table compares the preparation, compilation, and review services governed by SSARSs with an audit:

<table>
<thead>
<tr>
<th>Issue</th>
<th>Preparation</th>
<th>Compilation</th>
<th>Review</th>
<th>Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is assurance provided?</td>
<td>No</td>
<td>No</td>
<td>Limited</td>
<td>Positive</td>
</tr>
<tr>
<td>Is an engagement letter required?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Is a report required?</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>May the financial statements be released to users other than management?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>May the financial statements omit disclosures (notes)?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

[1] No determination of independence is required.
[2] A determination of independence is required. The report is modified if the accountant is not independent.

Refer to the above table after you have studied each of the first 4 subunits in this study unit. It provides a quick review before taking the exam. The Auditing and Attestation part of the CPA exam allocates 12%-16% of questions to preparation, compilation, and review topics. These subunits are especially important.

2. Accountant’s Responsibilities
   a. SSARSs describe responsibilities of the accountant for engagements to (1) prepare, (2) compile, or (3) review financial statements in accordance with the applicable financial reporting framework (typically GAAP). SSARSs should be adapted as necessary when those services are performed on other historical or prospective financial information. (But prospective financial information may be prepared or compiled but not reviewed.)

   1) The accountant is expected to follow any legal requirements. (S)he then can (a) evaluate whether completing the engagement according to SSARS requirements is possible and (b) complete the engagement accordingly. Thus, a redesign of the engagement may be necessary to ensure compliance with the relevant legal requirements.

   b. The CPA firm is required to have an effective quality control system. It should include a monitoring process designed to provide reasonable assurance that quality control policies and procedures are relevant, adequate, and operating effectively.

   1) Furthermore, all accountants on the engagement team should (a) comply with relevant ethical requirements and (b) exercise professional judgment and due care.

3. Acceptance and Continuation of Engagements
   a. As a condition for accepting an engagement, the accountant should

   1) Determine whether professional competence is obtainable.

   2) Determine whether the financial reporting framework selected by management is acceptable.

   3) Obtain the agreement of management that it acknowledges and understands its responsibilities for

      a) Selecting the financial reporting framework.
b) Designing, implementing, and maintaining internal control over financial reporting.

c) Preventing and detecting fraud.

d) Ensuring that the entity complies with laws and regulations.

e) Maintaining accurate and complete records, documents, explanations, and other information.

f) Providing access to all relevant information, including (1) information for preparing and fairly presenting the financial statements, (2) information the accountant may request, and (3) access to persons within the entity.

b. An engagement should **not** be accepted if the accountant

1) Believes that relevant ethical requirements will not be satisfied,
2) Has a preliminary understanding that information needed to perform the engagement is likely to be unavailable or unreliable, or
3) Doubts management’s integrity.

c. AR-C 60 does not address the agreement on the **terms** of the engagement. But, in an engagement to prepare, compile, or review financial statements, they should be documented in an **engagement letter** or other suitable form of written agreement. (Study Unit 3, Subunit 1, is relevant. It applies to pre-engagement acceptance activities.) The following are terms common to such engagements:

1) The objective(s) of the engagement
2) The responsibilities of management
3) The responsibilities of the accountant, which, in a preparation, do not include issuing a report
4) The limitations of the engagement
5) That the engagement cannot be relied upon to disclose fraud, error, or noncompliance with laws or regulations
6) Identification of the applicable reporting framework

4. **The Financial Reporting Framework**

a. The applicable financial reporting framework (**framework**) includes accounting standards issued by an authorized or recognized standards-setting organization, e.g., the FASB, GASB, or IASB.

b. The following are **special purpose** reporting frameworks:

1) The **cash** basis is (a) a basis used to record cash receipts and disbursements or (b) a modification of the cash basis having substantial support. An example of a modification is recording depreciation on fixed assets, a substantial, noncash item.
2) The **tax** basis is used to file the entity’s tax return for the period covered by the financial statements.
3) A **regulatory** basis is used to comply with the requirements or financial reporting provisions of a regulator with jurisdiction over the entity. An example is a basis that insurers use in accordance with the accounting practices prescribed or permitted by a state insurance commission.
4) A **contractual** basis is used to comply with an agreement between the entity and one or more third parties other than the accountant.
5) An **other** basis has a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

c. Special purpose frameworks other than the contractual basis are known as other comprehensive bases of accounting (**OCBOAs**).
d. Many frameworks intend that financial statements provide information about the (1) financial position, (2) financial performance, (3) cash flows, and (4) related disclosures of an entity. For some other frameworks, a single financial statement and the related notes might be a complete set. The following are examples of a single financial statement, each of which includes related notes:

1) Balance sheet  
2) Statement of income or statement of operations  
3) Statement of retained earnings  
4) Statement of cash flows  
5) Statement of assets and liabilities  
6) Statement of changes in owners’ equity  
7) Statement of revenue and expenses  
8) Statement of operations by product lines  

e. An accountant may (1) prepare, (2) compile, or (3) review a complete set of financial statements or a single statement (for example, a balance sheet). The statements may be for an annual or other period, depending on management’s needs. However, presenting statements other than for an annual period comparatively with statements for an annual period usually is inappropriate.

5. Understanding the Framework  
   a. AR-C 60 does not specifically address the understanding of the framework. But the guidance for a preparation, compilation, or review requires the following:

1) The accountant should obtain an understanding of (a) the framework and (b) the significant accounting policies adopted by management.  
2) The accountant is not prevented from accepting an engagement for an entity in an industry in which (s)he has no previous experience. The understanding may be obtained, for example, by consulting (a) AICPA guides, (b) industry publications, (c) financial statements of other entities in the industry, (d) textbooks and periodicals, (e) appropriate continuing professional education, or (f) individuals knowledgeable about the industry.  
3) Obtaining the understanding satisfies the accountant’s ethical obligation to perform services with competence (due care).  

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 1 through 6 beginning on page 619.

19.2 PREPARATION OF FINANCIAL STATEMENTS (AR-C 70)  

1. Nature of the Engagement  
   a. A preparation engagement is a nonattest service that does not require the accountant to determine whether (s)he is independent of the entity. Furthermore, the accountant need not  
      1) Verify the accuracy or completeness of management’s information,  
      2) Obtain evidence to express an opinion or a conclusion, or  
      3) Report on the financial statements.  
   b. The accountant’s engagement cannot be relied upon to identify or disclose  
      1) Misstatements, including those caused by fraud or error, or  
      2) Wrongdoing (e.g., fraud) or noncompliance with laws and regulations.  
   c. The preparation service  
      1) Allows accountants to use software to generate client financial statements and release them to the client or third parties without attaching a report.
2) May be in conjunction with other services, such as a preparation of interim statements followed by an audit, review, or compilation of fiscal year-end statements.

2. Applicability
   a. AR-C 70 applies when an accountant in public practice is engaged to prepare financial statements. It does not apply when the accountant merely assists in their preparation (a bookkeeping service).
   b. This guidance also applies, adopted as necessary, to the preparation of other historical or prospective information.
   c. Thus, AR-C 70 applies to preparation of
      1) Statements for use by the entity or a third party;
      2) Statements prior to an audit or review by another accountant;
      3) Statements to be presented with the entity’s tax return;
      4) Personal financial statements for presentation with a financial plan;
      5) Single statements, such as a balance sheet or income statement, or statements that omit substantially all disclosures;
      6) Statements outside of an accounting software system using the information in a general ledger; and
      7) Other historical or prospective financial information, including
         a) Specified elements, accounts, or items of a statement, such as schedules of rents, royalties, profit participations, or provisions for income taxes;
         b) Supplementary information, whether or not such information is required;
         c) Required supplementary information;
         d) Pro forma financial information; and
         e) Prospective financial information, including budgets, forecasts, and projections.
   d. AR-C 70 does not apply if other AICPA pronouncements govern. Thus, it does not apply when an accountant prepares financial statements and is engaged to audit, review, or compile them. AR-C 70 also does not apply when the statements are prepared
      1) Solely for submission to taxing authorities
      2) For inclusion in written personal financial plans prepared by the accountant
      3) In conjunction with litigation services involving pending or potential legal or regulatory proceedings
      4) In conjunction with business valuation services
   e. When an accountant does not prepare financial statements, AR-C 70 does not apply if the accountant
      1) Maintains depreciation schedules;
      2) Prepares or proposes certain adjustments, such as those applicable to deferred income taxes, depreciation, or leases;
      3) Drafts financial statement notes; or
      4) Enters general ledger transactions or processes payments (general bookkeeping) in an accounting software system.

3. Independence
   a. The accountant need not be independent of the client, and no disclosure is necessary if independence is impaired.
   b. An accountant’s name is not required to be identified or associated with the financial statements, but the accountant may be identified if a disclaimer is attached.
4. **Preparation Procedures**
   a. The accountant should prepare the financial statements using the records, documents, explanations, and other information provided by management.
   b. The accountant need not (1) verify the accuracy or completeness of the information provided by management or (2) otherwise gather evidence to report (e.g., express an opinion or conclusion) on the fairness of the statements.
   c. The accountant may become aware that the information, including significant judgments, used to prepare the statements is incomplete, inaccurate, or otherwise unsatisfactory.
      1) In these circumstances, the accountant should request that management provide additional or corrected information.
      2) After discussions with management, the accountant may prepare statements that contain a **known departure** from the framework (including inadequate disclosure) and then should disclose the material misstatement.
         a) A **misstatement** may result from fraud or error. It is the difference between (1) the amount, classification, presentation, or disclosure of an item and (2) the amount, etc., required for the item to be fairly presented.
      3) A known departure ordinarily is disclosed in the notes but may be stated on the face of the statements.

**EXAMPLE**

Accounting principles generally accepted in the United States of America require that land be stated at cost. Management reported land at appraised value. If land had been reported at cost, the balances of the land account and shareholders’ equity would have decreased by $500,000.

4) Statements may be prepared that omit **substantially all disclosures** required by the framework unless the intent is to mislead users. The accountant should disclose the omission on the face of the statements or in a note.
   a) If some disclosures are omitted, the statements should include a heading such as “**Selected Information—Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included.**”

   d. When preparing statements in accordance with a **special purpose** framework, for example, the cash basis, the accountant should describe the framework on the face of the statements or in a note.

   e. The accountant may assist management in making **significant judgments**. For example, the accountant may (1) advise management on alternative significant accounting policies or (2) help management with significant judgments about accounting estimates.
      1) But management should understand and accept responsibility for significant judgments after discussions with the accountant.

