December 15, 2008

Mr. James M. Sylph
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International Federation of Accountants
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USA

By e-mail: reviewengagements@ifac.org

Consultation Paper: Matters to Consider in a Revision of International Standard on Review Engagements 2400, *Engagements to Review Financial Statements*

Dear Mr. Sylph:

The American Institute of Certified Public Accountants' (AICPA) Accounting and Review Services Committee (ARSC) is pleased to provide comments with respect to the above-referenced consultation paper. The ARSC is the senior technical committee of the AICPA designated to issue enforceable standards in connection with the unaudited financial statements or other unaudited financial information of a nonissuer.

We support the stated goal of the IAASB to consider "a relevant and cost-effective assurance service that is an alternative to an audit for small- and medium-sized entities in particular" and its efforts to revise ISRE 2400. Following are our responses to your requests for specific comments:

Moderate Level of Assurance and Engagement Risk

Question 1 – Is the concept of a 'moderate level of assurance' meaningful for practitioners?

The results of surveys conducted by the IAASB and in Canada mirror our experiences as we discuss the concept of 'moderate assurance' in the United States. We believe that the concepts of 'moderate assurance' and 'limited assurance' could be made more meaningful for practitioners if such concepts were defined and reconciled. Practitioners in the United States, and perhaps elsewhere, are familiar with the term 'limited assurance' with respect to a review engagement. Therefore, we urge the IAASB to be careful not to create a situation where 'moderate assurance' and 'limited assurance' are viewed as being different levels of assurance.

Question 2 – How should the practitioner determine what constitutes a moderate level of assurance for a review of financial statements?

We believe that 'moderate assurance' should be tied into the concepts of review risk and review evidence. Similar to how these concepts are expressed in the auditing literature, we believe that sufficient and appropriate review evidence should be obtained by a practitioner to restrict review risk to a moderate level. We further believe that such evidence can be obtained primarily through analytical procedures and inquiries. The extent and nature of review evidence necessary however will be a matter of professional judgment that will vary between engagements and practitioners just as the term 'high assurance' is a matter of professional judgment when describing the extent of audit evidence necessary to obtain reasonable or high assurance.

Question #3 – Should ISRE 2400 contain requirements and guidance to assist practitioner's judgments at the pre-acceptance stage as to whether a request to undertake a review of an entity's financial statements is:

(a) practicable; and

(b) appropriate, in the sense of being likely to meet the needs and expectations of the engaging party and those parties who are intended users of the report?

Generally, we believe that "pre-acceptance" requirements and guidance should be left to ISQC 1. However, there may be certain pre-acceptance guidance that should be discussed in a review standard; for example, an entity looking to "step down" to a review engagement when a scope limitation is imposed on the auditor. This form of guidance is currently included in Statements on Standards for Accounting and Review Services (SSARSs). A review should be a user's decision based on the cost versus the benefit (assurance being expressed).

<u>Conditions for Engagement Acceptance</u>

Question #4 – Should ISRE 2400 explicitly describe the respective obligations of the entity's management and those charged with governance, and of the practitioner performing the review of the entity's financial statements?

We believe that it would be beneficial if ISRE 2400 explicitly described the respective obligations of the entity (including management, owners, and those charged with governance) and the practitioner performing the review of the entity's financial statements. We believe that these premises are as applicable to a review as they are in an audit. However, unless such descriptions are included in a written engagement letter, they will only benefit the practitioner.

<u>Evidence to Support the Review Engagement Report</u>

Question #5 – To achieve the objective of a review engagement, what factors influence the practitioner's assessment of the work effort required to provide a reasonable basis for reporting the practitioner's conclusion(s) on the financial statements? To what extent are the illustrative detailed procedures contained in Appendix 2 to ISRE 2400 used in practice?

We believe that the concepts of risk are just as important in a review as they are in an audit. Accordingly, the primary factor is obtaining sufficient evidence to reduce review risk to a moderate level. However, the ARSC does not believe that the same level of risk assessment is needed for a review as compared to an audit. We believe that ordinarily review risk can be reduced to a moderate level through the performance of analytical procedures and inquiries.

The extent and nature of analytical procedures and inquiries should be based on a risk assessment that focuses primarily on inherent risk. When additional procedures are deemed necessary due to higher risks or indications of misstatements that come from results of performing analytical procedures and inquiries, the practitioner should be instructed to perform any additional procedures necessary (even "audit-like" procedures, if necessary) to reduce review risk to a moderate level. The practitioner should tailor the extent and nature of analytical procedures and inquiries based on his or her professional judgment; on his or her knowledge of the accounting principles and practices of the industry in which the entity operates; and on his or her general understanding of the entity and the manner in which it operates.

With respect to Appendix 2 to ISRE 2400, we believe that those procedures are widely used in practice (we analogize to Appendix B to our AR section 100). Since those procedures are widely used, we recommend that the IAASB undergo an annual process to review those procedures – especially the illustrative inquiries – to ensure that the procedures remain relevant. As new accounting standards are issued, the procedures will necessarily need to be updated.