5. **Notation on the Financial Statements**
   a. A preparation provides no assurance on the financial statements, and the accountant should include on **each page** (including notes) a notation that **no assurance is provided**.
      1) The notation is intended to avoid misunderstanding by users of the accountant’s involvement, and the accountant’s name is not required to be included.
      2) An alternative notation is that the financial statements have not been subjected to an audit, review, or compilation engagement, and no assurance is provided on them.
         a) Similar wording also is acceptable.
3) If the accountant is unable to include a notation on each page of the financial statements, (s)he should (a) issue a disclaimer clarifying that no assurance is provided on the financial statements or (b) perform a compilation engagement.

**EXAMPLE**
The accompanying financial statements of XYZ Company as of and for the year ended December 31, 20XX, were not subjected to an audit, review, or compilation engagement by me (us) and, accordingly, I (we) do not express an opinion or a conclusion or provide any assurance on them.

Signature of accounting firm or accountant, as appropriate  
Accountant's city and state  
Date of the accountant's preparation disclaimer

6. **Other Presentation Considerations**
   a. The accountant should modify the titles on the statements when they are not in accordance with GAAP. For example, if the tax basis is the applicable framework, "balance sheet" should be replaced with a title similar to "Statement of Assets, Liabilities, and Equity – Income Tax Basis."
   b. When the statements do not include substantially all disclosures, the accountant should disclose the omission in the statements even though no accountant's report is presented. The following is an example of an appropriate notation on the face of the financial statements:

**EXAMPLE**
Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared in accordance with the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's assets, liabilities, equity, revenues, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

   c. The accountant should not prepare financial statements that omit substantially all disclosures if the intent is to mislead users.

7. **Documentation**
   a. Documentation in connection with each preparation engagement should provide a clear understanding of the work performed and, at a minimum, include (1) the **engagement letter** and (2) a copy of the **financial statements**.
   b. Significant (1) consultations or (2) professional judgments made during the engagement may be documented.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 7 though 12 beginning on page 621.

**19.3 COMPILATION OF FINANCIAL STATEMENTS (AR-C 80)**

1. **Scope and Objective**
   a. The guidance for a compilation of financial statements also applies, adopted as needed, to other historical or prospective financial information.
   b. The objective of a compilation is to apply accounting and financial reporting expertise to **assist management** in the presentation of financial statements without undertaking to obtain or provide any assurance on them. Unlike a preparation service, a compilation requires the accountant to
      1) Determine whether (s)he is independent.
      2) Report on the statements.
      3) Disclose any lack of independence.
      4) Associate his or her name with the statements. (It is included in the report.)
2. **Acceptance**
   a. A compilation engagement should **not** be accepted unless the accountant obtains the agreement of management (typically in an engagement letter) that it acknowledges and understands its responsibility for
      1) Preparing and fairly presenting financial statements and including all informative disclosures that are appropriate
      2) Including the accountant’s compilation report in any document containing financial statements if it indicates that the accountant has performed a compilation (unless a different understanding is reached)

3. **Compilation Procedures**
   a. The accountant should read the statements after obtaining an understanding of the framework and significant accounting policies.
   b. The accountant then considers whether the statements appear to be appropriate in form and free from obvious material misstatements.
   c. The accountant is **not** required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity.
      1) However, the accountant may have performed such inquiries or other procedures.
      2) The (a) results of any procedures, (b) knowledge from prior engagements, or (c) statements themselves may cause the accountant to become aware that information provided by management is incorrect, incomplete, or otherwise unsatisfactory.
         a) The accountant should bring such issues to the attention of management and request additional or corrected information.
   d. If the accountant becomes aware that (1) the statements do not adequately refer to or describe the framework, (2) revisions of the statements are required for them to be in accordance with the framework, or (3) the statements are otherwise misleading, the accountant should propose the appropriate revisions to management.
      1) For example, statements may be misleading if (a) the framework includes the assumption that the statements are prepared on the going concern basis, and (b) uncertainties about the entity’s ability to do so are undisclosed.
         a) If the accountant becomes aware of such uncertainties, (s)he may suggest additional disclosures.
      2) But the existence of an adequately disclosed uncertainty does **not** require modification of the report.
   e. The accountant should withdraw from the engagement and inform management of the reasons for withdrawing if
      1) (S)he is **unable to complete** the engagement because management has failed to provide records, documents, explanations, or other information, including significant judgments, as requested, or
      2) Management does **not** (a) make appropriate revisions proposed by the accountant or (b) disclose such departures in the statements, and the accountant determines not to disclose such departures in the compilation report.
   f. When making withdrawal decisions, the accountant may wish to consult legal counsel.
   g. Disclosure of items, such as an uncertainty, is not required in statements that omit substantially all disclosures required by the framework.
4. **Compilation Reports**
   
a. The accountant should prepare a **written report** to accompany the statements. The compilation report consists of one paragraph. It should
   1) State that management (owners) is (are) responsible for the financial statements.
   2) Identify the statements.
   3) Identify the entity.
   4) Specify the date or period covered by the statements.
   5) State that the accountant performed the compilation engagement in accordance with SSARSs issued by the ARSC of the AICPA. (But the procedures performed and their results are not described in the report.)
   6) State that the accountant (a) did not audit or review the statements and (b) was not required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, the accountant issues a **disclaimer**. (S)he does not express an opinion or a conclusion or provide any assurance on the statements.
   7) Include a manual, printed, or digital signature of the accountant or the accountant’s firm.
   8) Include the city and state where the accountant practices.
   9) Include the date of the report, which should be the day that the accountant completed the required procedures.

b. The accountant’s written report may become unattached from the statements. Thus, (s)he may request that management refer on each page of the statements to the accountant’s written report. Examples are
   1) “See Accountant’s Report.”
   2) “See Accountant’s Compilation Report.”

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**EXAMPLE -- Standard Compilation Report**

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1 and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements, and I (we) was (were) not required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion or a conclusion or provide any form of assurance on these financial statements.

Signature of accounting firm or accountant, as appropriate  
Accountant’s city and state  
Date of the accountant’s preparation disclaimer

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c. Neither the report nor the paragraph (paragraphs in a modified report) has a heading.

5. **Reporting on Statements Prepared Using a Special Purpose Framework**
   
a. a. Unless the entity elects to omit substantially all disclosures, the accountant should modify the compilation report when the statements do **not** include
   1) A description of the special purpose framework, including a summary of significant accounting policies;
   2) An adequate description of how the special purpose framework materially differs from GAAP (but the effects of the differences need not be quantified); and
   3) Informative disclosures similar to those required by GAAP if the statements contain items that are the same as, or similar to, those in GAAP-based statements.
b. The report should refer to management’s responsibility for determining that the framework is acceptable. If a regulatory or contractual basis of accounting is used, the report also should describe the purpose for which the statements are prepared or refer to a note that contains that information.

c. The report should include a separate paragraph that (1) indicates that the statements are prepared in accordance with the special purpose framework, (2) refers to the note to the statements that describes the framework (if applicable), and (3) states that the framework is a basis of accounting other than GAAP.

d. The following is an example of a paragraph added to a report on statements prepared in accordance with a special purpose framework (i.e., the tax basis):

```
EXAMPLE
The financial statements are prepared in accordance with the tax basis of accounting, described in note 1 to the financial statements, which is a basis of accounting other than accounting principles generally accepted in the United States of America.
```

6. Reporting When the Accountant Is Not Independent

a. An accountant who is not independent with respect to the entity should indicate his or her lack of independence in a final paragraph of the report.

b. The following is an example of a paragraph indicating a lack of independence:

```
EXAMPLE
I am not independent with respect to XYZ Company.
```

c. If the accountant elects to disclose the reasons independence is impaired, (s)he should include all the reasons.

d. The following is an example of a paragraph indicating lack of independence:

```
EXAMPLE
I am not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I had a direct financial interest in XYZ Company.
```

7. Reporting on Financial Statements that Omit Substantially All Required Disclosures

a. An accountant should not report on statements that omit such disclosures if the omission was intended to mislead users.

b. When the accountant reports on statements that omit disclosures, the report should state in a separate paragraph that

1) Management has elected to omit substantially all disclosures (and the statement of cash flows, if applicable) required by the framework.

2) The omitted disclosures might influence the user’s conclusions if they (and the statement of cash flows, if applicable) were included in the statements.

3) The statements are not designed for those who are not informed about such matters.
c. The following is an example paragraph that describes omitted disclosures:

```
EXAMPLE
Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.
```

d. The omission of one or more **notes**, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the framework. The nature of the departure and its effects, if known, should be disclosed in the report as discussed in the following section.

8. **Reporting Known Departures from the Applicable Financial Reporting Framework**

a. The accountant may become aware of a material departure from the framework (including inadequate disclosure). If (1) the statements are not revised or (2) the departure is not disclosed by the entity, the accountant should **modify** the compilation report by adding a separate paragraph to disclose the departure.

b. The **effects** of the departure should be disclosed if they (1) have been determined by management or (2) are readily known to the accountant.

c. The following is an example of a separate paragraph:

```
EXAMPLE
Accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me that XYZ Company has stated its land at appraised value and that, if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders’ equity would have been decreased by $500,000.
```

d. If the effects of the departure are **not** known, the accountant is not required to determine its effects. But the report should state that the determination has not been made by management.

e. If modification of the compilation report is **not** adequate to indicate the deficiencies in the statements as a whole, the accountant should (1) withdraw from the engagement and (2) provide no further services with respect to those statements. (The accountant may want to consult legal counsel.)

f. The accountant **never** indicates in the compilation report that the statements do not conform with the framework. This conclusion can be formed only on the basis of an audit.

9. **Supplementary Information**

a. When supplementary information accompanies financial statements, the accountant should clearly indicate the degree of responsibility, if any, (s)he is taking with respect to the information.

1) This indication may be in (a) an **other-matter** paragraph in the compilation report on the statements or (b) a **separate report** on the supplementary information.

b. An accountant who has performed a compilation of the statements and the supplementary information may elect to issue a separate report on the supplementary information. The separate report should state that the information is

1) Presented for additional analysis and is not required
2) The representation of management
3) Subject to the compilation engagement
4) Not audited or reviewed, and the accountant does not (a) express an opinion or a conclusion or (b) provide any assurance on the information
c. If the supplementary information was not compiled, the accountant also may elect to issue a separate report. The separate report should state that the supplementary information is
1) Presented for additional analysis and is not required
2) The representation of management
3) Not compiled and the accountant does not (a) express an opinion or a conclusion or (b) provide any assurance on the information
d. If a separate report is not presented, the disclosures discussed in this subunit are included in an other-matter paragraph of the compilation report.

10. Required Supplementary Information (RSI)
   a. If supplementary information is required, the accountant should explain one of the following in an other-matter paragraph:
      1) RSI is included, and the accountant compiled it.
      2) RSI is included, and the accountant did not compile, review, or audit the RSI.
      3) RSI is omitted.
      4) Some RSI is missing, and some is presented in accordance with prescribed guidelines.
      5) The accountant has identified departures from prescribed guidelines.
      6) The accountant has unresolved doubts about whether the RSI is presented in accordance with prescribed guidelines.

11. Compilation of Pro Forma Financial Information (Existing AR 120)
   a. An accountant may assist management to compile pro forma financial statements and submit them to a third party.
      1) An accountant, in certain cases, may do so without issuing a compilation report.
      2) However, if the accountant has been engaged to report on such statements, a compilation report should be issued.
   b. The accountant may agree to compile pro forma financial information only if it is contained in a document that includes (or incorporates by reference) the historical statements of the entity on which it is based.
   c. The accountant should follow the guidelines for compiling and reporting on compiled financial statements.

12. Documentation of a Compilation Engagement
   a. The accountant should prepare documentation for each compilation engagement in sufficient detail to provide a clear understanding of the work performed.
   b. The minimum presentation includes the following:
      1) The engagement letter or other suitable written documentation of the understanding with management
      2) A copy of the financial statements
      3) A copy of the accountant’s report

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 13 through 15 on page 623.
19.4 REVIEW OF THE FINANCIAL STATEMENTS (AR-C 90)

1. Scope and Objective
   a. The guidance for a review of financial statements also applies, as necessary, to reviews of other historical (but not prospective) financial information.
   b. The objective of a review of financial statements is to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the statements for them to be in accordance with the reporting framework (e.g., GAAP).
   c. Limited assurance also is known as negative assurance, in contrast with the positive assurance provided by an audit.
   d. A review is performed primarily through inquiry and analytical procedures.
   e. The accountant must be independent of the entity when performing a review. If, during the review, the accountant determines that independence is impaired, (s)he should withdraw from the engagement.
      1) However, if the accountant lacks independence, (s)he may accept a new engagement to prepare or compile the statements.

2. Communication with Management and Those Charged with Governance
   a. The accountant should communicate appropriately during the review all related significant matters that merit the attention of (1) management and (2) those charged with governance.
      1) Management consists of persons with executive responsibility for the entity’s operations.
      2) Those charged with governance include the persons or organizations (e.g., a corporate trustee) responsible for (a) overseeing the strategic direction of the entity and (b) the obligations related to the accountability of the entity (e.g., for oversight of financial reporting).
      3) Those charged with governance may include management personnel.
   b. Matters communicated include (1) the accountant’s responsibilities and (2) significant findings. The following are examples of findings:
      1) Views about the entity’s accounting practices
      2) The need to perform additional procedures
      3) Matters, such as fraud or noncompliance, that may require modification of the report
      4) Significant difficulties that may lead to withdrawal from the engagement
   c. Communication may be in the form of (1) inquiries while performing procedures or (2) other communications as part of having an effective dialogue to understand issues and develop a working relationship.
   d. The communication may be oral or written.
   e. The accountant normally is not required to communicate with those outside the entity unless required by law or regulation.

3. Nature of a Review
   a. The accountant should possess or obtain a sufficient understanding of the industry and knowledge of the entity.
      1) The understanding of the industry includes the accounting principles and practices generally used.
      2) The knowledge of the entity includes an understanding of (a) the entity’s business and (b) its accounting principles and practices.
3) The understanding should suffice to (a) identify the assertions in the financial statements having a greater likelihood of material misstatement and (b) design procedures to address those risks.

4) A review is not as comprehensive as an audit. Thus, the accountant is not expected to (a) obtain an understanding of the entity's internal control, (b) assess fraud risks, (c) test the accounting records, (d) examine source documents, or (e) perform other audit procedures.

b. Designing and Performing Review Procedures

1) The accountant should (a) design and perform analytical procedures; (b) make inquiries; and (c) perform other procedures, as appropriate, to obtain limited assurance.

2) Review evidence is information used by the accountant to provide a reasonable basis for obtaining limited assurance.

3) The procedures to obtain review evidence should be based on the accountant's (a) understanding of the industry, (b) knowledge of the entity, and (c) awareness of risks.
   a) The accountant should concentrate on assertions having increased risks of material misstatement (RMMs).

4. Review Evidence – Analytical Procedures

a. Analytical procedures are evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data.

1) They also include any necessary investigation of identified fluctuations or relationships that (a) are inconsistent with other relevant information or (b) differ significantly from expected values.

2) The accountant should apply analytical procedures to the financial statements to identify, and provide a basis for inquiry about, the relationships and individual items that (a) appear to be unusual and (b) may indicate a material misstatement.

3) The basic premise of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.

b. Analytical procedures should

1) Compare the statements with comparable information for the prior period, considering knowledge about changes in the entity's business and specific transactions.

2) Consider plausible relationships among both financial and, when relevant, nonfinancial information.

3) Compare recorded amounts, or ratios developed from recorded amounts, with expectations developed from relationships within the entity or the entity's industry.

4) Compare disaggregated revenue data, as applicable.

c. When designing and performing analytical procedures, the accountant should

1) Determine the suitability of particular procedures.

2) Consider the reliability of the underlying data from which the expectations of recorded amounts or ratios are developed.

3) Develop an expectation of recorded amounts or ratios and evaluate whether it is sufficiently precise to provide limited assurance of identifying a material misstatement.

4) Determine the amount of any difference between recorded amounts and expected values that is acceptable without further investigation.

5) Compare the recorded amounts or ratios with expectations.
d. The following are examples of potentially useful analytical procedures:

1) Comparing revenues and expenses of the current period and the prior period
2) Comparing current statements with anticipated results, such as budgets and forecasts
3) Comparing current statement information with relevant nonfinancial information, such as hours worked or product shipped
4) Comparing the current-period and prior-period measures of (a) the current ratio, (b) receivables turnover, (c) inventory turnover, (d) depreciation to average fixed assets, (e) debt to equity, (f) gross profit percentage, and (g) net income percentage
5) Comparing ratios and indicators for the current period with those of entities in the same industry
6) Comparing disaggregated data, e.g., monthly or weekly amounts of (a) sales or (b) sales by product line, operating segment, or location, with data from prior periods or budgets

e. Analytical procedures may be performed at the statement level or the detailed account level.

1) Those at the statement level provide evidence to support overall conclusions. For example, the accountant may question whether the size of a warehouse can hold all of the reported inventory.
2) Those at the detailed account level provide evidence of potential account balance misstatement. For example, the accountant may compare monthly balances of receivables for the current year and prior year.

f. Analytical procedures may identify fluctuations or relationships that (1) are inconsistent with other relevant information or (2) differ significantly from expected values.

g. The accountant should investigate such differences by (1) inquiring of management and (2) performing other review procedures if necessary.

h. The following is an example of this process:

EXAMPLE

By applying an analytical procedure, the accountant discovered that the accounts receivable balance was greater than expected based on the prior year’s balance. The accountant inquired of management about the reason. The response was that the cash receipts clerk was absent from work during the last week of the year. An inspection of the cash receipts records determined that cash receipts were not recorded for the last week. Accordingly, cash was understated and accounts receivable overstated. Based on this finding, management corrected the misstatement.

5. Review Evidence – Inquiries of Management

a. The accountant should obtain review evidence by inquiring of members of management who have responsibility for financial and accounting matters related to the financial statements.

b. Inquiries should be made about matters the accountant considers necessary, such as the following:

1) Whether the statements have been prepared and fairly presented in accordance with the reporting framework consistently applied
2) Unusual or complex situations that may affect the statements
3) Significant transactions occurring or recognized during the period, particularly in the last several days of the period
4) The status of uncorrected misstatements identified during the previous review
5) Matters about which questions have arisen during the review
6) Events subsequent to the date of the statements that could have a material effect on their fair presentation
7) Knowledge of fraud or suspected fraud involving (a) management, (b) employees with significant roles in internal control, or (c) others if the fraud could materially affect the statements
8) Awareness of any allegations of fraud or suspected fraud affecting the entity
9) Whether management has disclosed all known or suspected noncompliance with laws and regulations that may affect the statements
10) Significant journal entries and other adjustments
11) Communications from regulatory agencies
12) Related parties and significant new related-party transactions
13) Any litigation, claims, and assessments (a) at the date of the balance sheet and (b) during the period from the balance sheet date to the date of management’s response
14) Whether management believes that significant assumptions used in making accounting estimates are reasonable
15) Actions taken at meetings of shareholders, the board, or comparable meetings that may affect the statements
c. The accountant should consider the (1) reasonableness and consistency of the responses given, (2) results of other review procedures, and (3) accountant’s knowledge of the entity’s business. However, the accountant is not required to corroborate the responses.

6. Review Evidence – Written Representations
   a. A representation letter addressed to the accountant should be obtained to confirm certain matters or to support other review evidence. (Study Unit 14, Subunit 3, provides an example.)
   b. The letter typically is signed by members of management in key financial positions, such as the chief executive officer and the chief financial officer.
   c. It should be dated as of the date of the review report.

7. Review Evidence – Other Procedures
   a. The accountant should read the statements and consider whether any information has come to his or her attention to indicate that they are not in accordance with the framework.
   b. The accountant also should (1) obtain evidence that the statements agree or reconcile with the accounting records and (2) read the reports of other accountants who have reported on significant components of the entity.

8. Evaluating Evidence
   a. The accountant should accumulate misstatements, including inadequate disclosure.
   b. The accountant should evaluate misstatements, individually and in the aggregate, to determine whether the statements should be materially modified for them to be in accordance with the framework.
   c. The accountant may become aware that information is incorrect, incomplete, or otherwise unsatisfactory. The accountant then should
      1) Request that management (a) consider the effect on the statements and (b) communicate the results of the consideration to the accountant.
      2) Consider (a) the results and (b) whether they indicate that the statements may be materially misstated.
   d. If the accountant believes that the statements may be materially misstated, (s)he should perform the additional procedures necessary to obtain limited assurance.
   e. If the accountant concludes that the statements are materially misstated, the reporting guidance for known departures from the framework applies (item 11. on page 607).
f. Even if the accountant has no reason to believe that the statements are materially misstated, (s)he should evaluate whether the review evidence obtained is **sufficient and appropriate** to form a conclusion.

1) If it is not, the accountant should (a) extend the work performed or (b) perform other procedures that, in his or her professional judgment, are necessary.

2) The AICPA does **not** specify what additional (or other) procedures should be performed, but they might include tests of details, confirmations, and reconciliations.

9. **Review Report**

a. A written review report in hard copy or electronic format should be presented that consists of

1) A title that includes the word **independent** to indicate clearly that it is the report of an independent accountant.

2) An addressee, as appropriate.

3) An introductory paragraph that
a) Identifies the entity whose financial statements have been reviewed.

b) States that the statements identified in the report were reviewed.

c) Identifies the statements.

d) Specifies the date or period covered by each statement.

e) States that a review primarily includes applying analytical procedures to management’s (owner’s) financial data and making inquiries of company management (owners).

f) States that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the statements as a whole. Accordingly, the accountant does not express such an opinion.

4) A section with the heading **Management’s Responsibility for the Financial Statements** that includes an explanation that management is responsible for the preparation and fair presentation of the statements in accordance with the applicable reporting framework. This responsibility includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the presentation.

5) A section with the heading **Accountant’s Responsibility** that includes the following statements:

a) The accountant’s responsibility is to conduct the review in accordance with SSARSs promulgated by the Accounting and Review Services Committee of the AICPA.

b) The accountant believes that the review evidence obtained is sufficient and appropriate to provide a basis for the conclusion.

6) A concluding section with an appropriate heading, for example, **Accountant’s Conclusion**. It includes a statement about whether the accountant is aware of any material modifications that should be made to the accompanying statements for them to be in accordance with the applicable reporting framework and identifies the country of origin of those accounting principles, if applicable.

7) The manual, printed, or digital signature of the accountant or the accountant’s firm.

8) The city and state where the accountant practices.

9) The date of the review report. It should be dated no earlier than the date on which the accountant has completed procedures sufficient to obtain limited assurance.
b. The accountant should consider including a reference on each page of the financial statements, such as See Independent Accountant's Review Report.

c. A continuing accountant should update the report on one or more prior periods presented comparatively with those of the current period. An updated report considers information the continuing accountant has obtained during the current engagement and

1) Re-expresses the accountant’s previous conclusions or
2) Depending on the circumstances, expresses different conclusions on the statements of a prior period as of the date of the current report.

d. The following is an example of a review report on comparative financial statements:

### EXAMPLE -- Standard Review Report

Independent Accountant’s Review Report

To the owners of XYZ Company

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management’s Responsibility for the Financial Statements

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for our conclusion.

Accountant’s Conclusion

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

| Signature of accounting firm or accountant, as appropriate | May be manual, printed, or digital |
| Accountant’s city and state | Accountant’s office location |
| Date of the accountant’s review report | Date of completion of preparation |

10. Special Purpose Frameworks

a. The accountant’s review report on statements prepared in accordance with a special purpose framework (e.g., cash basis, tax basis, or a contractual or regulatory basis) should

1) Refer to management’s responsibility for determining that the framework is acceptable.

2) Describe the purpose for which the statements are prepared or refer to a note that contains that information when they are prepared in accordance with a regulatory basis or a contractual basis.
3) Include an emphasis-of-matter paragraph, under an appropriate heading, that
   a) Indicates that the statements are prepared in accordance with the special
   purpose framework,
   b) Refers to the note that describes the framework, and
   c) States that the framework is a basis of accounting other than GAAP.

b. The accountant should modify the review report if the statements do not include
   1) A description of the framework
   2) A summary of significant accounting policies
   3) An adequate description of how the framework differs from GAAP
   4) Informative disclosures similar to GAAP disclosures if items are included that are
      similar to items included in GAAP-based statements

11. Known Departures from the Framework
   a. The accountant may become aware of a departure (including inadequate disclosure)
      that is material to the financial statements. If they are not revised, (s)he should
      consider whether modification of the report is adequate to disclose the departure.
      1) If the accountant concludes that modification is adequate, the departure should
         be disclosed in a separate paragraph of the report under the heading Known
         Departures From Accounting Principles Generally Accepted in the United
         States of America (or other applicable framework).
            a) The disclosure should include the effects of the departure if they (a) have
               been determined by management or (b) are known to the accountant as
               the result of his or her procedures.
            b) If the effects of the departure have not been determined by management
               or are not known, the accountant is not required to determine the effects.
               In such circumstances, the accountant should state in the report that the
               determination has not been made.
            c) The Accountant’s Conclusion paragraph is modified to include the phrase “... except for the issue noted in the Known Departure From Accounting Principles Generally Accepted in the United States of America paragraph ...”
            d) The following is an example of the final two paragraphs in a report to disclose known departures from GAAP.

<table>
<thead>
<tr>
<th>EXAMPLE</th>
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<tbody>
<tr>
<td><strong>Accountant’s Conclusion</strong></td>
</tr>
<tr>
<td>Based on my (our) reviews, except for the issue noted in the Known Departure From Accounting Principles Generally Accepted in the United States of America paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.</td>
</tr>
<tr>
<td><strong>Known Departure From Accounting Principles Generally Accepted in the United States of America</strong></td>
</tr>
<tr>
<td>As disclosed in Note X to these financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.</td>
</tr>
</tbody>
</table>

2) If modification of the report is not adequate to indicate the deficiencies in the statements as a whole, the accountant should withdraw from the engagement. The accountant also may wish to consult legal counsel.
b. The accountant must **not** modify the report to state that the financial statements are not in accordance with the applicable framework. A review engagement provides no form of reporting that corresponds to an adverse opinion on audited financial statements. Thus, no **adverse** review report may be issued.

12. **Fraud and Noncompliance**
   
a. The accountant may become aware that **fraud** (including misappropriation of assets) might have occurred. (S)he then should communicate the matter as soon as practicable to the appropriate level of management (at a level above those involved with the suspected fraud, if possible).

b. The accountant also may become aware of **noncompliance** that should be considered when preparing the financial statements. Unless the matter is clearly inconsequential, it should be communicated to management.

c. If the fraud or noncompliance (1) involves senior management or (2) results in a material misstatement, the accountant should communicate the matter directly to those charged with governance.

d. Management or those charged with governance (if appropriate) may not provide sufficient information that supports the conclusion that the statements are not materially misstated due to fraud or noncompliance.

   1) The accountant then should consider the need to obtain legal advice and take appropriate action, including potential withdrawal.

   
a. An **emphasis-of-matter** paragraph is included in the review report (1) if required by SSARSs or (2) at the accountant's discretion.

   1) It refers to a matter that is **appropriately presented or disclosed** in the statements that, in the accountant’s judgment, is fundamental to users’ understanding and is a matter to which attention should be drawn.

   2) An accountant may add more than one such paragraph.

   3) The paragraph should have the heading **Emphasis-of-Matter** and follow the Accountant’s Conclusion paragraph. The following are examples of matters that may be emphasized:

      a) Uncertainties

      b) That the entity is a component of a larger business enterprise

      c) That the entity has had significant transactions with related parties

      d) Unusually important subsequent events

b. An **other-matter paragraph** is included in the report (1) if required by SSARSs or (2) at the accountant’s discretion. It refers to a matter **other** than those presented or disclosed in the statements that, in the accountant’s judgment, is relevant to (1) users’ understanding of the review, (2) the accountant’s responsibilities, or (3) the report.

   1) The paragraph should have the heading **Other Matter** and follow (a) the Accountant’s Conclusion paragraph and (b) any emphasis-of-matter paragraph(s).

   2) Examples of other matters include the accountant’s responsibility for (1) supplementary information included by management or (2) reporting on a regulatory requirement applying to the client.
14. **Ability to Continue as a Going Concern**

   a. During the review, evidence or information may come to the accountant’s attention indicating an **uncertainty** about the entity’s ability to continue as a going concern for a reasonable period of time. (The period specified by U.S. GAAP is 1 year from the date the statements are issued or are available to be issued.)

   1) If an uncertainty exists about an entity’s ability to continue as a going concern, the accountant should request that management consider the **possible effects** on the statements, including the need for disclosure.

   2) After management communicates the results of its consideration of the possible effects, the accountant should consider the reasonableness of the conclusions, including the adequacy of disclosure.

   a) If the accountant determines that (1) management’s conclusions are adequate and (2) the going concern uncertainty is appropriately presented and disclosed, (s)he may, but is **not** required, to include an **emphasis-of-matter** paragraph in the review report.

   3) The accountant may determine that (a) management’s conclusions are unreasonable or (b) its disclosure is **not** adequate. These determinations should be included in a **Known Departures From the Reporting Framework** section of the report.

15. **Subsequent Events**

   a. Subsequent events occur between the date of the financial statements and the date of the review report.

   b. The accountant may identify evidence or information of a subsequent event that requires adjustment of, or disclosure in, the statements. The accountant then should request that management consider whether the subsequent event is appropriately reflected in the statements in accordance with the reporting framework.

   c. The accountant may determine that the subsequent event is **not** adequately accounted for or disclosed. These determinations should be included in a **Known Departures From the Reporting Framework** section of the report.

16. **Subsequently Discovered Facts**

   a. Subsequently discovered facts (1) become known to the accountant after the date of the review report and (2) might have caused a revision of the report if they had been known at that date.

   b. The accountant is **not** required to perform any procedures after the date of the report.

   c. However, if a subsequently discovered fact becomes known to the accountant **before the report release date**, (s)he should (1) discuss the matter with management and, when appropriate, those charged with governance and (2) determine whether the statements need revision and, if so, inquire how management intends to address the matter in the statements.

   1) If management **revises** the statements, the accountant should perform the necessary procedures on the revision.

   a) The accountant also should either (1) date the review report as of a later date or (2) include an additional date in the report on the revised statements that is limited to the revision (dual-date the report).

   b) **Dual-dating** indicates that the review procedures subsequent to the original date of the report are limited solely to the revision described in the relevant note to the statements.

   2) If management does **not revise** the statements when the accountant believes they should be revised, (s)he should modify the report as appropriate or consider withdrawal from the engagement.
d. A subsequently discovered fact may become known to the accountant after the report release date.
   1) The accountant should (a) discuss the matter with management and, when appropriate, those charged with governance and (b) determine whether the statements need revision and, if so, inquire how management intends to address the matter.
   2) If management does not take the appropriate action, the accountant should ensure that users do not rely on the accountant’s report. For example, (s)he might notify users.

17. Supplementary Information Accompanying the Statements
   a. Supplementary information, other than that required, is (1) presented outside the basic financial statements and (2) not considered necessary for fair presentation in accordance with the reporting framework.
   b. The accountant should clearly indicate the degree of responsibility, if any, (s)he is taking with respect to such information in either (1) an other-matter paragraph in the report on the statements or (2) a separate report on the supplementary information.
   c. If the accountant has reviewed the financial statements and the supplementary information, the other-matter paragraph or the separate report should state that
      1) The information is presented for additional analysis and is not required.
      2) The information is the representation of management.
      3) The accountant has reviewed the information.
         a) The accountant also should state, based on the review, whether (s)he can provide limited assurance.
      4) The accountant has not audited the information and does not express an opinion on it.
   d. If the accountant has reviewed the statements but not the supplementary information, the other-matter paragraph or the separate report should state that
      1) The information is presented for additional analysis and is not required;
      2) The information is the representation of management; and
      3) The accountant has not audited or reviewed the information and does not express an opinion or a conclusion or provide any assurance on it.

18. Required Supplementary Information (RSI)
   a. RSI is required by a designated accounting standards setter to accompany basic financial statements.
   b. RSI is not part of those statements, but a designated standards setter considers it essential to place the statements in an appropriate operational, economic, or historical context. Also, authoritative guidelines for its measurement and presentation have been established. (An example is reserve information for oil and gas producers.)
   c. The accountant should include an other-matter paragraph regarding RSI in the review report to explain one or more of the following, if applicable:
      1) RSI is included and was compiled or reviewed by the accountant.
      2) RSI is included and was not compiled, reviewed, or audited by the accountant.
      3) Some or all of the RSI is omitted.
      4) The accountant has identified departures from the prescribed guidelines.
      5) The accountant has unresolved doubts about whether the RSI is presented in accordance with prescribed guidelines.
19. **Review Documentation**

a. Review documentation is the record of (1) review procedures performed, (2) relevant review evidence obtained, and (3) conclusions reached. (Other terms sometimes used are working papers or workpapers.)

b. The accountant should prepare documentation that suffices to enable an experienced accountant, having no previous connection to the review, to understand

1) The nature, timing, and extent of the procedures performed to comply with SSARSs;
2) The results of the procedures performed and the evidence obtained; and
3) Significant findings or issues arising during the review, the conclusions reached, and significant professional judgments made in reaching those conclusions.

c. In addition, review documentation should include the following:

1) The engagement letter or other suitable form of written agreement with management
2) Communications to management and others about fraud or noncompliance with laws and regulations
3) Communications with management about the accountant’s expectation to include an emphasis-of-matter or other-matter paragraph in the report
4) Communications with other accountants that have audited or reviewed the statements
5) The representation letter
6) A copy of the reviewed statements and the accountant’s review report

20. **Change in Engagement From Audit to Review**

a. An accountant engaged to audit the statements of a nonissuer may be requested to change the engagement to a review.

1) The request may result from (a) a change in circumstances affecting the entity’s need for an audit, (b) a misunderstanding about the nature of an audit or review, or (c) a restriction on the scope of the audit.

2) Before an accountant engaged to perform an audit in accordance with GAAS agrees to change the engagement to a review, at least the following should be considered:

   a) The reason given for the request, especially the implications of a restriction on the scope of the engagement, whether imposed by management or by circumstances

   b) The additional audit effort required to complete the audit

   c) The estimated additional cost to complete the audit

b. In all circumstances, if audit procedures are substantially complete, or the cost to complete the procedures is relatively insignificant, the accountant should **consider** the propriety of a change in the engagement.

c. If the accountant (1) concludes that the change is reasonably justified and (2) complies with the standards applicable to a review, (s)he should issue an appropriate review report. The report should **not** refer to

1) The original engagement,
2) Any audit procedures that may have been performed, or
3) Scope limitations that resulted in the change.

d. If (1) the original engagement was to perform an audit and (2) management refused to allow the accountant to correspond with the entity’s legal counsel, the accountant, except in rare circumstances, is precluded from accepting a review engagement.
21. **Reference to the Work of Other Accountants**
   a. Other accountants may have audited or reviewed the statements of significant components (e.g., subsidiaries). If the reporting accountant decides not to assume responsibility for the audit or review, (s)he should indicate in the review report (1) that the work was used and (2) the magnitude of the portion of the statements audited or reviewed by other auditors.
   b. Whether or not reference is made, the reporting accountant should communicate with the other accountants to determine that
      1) They are aware of the use of their work, and
      2) They are familiar with the reporting framework and applicable standards.

22. **Reporting when One Period is Audited**
   a. When the prior period statements were audited and the auditor’s report is not reissued, the review report on the current statements should include an other-matter paragraph indicating
      1) That the statements of the prior period were audited;
      2) The date of the auditor’s report;
      3) The type of opinion expressed;
      4) The substantive reasons for any modification of opinion; and
      5) That no auditing procedures were performed after the date of the previous report.

23. **Restricted Use of the Report**
   a. When the accountant concludes that the financial information reported on is suitable only for a limited set of users, the report should contain a separate paragraph that restricts the use of the report to those users.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 16 though 23 beginning on page 624.
QUESTIONS

19.1 General Principles for SSARSs Engagements (AR-C 60)

1. Statements on Standards for Accounting and Review Services (SSARSs) require an accountant to report when the accountant has

   A. Photocopied client-prepared financial statements, without modification, as an accommodation to the client.
   B. Provided a client with a financial statement format that does not include monetary amounts, to be used by the client in preparing financial statements.
   C. Proposed correcting journal entries to be recorded by the client that change client-prepared financial statements.
   D. Compiled, through the use of computer software, financial statements to be used by third parties.

   Answer (D) is correct.

   REQUIRED: The situation in which an accountant must issue a report.

   DISCUSSION: Unlike a preparation, compilations and reviews require an accountant’s report.

   Answer (A) is incorrect. Typing or reproducing client-prepared financial statements, without modification, as an accommodation to a client does not constitute a SSARSs service. Answer (B) is incorrect. Without monetary amounts, the presentation is not a financial statement. Answer (C) is incorrect. Journal entries are not a financial statement.

2. May an accountant accept an engagement to compile or review the financial statements of a not-for-profit entity if the accountant is unfamiliar with the specialized industry accounting principles but plans to obtain the required level of knowledge before compiling or reviewing the financial statements?

   Answer (D) is correct.

   REQUIRED: The ability of an accountant to accept an engagement without the required level of knowledge.

   DISCUSSION: The accountant may accept a compilation or review engagement for an entity in an industry with which the accountant has no previous experience. However, (s)he has a responsibility to obtain the required level of knowledge prior to completing the engagement.

<table>
<thead>
<tr>
<th>Compilation</th>
<th>Review</th>
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<tbody>
<tr>
<td>A. No</td>
<td>No</td>
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<tr>
<td>B. Yes</td>
<td>No</td>
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<tr>
<td>C. No</td>
<td>Yes</td>
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<tr>
<td>D. Yes</td>
<td>Yes</td>
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3. SSARSs are primarily useful for the preparation, compilation, and review of financial statements for

   A. Issuers.
   B. Companies that report to the SEC.
   C. Private companies.

   Answer (C) is correct.

   REQUIRED: The clients for SSARSs services.

   DISCUSSION: SSARSs describe the standards for preparation, compilation, and review of financial statements for nonissuers (private companies).

   Answer (A) is incorrect. Issuers (public companies) require audits and are subject to the auditing standards. Answer (B) is incorrect. Companies that report to the SEC are issuers that require audits and are subject to the auditing standards.

   Answer (D) is incorrect. Companies subject to the Securities Exchange Act of 1934 (issuers or public companies) require audits and are subject to the auditing standards.

4. A CPA firm providing SSARSs services is required to have

   A. An appropriate internal control system.
   B. The same financial reporting framework as the client.
   C. A system of financial checks and balances.
   D. An effective quality control system.

   Answer (D) is correct.

   REQUIRED: The condition for providing SSARSs services.

   DISCUSSION: The CPA firm is required to have an effective quality control system. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that the firm’s policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively.

   Answer (A) is incorrect. A CPA firm is not required to have an appropriate internal control system to provide accounting and review services. Answer (B) is incorrect. The requirement is that management use an acceptable financial reporting framework. Answer (C) is incorrect. The use of checks and balances may be part of a quality control system, but it is not a requirement.
5. In a SSARSs engagement, the accountant is responsible for selecting the

<table>
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<tr>
<th>Financial Reporting Framework</th>
<th>Procedures to be Applied in the Engagement</th>
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<tbody>
<tr>
<td>A. No</td>
<td>No</td>
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<tr>
<td>B. Yes</td>
<td>No</td>
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<tr>
<td>C. No</td>
<td>Yes</td>
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<tr>
<td>D. Yes</td>
<td>Yes</td>
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Answer (C) is correct.

REQUIRED: The responsibility of an accountant in a SSARSs engagement.

DISCUSSION: Management is responsible for selecting the financial reporting framework. The accountant is responsible for (1) determining whether the framework is acceptable and (2) selecting the procedures used in the engagement. Answer (B) is incorrect. The accountant is responsible for selecting the procedures used in the engagement. Answer (D) is incorrect. Management is responsible for selecting the financial reporting framework, and the accountant is responsible for selecting the procedures used in the engagement. Answer (D) is incorrect. Management is responsible for selecting the financial reporting framework, and the accountant is responsible for determining whether the framework selected is acceptable.

6. The cash basis of accounting is commonly known as an other comprehensive basis of accounting (OCBOA). The term for an OCBOA used in SSARSs is

A. GAAP.
B. A governmental basis.
C. Little GAAP.
D. A special purpose framework.

Answer (D) is correct.

REQUIRED: The term for an OCBOA used in SSARSs.

DISCUSSION: The cash basis is a special purpose framework. It is (1) a basis used to record cash receipts and disbursements or (2) a modification of the cash basis having substantial support.

Answer (A) is incorrect. GAAP apply to audits. Answer (B) is incorrect. Special purpose frameworks include (1) the cash basis, (2) the tax basis, (3) a regulatory (governmental) basis, (4) a contractual basis, and (5) an other basis. The unofficial generic term for special purpose frameworks is OCBOAs, not a governmental basis. Answer (C) is incorrect. Little GAAP apply to audits.

7. Which of the following is a true statement about preparing financial statements in accordance with SSARSs?

A. The accountant must be independent.
B. The accountant’s name must appear on the financial statements.
C. The financial framework must be GAAP.
D. Management must accept responsibility for the financial statements.

Answer (D) is correct.

REQUIRED: The true statement about preparing financial statements under SSARSs.

DISCUSSION: Management is responsible for (1) selection of the reporting framework, (2) internal control over financial reporting, (3) prevention and detection of fraud, (4) ensuring compliance with laws and regulations, and (5) maintaining accurate and complete information. Thus, management must accept responsibility for the financial statements.

Answer (A) is incorrect. The accountant need not be independent of the entity, and no disclosure is made if independence is lacking. Answer (B) is incorrect. AR-C 70 does not require an accountant’s name to be identified or associated with the financial statements. But it also does not prohibit the identification of the accountant if a disclaimer is included with the financial statements. Answer (C) is incorrect. The statements may be prepared using any acceptable financial reporting framework.

8. In accordance with SSARSs, which of the following is an accurate comparison of a preparation service with a compilation service?

A. Both services require a full set of notes to be presented with the financial statements.
B. Only a compilation service requires an engagement letter.
C. Both services allow the financial statements to be released to outside users.
D. Both services require a report to be presented by the accountant.

Answer (C) is correct.

REQUIRED: The accurate comparison of a preparation service with a compilation service.

DISCUSSION: SSARSs allows release of financial statements for a preparation, compilation, or review service. Answer (A) is incorrect. Neither a preparation nor a compilation requires management to present appropriate note disclosures. Answer (B) is incorrect. All SSARSs engagements require the accountant to obtain an engagement letter or other suitable form of written agreement. Answer (D) is incorrect. The preparation service does not require the accountant to present a report.
9. An accountant may complete an engagement to prepare financial statements under SSARSs even if
   A. The accountant lacks professional competence.
   B. Management uses an unacceptable financial reporting framework.
   C. Management does not accept responsibility for the financial statements.
   D. The accountant is not independent.
   
   Answer (D) is correct.
   
   **REQUIRED:** The item not a condition for accepting a preparation engagement.
   
   **DISCUSSION:** The accountant need not (1) be independent or (2) determine whether (s)he is independent to prepare financial statements under SSARSs.

   Answer (A) is incorrect. The accountant must have or be able to obtain professional competence to complete the engagement.

   Answer (B) is incorrect. The accountant must determine whether management has selected an acceptable financial reporting framework.

   Answer (C) is incorrect. The accountant must obtain management's agreement that it acknowledges and understands its responsibilities for the financial statements.

10. Which of the following is a true statement about a report on a preparation of financial statements under SSARSs?
   A. The report must state whether the accountant is independent.
   B. The report must state whether any material fraud was detected.
   C. The report must state any reservations the accountant experienced during the engagement.
   D. No report is presented for a preparation engagement.
   
   Answer (D) is correct.
   
   **REQUIRED:** The true statement about reporting on a preparation service.
   
   **DISCUSSION:** An engagement to compile, review, or audit financial statements requires a report by the accountant or auditor. A preparation engagement does not result in a report presented by the accountant.

   Answer (A) is incorrect. A preparation engagement does not require even a determination of independence.

   Answer (B) is incorrect. A preparation engagement does not result in a report.

   Answer (C) is incorrect. A preparation engagement does not result in a report presented by the accountant.

11. An accountant may prepare financial statements that exclude substantially all disclosures unless
   A. The notes are important to understanding the financial statements.
   B. The purpose is to mislead users.
   C. The notes describe significant related party transactions.
   D. The accountant believes that the notes help the users interpret the financial statements.
   
   Answer (B) is correct.
   
   **REQUIRED:** The reason for not performing a preparation service when the financial statements omit all disclosures.
   
   **DISCUSSION:** Disclosures may be excluded unless the purpose is to mislead users. But the accountant still must disclose the omission in the financial statements.

   Answer (A) is incorrect. Disclosures almost always are important to understanding financial statements. However, they may be excluded unless the purpose is to mislead users.

   Answer (C) is incorrect. Disclosures almost always are important to understanding financial statements, including transactions with related parties. However, notes may be excluded unless the purpose is to mislead users.

   Answer (D) is incorrect. Disclosures may be excluded unless the purpose is to mislead users.

12. In a preparation engagement, the financial statements should include a statement such as
   A. “No assurance is provided.”
   B. “Use at your own risk.”
   C. “No accountant’s report is presented.”
   D. “For management’s use only.”
   
   Answer (A) is correct.
   
   **REQUIRED:** The statement in the financial statements when a preparation engagement is performed.
   
   **DISCUSSION:** A notation on each page (including notes) of financial statements prepared by an accountant should state, “No assurance is provided.” The statement is intended to avoid misunderstanding of the accountant’s involvement.

   Answer (B) is incorrect. The financial statements should state, “No assurance is provided.” Answer (C) is incorrect. A preparation service does not result in an accountant’s report. But the lack of a report is not noted on the statements. Answer (D) is incorrect. Prepared financial statements may be released to users other than management.
19.3 Compilation of Financial Statements (AR-C 80)

13. Compiled financial statements of a nonissuer intended for third-party use should be accompanied by a report stating that

A. The scope of the accountant’s procedures has not been restricted in testing the financial information that is the representation of management.

B. The accountant assessed the accounting principles used and significant estimates made by management.

C. The accountant does not express an opinion or any other form of assurance on the financial statements.

D. A compilation consists principally of inquiries of entity personnel and analytical procedures applied to financial data.

Answer (C) is correct.

REQUIRED: The language included in a compilation report.

DISCUSSION: A compilation report contains a disclaimer stating that the accountant has not audited or reviewed the financial statements and does not express an opinion or any other form of assurance on them.

Answer (A) is incorrect. A compilation does not entail testing the financial information. Answer (B) is incorrect. A financial statement audit, not a compilation, involves assessing the accounting principles used and the estimates made by management. Answer (D) is incorrect. A review, not a compilation, consists principally of inquiries and analytical procedures.

14. When compiling a nonissuer’s financial statements, an accountant is least likely to

A. Perform analytical procedures designed to identify relationships that appear to be unusual.

B. Read the compiled financial statements and consider whether they appear to include adequate disclosure.

C. Omit substantially all of the disclosures required by generally accepted accounting principles.

D. Issue a compilation report on one or more, but not all, of the basic financial statements.

Answer (A) is correct.

REQUIRED: The procedure least likely to be performed in a compilation.

DISCUSSION: In a compilation engagement, the accountant is not required to make inquiries or perform analytical or other procedures to verify, corroborate, or review information supplied by the entity. However, analytical procedures are necessary in review and audit engagements.

Answer (B) is incorrect. The accountant should read the compiled statements and consider whether they are free from obvious material errors, including inadequate disclosure. Answer (C) is incorrect. A compilation may omit substantially all disclosures required by the applicable reporting framework, provided the omission is clearly indicated in the report and, to the accountant’s knowledge, is not done to mislead. Answer (D) is incorrect. An accountant may issue a compilation report on one or more, but not all, of the basic financial statements.

15. Miller, CPA, is engaged to compile the financial statements of Web Co., a nonissuer, in conformity with the income tax basis of accounting. If Web’s financial statements do not disclose the basis of accounting used, Miller should

A. Disclose the basis of accounting in the accountant’s compilation report.

B. Clearly label each page “Distribution Restricted--Material Modifications Required.”

C. Issue a special report describing the effect of the incomplete presentation.

D. Withdraw from the engagement and provide no further services to Web.

Answer (A) is correct.

REQUIRED: The effect on a compilation report of failure to disclose the basis of accounting used.

DISCUSSION: Although the accountant is expected to perform no procedures, if (s)he is aware of misapplications of GAAP or the absence of required disclosures, (s)he should disclose that information in the compilation report.

Answer (B) is incorrect. Each page of the financial statements may contain the statement, “See Accountant’s Compilation Report.” Answer (C) is incorrect. A special report is issued in conjunction with an audit. Answer (D) is incorrect. The accountant need not withdraw from the engagement.
19.4 Review of the Financial Statements (AR-C 90)

16. Which of the following should be the first step in reviewing the financial statements of a nonissuer?

A. Comparing the financial statements with statements for comparable prior periods and with anticipated results.
B. Completing a series of inquiries concerning the entity’s procedures for recording, classifying, and summarizing transactions.
C. Obtaining a general understanding of the entity’s organization, its operating characteristics, and its products or services.
D. Applying analytical procedures designed to identify relationships and individual items that appear to be unusual.

Answer (C) is correct.

REQUIRED: The first step in reviewing the financial statements of a nonissuer.

DISCUSSION: In a review, the auditor expresses limited assurance concerning the financial statements. In performing the review, the auditor should first obtain an understanding of the entity and the entity’s industry. This will provide a foundation for completing the review.

Answer (A) is incorrect. Comparing the financial statement with statements for comparable prior periods and with anticipated results is an analytical procedure, which is performed after obtaining an understanding of the business. Answer (B) is incorrect. Completing a series of inquiries concerning the entity’s procedures for recording, classifying, and summarizing transactions is performed after obtaining an understanding of the entity’s business. Answer (D) is incorrect. Applying analytical procedures designed to identify relationships and individual items that appear to be unusual is done after obtaining an understanding of the business.

17. Which of the following procedures should an accountant perform during an engagement to review the financial statements of a nonissuer?

A. Communicating control deficiencies discovered during the assessment of control risk.
B. Obtaining a client representation letter from members of management.
C. Sending bank confirmation letters to the entity’s financial institutions.
D. Examining cash disbursements in the subsequent period for unrecorded liabilities.

Answer (B) is correct.

REQUIRED: The procedure performed during an engagement to review the financial statements of a nonissuer.

DISCUSSION: A review primarily consists of inquiries, analytical procedures, and management representations. In addition, the accountant must obtain a sufficient knowledge of the accounting principles and practices of the entity’s industry and an understanding of the entity’s business. The representations from management should encompass all statements and periods to be covered by the report. The representation letter should be signed by the current managers (usually the CEO and CFO or the equivalent) responsible for, and knowledgeable about, the matters covered (AR-C 90).

Answer (A) is incorrect. Significant deficiencies and material weaknesses must be communicated in an audit, not a review. Answer (C) is incorrect. Confirmations to financial institutions are normally sent in an audit, not a review. Answer (D) is incorrect. Tests of details, e.g., tests of subsequent payments, are performed in an audit, not a review.

18. Each page of a nonissuer’s financial statements reviewed by an accountant should include the following reference:

A. See Accountant’s Review Report.
B. Reviewed, No Accountant’s Assurance Expressed.
C. See Accompanying Accountant’s Notes.
D. Reviewed, No Material Modifications Required.

Answer (A) is correct.

REQUIRED: The reference on each page of a nonissuer’s financial statements reviewed by an accountant.

DISCUSSION: Each page should include a reference such as “See Accountant’s Review Report” (AR-C 90).

Answer (B) is incorrect. A review report ordinarily expresses limited assurance. Answer (C) is incorrect. Notes are part of the financial statements, not the accountant’s report. Answer (D) is incorrect. The review report states that the accountant is not aware of any modifications that should be made other than those indicated in the report.

19. Moore, CPA, has been asked to issue a review report on the balance sheet of Dover Co., a nonissuer. Moore will not be reporting on Dover’s statements of income, retained earnings, and cash flows. Moore may issue the review report provided the

A. Balance sheet is presented in a prescribed form of an industry trade association.
B. Scope of the inquiry and analytical procedures has not been restricted.
C. Balance sheet is not to be used to obtain credit or distributed to creditors.
D. Specialized accounting principles and practices of Dover’s industry are disclosed.

Answer (B) is correct.

REQUIRED: The condition under which an accountant may issue a report on one or more of the financial statements and not on the others. This form of reporting is not considered a limitation on scope but a limited reporting engagement. However, the accountant must not be restricted in the procedures to be applied, which, in a review, consist primarily of inquiries and analytical procedures.

Answer (A) is incorrect. The decision is independent of whether the balance sheet is to be presented in a prescribed form. Answer (C) is incorrect. A reviewed financial statement may be used for any appropriate purpose. Answer (D) is incorrect. A review report may be issued on a comprehensive basis of accounting other than GAAP. The specialized principles, however, need not be disclosed.
20. Financial statements of a nonissuer that have been reviewed by an accountant should be accompanied by a report stating that a review

A. Provides only limited assurance that the financial statements are fairly presented.
B. Includes examining, on a test basis, information that is the representation of management.
C. Includes primarily applying analytical procedures to management’s financial data and making inquiries of company management.
D. Does not contemplate obtaining corroborating evidential matter or applying certain other procedures ordinarily performed during an audit.

Answer (C) is correct.

REQUIRED: The statement included in the review report.

DISCUSSION: The first paragraph of the review report contains a sentence stating, “A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management.”

Answer (A) is incorrect. The report states that the accountant is not aware of material modifications that should be made to the financial statements for them to be in conformity with GAAP.

Answer (B) is incorrect. A review engagement does not include examining information that is the representation of management.

Answer (D) is incorrect. The report does not contain an explicit description of the difference between an audit and a review.

21. During an engagement to review the financial statements of a nonissuer, an accountant becomes aware that several leases that should be capitalized are not capitalized. The accountant considers these leases to be material to the financial statements. The accountant decides to modify the standard review report because management will not capitalize the leases. Under these circumstances, the accountant should

A. Express an adverse opinion because of the departure from GAAP.
B. Express no assurance of any kind on the entity’s financial statements.
C. Emphasize that the financial statements are for limited use only.
D. Disclose the departure from GAAP in a separate paragraph of the accountant’s report.

Answer (D) is correct.

REQUIRED: The modification of a review report for a departure from GAAP.

DISCUSSION: When a departure from GAAP precludes an unmodified review report, and modification of the standard report is sufficient to disclose the departure, the accountant should add an additional paragraph to the report disclosing the departure, including its effects on the financial statements if they have been determined by management or are known as the result of the accountant’s procedures. The paragraph should have a heading such as “Known Departure From Accounting Principles Generally Accepted in the United States of America.”

Answer (A) is incorrect. Unless an audit has been conducted, an opinion may not be expressed. If modification of the report is not adequate to indicate the deficiencies, the auditor should withdraw from the engagement. Answer (B) is incorrect. The accountant provides limited assurance in a review report.

Answer (C) is incorrect. A review report need not be limited in distribution.

22. Gole, CPA, is engaged to review the Year 2 financial statements of North Co., a nonissuer. Previously, Gole audited North’s Year 1 financial statements and expressed an unmodified opinion. Gole decides to include a separate paragraph in the Year 2 review report because North plans to present comparative financial statements for Year 2 and Year 1. This separate paragraph should indicate that

A. The Year 2 review report is intended solely for the information of management and the board of directors.
B. The Year 1 auditor’s report may no longer be relied on.
C. No auditing procedures were performed after the date of the Year 1 auditor’s report.
D. There are justifiable reasons for changing the level of service from an audit to a review.

Answer (C) is correct.

REQUIRED: The reference in a separate paragraph in a review report when comparative statements are presented and an audit was performed in the previous year.

DISCUSSION: A continuing accountant who performs a lower level of service should include a separate paragraph describing the responsibility assumed for the financial statements of the prior period or reissue the previous report. The paragraph included in the review report should indicate that no auditing procedures were performed after the date of the original auditor’s report.

Answer (A) is incorrect. A review report may be distributed to any user. Answer (B) is incorrect. The previous auditor’s report may still be relied upon. Answer (D) is incorrect. No mention of the reasons for the change of service should be made in the review report.
23. An accountant's standard report on a review of the financial statements of a nonissuer should state that the accountant

A. Does not express an opinion or any form of limited assurance on the financial statements.
B. Is not aware of any material modifications that should be made to the financial statements for them to conform with GAAP.
C. Obtained reasonable assurance about whether the financial statements are free of material misstatement.
D. Examined evidence, on a test basis, supporting the amounts and disclosures in the financial statements.

Answer (B) is correct. 

REQUIRED: The statement in a review report.

DISCUSSION: The review report states, "Based on my review, I am not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America" (AR-C 90).

Answer (A) is incorrect. A review provides limited assurance. Answer (C) is incorrect. An audit provides reasonable assurance about whether the financial statements are free of material misstatement. Answer (D) is incorrect. An audit involves gathering sufficient appropriate evidence to support the amounts and disclosures in the financial statements.
The following draft of a review engagement report has been submitted by a staff member to the manager for review. The table below contains the comments by the manager about the draft. Indicate by selecting from the list provided whether the original draft is correct, the audit manager’s comment is correct, or neither is correct.

We have reviewed the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, Year 1, and the related statements of income, changes in stockholder’s equity, and cash flows for the year then ended. A review includes primarily making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management’s Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant’s Responsibility
Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Auditing Standards Board. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. We believe that the results of our procedures provide a reasonable basis for our conclusion.

Accountant’s Conclusion
Based on our examination, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

<table>
<thead>
<tr>
<th>Manager’s Comments</th>
<th>Answer</th>
<th>Choices</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The report should not refer to the statement of cash flows because a nonissuer does not prepare this statement.</td>
<td></td>
<td>A) The original draft is correct.</td>
</tr>
<tr>
<td>2. The second sentence in the first paragraph also should refer to analytical procedures.</td>
<td></td>
<td>B) The manager’s comment is correct.</td>
</tr>
<tr>
<td>3. The third sentence in the first paragraph should state that the review is “substantially greater in scope . . .”</td>
<td></td>
<td>C) Neither the original draft nor the manager’s comment is correct.</td>
</tr>
<tr>
<td>4. The last sentence in the first paragraph should be deleted.</td>
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<tr>
<td>5. The second paragraph should state that the CPA is responsible for the preparation of the fair presentation of the financial statements.</td>
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<tr>
<td>6. The first sentence in the third paragraph should state that the accounting and review standards are established by the federal government.</td>
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<tr>
<td>7. The fourth paragraph should state, “Based on our study . . .” rather than “Based on our examination . . .”</td>
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<td></td>
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<tr>
<td>8. The fourth paragraph should state, “in accordance with auditing principles” rather than “in accordance with accounting principles.”</td>
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</tbody>
</table>
Jenny Rowland, CPA, is not independent of her client in a compilation engagement. Which section of the professional standards best states how the lack of independence should be disclosed in the report?

<table>
<thead>
<tr>
<th>Title</th>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>AU-C</td>
<td>PCAOB</td>
<td>AT</td>
</tr>
<tr>
<td>CS</td>
<td>QC</td>
<td>PR</td>
</tr>
<tr>
<td>AR-C</td>
<td>ET</td>
<td>BL</td>
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<td></td>
<td>PFP</td>
<td>CPE</td>
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</tbody>
</table>

Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, Year 1, and expressed an unmodified opinion. For the year ended December 31, Year 2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech’s Year 2 financial statements and Kent, an assistant on the engagement, drafted the accountants’ review report below. Land, the engagement supervisor, decided not to reissue the prior year’s auditor’s report.

Land reviewed Kent’s draft presented below and indicated in the Supervisor’s Noted Deficiencies below that 13 deficiencies were in Kent’s draft.

We have reviewed and audited the accompanying balance sheets of Tech Co. as of December 31, Year 1 and Year 2, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and full presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Accountant’s Responsibility

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain significant assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our conclusion.

Accountant’s Conclusion

Based on our study, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America. Because of inherent limitations in a review engagement, this report is intended for the information of management and should not be used for any other purpose.

Other Matter

The financial statements for the year ended December 31, Year 1, were audited by us, and our report was dated March 2, Year 2. We have no responsibility for updating that report for events and circumstances occurring after that date.

Jordan and Stone, CPAs
Anytown, Anystate
March 1, Year 3

For each noted deficiency, indicate whether Kent’s draft is correct, Land’s noted deficiency is correct, or neither Kent’s draft nor Land’s noted deficiency is correct. Each item in the answer list may be used once, more than once, or not at all.

-- Continued on next page --
### Supervisor's Noted Deficiencies

<table>
<thead>
<tr>
<th></th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>The reference to the prior year’s audited financial statements should be in a separate paragraph.</td>
</tr>
<tr>
<td>2.</td>
<td>All the current-year basic financial statements are not properly identified in the first (introductory) paragraph.</td>
</tr>
<tr>
<td>3.</td>
<td>The first paragraph should state that a review includes primarily applying analytical procedures to management's financial data and making inquiries of company management.</td>
</tr>
<tr>
<td>4.</td>
<td>In the second paragraph, “full presentation” should be replaced with “accurate presentation.”</td>
</tr>
<tr>
<td>5.</td>
<td>The reference should be to the PCAOB, not the American Institute of Certified Public Accountants in the third paragraph.</td>
</tr>
<tr>
<td>6.</td>
<td>The phrase “to obtain significant assurance” in the third paragraph should be replaced with “to obtain limited assurance.”</td>
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<tr>
<td>7.</td>
<td>The last sentence in the third paragraph that begins, “We believe that the results . . .” should be deleted.</td>
</tr>
<tr>
<td>8.</td>
<td>The fourth paragraph should begin, “Based on our evidence . . .”</td>
</tr>
<tr>
<td>9.</td>
<td>No restriction on the distribution of the accountant’s review report should be included in the fourth paragraph.</td>
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<tr>
<td>10.</td>
<td>The reference should be “material misstatements,” not to “material modifications” in the fourth paragraph.</td>
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<tr>
<td>11.</td>
<td>An indication of the type of opinion expressed on the prior year’s audited financial statements should be included in a separate paragraph.</td>
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<tr>
<td>12.</td>
<td>An indication that no auditing procedures were performed after the date of the report on the prior year’s financial statements should be included in a separate paragraph.</td>
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<tr>
<td>13.</td>
<td>No reference to “updating that report for events and circumstances occurring after that date” should be included in the fourth (separate) paragraph.</td>
</tr>
</tbody>
</table>

### Choices

- A) Kent’s draft is correct.  
- B) Land’s noted deficiency is correct.  
- C) Neither Kent’s draft nor Land’s noted deficiency is correct.
Items 1 through 12 state unrelated activities that an accountant may consider undertaking in separate engagements to
(1) review the financial statements of a nonissuer (a review), (2) compile the financial statements of a nonissuer
(a compilation), and (3) prepare the financial statements of a nonissuer (a preparation). Indicate whether each activity is
contemplated for a review, compilation, and preparation. Make three selections for each item.

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Review A or B</th>
<th>Compilation A or B</th>
<th>Preparation A or B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The accountant establishes an understanding with the entity about the nature and limitations of the services to be performed.</td>
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<tr>
<td>2. The accountant issues a report.</td>
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<tr>
<td>3. The accountant obtains a level of knowledge of the accounting principles and practices of the entity.</td>
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<tr>
<td>4. The accountant assesses fraud risk.</td>
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<tr>
<td>5. The accountant performs analytical procedures designed to identify relationships that appear to be unusual.</td>
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<tr>
<td>6. The accountant obtains an understanding of internal control.</td>
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<tr>
<td>7. The accountant sends a letter of inquiry to the entity’s legal counsel to corroborate the information furnished by management concerning litigation.</td>
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<tr>
<td>8. The accountant obtains written representations from management of the entity.</td>
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<tr>
<td>9. The accountant communicates to the entity’s senior management illegal employee acts discovered by the accountant that are clearly inconsequential.</td>
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<tr>
<td>10. The accountant makes inquiries about events subsequent to the date of the financial statements that have a material effect on the financial statements.</td>
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<tr>
<td>11. The accountant modifies the accountant’s report for a change in accounting principles that is adequately disclosed.</td>
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<tr>
<td>12. The accountant performs specific procedures to evaluate whether substantial doubt exists about the entity’s ability to continue as a going concern.</td>
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</tbody>
</table>

**Choices**

A) Procedure is contemplated.

B) Procedure is not contemplated.
The following report was drafted on October 25, Year 1, by Major, CPA, at the completion of the engagement to compile the financial statements of Ajax Company for the year ended September 30, Year 1. Ajax is a nonpublic entity in which Major’s child has a material direct financial interest. Ajax decided to omit substantially all of the disclosures required by GAAP because the financial statements will be for management’s use only. The statement of cash flows also was omitted because management does not believe it to be a useful financial statement.

Select from the list provided to indicate which items in Major’s report on the compiled financial statements contain a deficiency.

<table>
<thead>
<tr>
<th>Items</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Management is responsible for the accompanying financial statements of XYZ Company, . . .</td>
<td></td>
</tr>
<tr>
<td>2. . . . which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements . . .</td>
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<td>3. . . . in accordance with accounting principles generally accepted in the United States of America.</td>
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<tr>
<td>4. I have performed compilation engagements in accordance with Generally Accepted Auditing Standards promulgated by the Accounting and Review Services Committee of the AICPA.</td>
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<td>5. I did not audit or review the financial statements, and I was not required to perform any procedures to verify the accuracy or completeness of the information provided by management.</td>
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<td>6. Accordingly, I provide only limited assurance on these financial statements.</td>
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<td>7. Management has elected to omit substantially all of the disclosures (and the statement of cash flows) required by generally accepted accounting principles.</td>
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<tr>
<td>8. 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.</td>
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<tr>
<td>9. I am not independent with respect to Ajax Company.</td>
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<tr>
<td>10. This lack of independence is due to my child’s ownership of a material direct financial interest in Ajax Company.</td>
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</table>

**Choices**

- Deficient
- Not deficient
Unofficial Answers

1. **Review Report I** (8 Gradable Items)

1. **A)** The original draft is correct. A nonissuer is required to present a statement of cash flows, and the review report should refer to the statement.

2. **B)** The manager’s comment is correct. A review primarily includes applying analytical procedures to management’s financial data and making inquiries of management.

3. **A)** The original draft is correct. A review is less in scope as an audit.

4. **A)** The original draft is correct. A disclaimer is required.

5. **A)** The original draft is correct. Management is responsible for fair presentation.

6. **C)** Neither the original draft nor the manager’s comment is correct. The report should state that the SSARSs are issued by the American Institute of Certified Public Accountants.

7. **C)** Neither the original draft nor the manager’s comment is correct. The paragraph should begin, “Based on our review . . .”

8. **A)** The original draft is correct. The financial statements should be in accordance with U.S. GAAP.

2. **Research** (1 Gradable Item)

Answer: AR-C 80.22

AR-C 80 -- *Compilation of Financial Statements*

**Reporting when the Accountant is Not Independent**

.22 When the accountant is not independent with respect to the entity, the accountant should indicate the accountant’s lack of independence in a final paragraph of the accountant’s compilation report.

3. **Review Report II** (13 Gradable Items)

1. **B)** Land’s noted deficiency is correct. The prior-period statements were audited, and the report was not reissued. Thus, the current period’s report should include an other-matter paragraph indicating (1) that the prior-period statements were audited; (2) the date of the report on those statements; (3) the opinion expressed; (4) the substantive reasons for any modification of the opinion; and (5) that no audit procedures were performed after the date of the previous report.

2. **A)** Kent’s draft is correct. The basic financial statements are properly identified in the introductory paragraph.

3. **B)** Land’s noted deficiency is correct. The first paragraph describes, in general, the procedures performed in review.

4. **C)** Neither Kent’s draft nor Land’s noted deficiency is correct. The phase included in the report should be “fair presentation.”

5. **A)** Kent’s draft is correct. The identification of the applicable guidance should refer to the Accounting and Review Services Committee of the American Institute of Certified Public Accountants.

6. **B)** Land’s noted deficiency is correct. A review provides limited assurance.

7. **A)** Kent’s draft is correct. The statement, “We believe that the results of our procedures provide a reasonable basis for our conclusion.” should be included.

8. **C)** Neither Kent’s draft nor Land’s noted deficiency is correct. The fourth paragraph should begin, “Based on our review . . .”

9. **B)** Land’s noted deficiency is correct. A review report ordinarily is not limited regarding either its use or distribution. Exceptions are the use of measurement or disclosure criteria (1) suitable only for a limited number of users or (2) available only to specified parties.

10. **A)** Kent’s draft is correct. The report should refer to “material modifications” to the financial statements.

11. **B)** Land’s noted deficiency is correct. The opinion expressed on the audited financial statements should be described in the other-matter paragraph.

12. **B)** Land’s noted deficiency is correct. The paragraph describing the prior year’s audit should indicate that no auditing procedures were performed after the audit report date.

13. **B)** Land’s noted deficiency is correct. The review report should not refer to updating the prior-period report.
4. Reviews, Compilations, and Preparations (36 Gradable Items)

1. A) Procedure is contemplated; A) Procedure is contemplated; A) Procedure is contemplated. SSARSs require an accountant to establish an understanding with the entity about the nature and limitations of the services to be performed. The agreements should be documented in a suitable form of written agreement.

2. A) Procedure is contemplated; A) Procedure is contemplated; B) Procedure is not contemplated. A report is issued in a review or compilation engagement. No report is issued in a preparation engagement.

3. A) Procedure is contemplated; A) Procedure is contemplated; A) Procedure is contemplated. The accountant should obtain an understanding of the reporting framework and significant accounting policies intended to be used.

4. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. Auditors assess fraud risk, not accountants performing SSARSs engagements.

5. A) Procedure is contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. In performing review services, an accountant is required to apply analytical procedures to the financial statements, make inquiries of management, and obtain representations from management. In a compilation or preparation engagement, an accountant prepares the financial statements of an entity. No assurance is provided. Thus, analytical procedures are not required.

6. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. An auditor should obtain an understanding of internal control. Reviews, compilations, and preparations do not require the accountant to obtain an understanding of internal control.

7. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. During a review engagement, an accountant is required to obtain written representations from management but not to obtain corroborating evidence. Neither a compilation nor a preparation service involves corroboration of information supplied by management.

8. A) Procedure is contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. When performing a review of an entity’s financial statements, the accountant should obtain written representations from responsible and knowledgeable members of management (e.g., the CEO, the CFO, or the equivalent). However, neither a compilation nor a preparation service involves performing review procedures, for example, obtaining written representations from management.

9. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. The accountant should establish an understanding with the entity, in writing, regarding the services to be performed. The understanding should provide that the accountant will inform the appropriate level of management of any illegal acts that come to his or her attention, unless they are clearly inconsequential.

10. A) Procedure is contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. When performing a review, an accountant should make inquiries of members of management who have responsibility for financial and accounting matters related to the financial statements. The inquiries should be about, among other things, material events subsequent to the date of the statements. The accountant also may direct inquiries to others within the entity and those charged with governance.

11. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. Given proper disclosure, inconsistencies in the application of accounting principles ordinarily does not result in modification of the report for a review or compilation. No report is released for a preparation.

12. B) Procedure is not contemplated; B) Procedure is not contemplated; B) Procedure is not contemplated. SSARSs do not require the accountant to assess the entity’s ability to continue as a going concern. Nevertheless, in a review, the accountant should consider whether evidence or information came to his or her attention indicating that such an uncertainty exists.
5. **Compilation Report** (10 Gradable Items)

1. **Not deficient.** The report should state that management is responsible for the financial statements.
2. **Deficient.** The statement of cash flows is omitted.
3. **Not deficient.** The statement should include the origin of the accounting principles, e.g., the United States of America.
4. **Deficient.** The engagement should be performed in accordance with Statements on Standards for Accounting and Review Services. An audit should be performed in accordance with GAAS.
5. **Not deficient.** The report should state the nature of a compilation service.
6. **Deficient.** The report should state, “Accordingly, I do not express an opinion or a conclusion or provide any form of assurance on these financial statements.” A review provides limited assurance.
7. **Not deficient.** Assuming the omissions were not intended to mislead statement users, the accountant may report on the compilation engagement. But the report should include a separate paragraph regarding the omission.
8. **Not deficient.** If the omissions were not intended to mislead statement users, the report may state that the omissions might influence users’ conclusions.
9. **Not deficient.** In a compilation engagement, the accountant need not be independent but should determine whether (s)he is independent and disclose any lack of independence.
10. **Not deficient.** Nothing in AR-C 80 prevents the accountant from disclosing the reason for lack of independence.

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**Gleim Simulation Grading**

<table>
<thead>
<tr>
<th>Task</th>
<th>Correct Responses</th>
<th>Gradable Items</th>
<th>Score per Task</th>
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<tbody>
<tr>
<td>1</td>
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<td>8</td>
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Total of Scores per Task =

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\frac{\text{Total of Scores per Task}}{5} = \text{Total Score} \%
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Complete more Task-Based Simulations in your online course!