Question #6 – How should a practitioner performing a review of financial statements address engagement risk when performing the review?

To clarify, we believe engagement risk as used in the consultation paper is meant to be the review equivalent of audit risk (that is, the risk of material misstatement when the report expressed limited assurance that no misstatements came to the accountant's attention – which we refer to as 'review risk'). Given that assumption, we believe that this risk should be addressed by performing a risk based review engagement and by tailoring analytical procedures and inquiries based on the practitioner's knowledge of the entity and the industry in which the entity operates. We also believe that by establishing requirements and providing guidance as to how practitioners should address engagement or review risk when performing a review, the IAASB would reduce the diversity in practice that currently exists.

To address review risk when performing the review, the practitioner should consider his or knowledge of the entity and the industry in which the entity operates. If the practitioner is aware that an entity has poor controls (we are not suggesting that a practitioner should perform an assessment of control risk in a review engagement) or it is in an industry that has "higher than normal" inherent risks, then the practitioner should use that knowledge to modify his or her review approach in order to obtain sufficient review evidence to restrict review risk to a moderate level.

We would also favor limited documentation of the practitioner's consideration of review risk and how he or she was able to restrict that risk to a moderate level.

Question #7 – Would the nature, timing and extent of review engagement procedures be significantly different between a review engagement based on performance of procedures without an explicit assessment of risk of misstatement in the financial statements, and a review engagement where a risk-based approach is applied to assess and respond to those risks? Would the costs of the engagement differ significantly?

We believe that any assurance engagement that is without an assessment of risk will be less effective in achieving its objective than one based on a risk assessment. When review engagements are not based on a risk assessment, they become more like an agreed-upon procedures engagement where a practitioner merely takes the illustrative inquiries and analytical procedures laid out by the standard and performs them in a similar manner in each engagement.

In order to obtain a moderate level of assurance, we believe that some form of a risk assessment is essential. The practitioner would use the assessment of review risk to tailor the nature, timing, and extent of the analytical procedures and inquiries for the specific engagement – which would produce a more efficient review engagement.

ARSC is sensitive to the engagement cost and is not in favor of the same extent of risk assessment as a practitioner would perform in an audit. Another driver of cost is the extent of documentation that would be required in the standard to support the design of the review plan.

Question #8 – In general terms, what procedures are needed to obtain an understanding of the entity's internal control over financial reporting for purposes of performing a review of financial statements?

We do not believe that a review engagement should require an understanding of the entity's internal control. Unlike in an audit, an understanding of an entity's internal control is not necessary for designing inquiries and analytical procedures.

However, we acknowledge that the extent and nature of review procedures may be impacted if the practitioner had such an understanding. Where that understanding is obtained through an audit (or otherwise), we believe that a practitioner should use that knowledge in designing the nature and extent of review procedures.

Question #9 – If the entity does not have internal controls that would prevent or detect occurrence of misstatements in the entity's financial statements, what are the implications for the practitioner regarding the entity's internal controls for the purpose of the review?

In the instance where the entity does not have controls that would prevent or detect occurrence of misstatements in the entity's financial statements, the practitioner would tailor his or her procedures in order to reduce review risk to a moderate level. Such procedures may include additional inquiries of management with respect to fraud or potential misstatements. The practitioner should be required to exercise professional judgment in determining the specific procedures to be performed in accordance with a risk based review approach.

Question #10 – Does ISRE 2400 place appropriate emphasis on the use of enquiry (inquiry) as a source of evidence in a review engagement? To what extent, if at all, do you think use of enquiry (inquiry) in an engagement to review financial statements should differ from its use in an audit?

We believe that ISRE 2400 places the appropriate emphasis on the use of inquiry as a source of evidence in a review engagement. As previously stated, we strongly believe that the primary basis of review evidence should continue to be analytical procedures and inquiries of management. The primarily difference in the use of inquiries in a review engagement versus an audit engagement should be the extent of additional evidence that is necessary to corroborate management's response. In an audit, the auditor applies professional skepticism whereby his or her attitude is one of not assuming unquestioned honesty nor assuming management is dishonest. In a review intended to obtain moderate assurance as compared to high assurance, we believe the practitioner may assume management's honesty unless he or she becomes aware of reasons why management's responses may not be factual.

Question #11 – Does ISRE 2400 provide sufficient guidance on how to apply analytical review procedures effectively in an engagement to review financial statements? If not, what additional guidance might be provided to assist practitioners?

We believe that additional guidance with respect to the use of analytical procedures in a review engagement would be helpful. While many of the same analytical procedures will be performed in a review as in an audit, the difference should be in the precision of the procedure and in the expectation. In a review engagement, a practitioner should be entitled to use a wider level of precision since the level of confidence is lower in a review than in an audit.

However, we strongly encourage that the additional guidance should reside in ISRE 2400 as opposed to including a cross reference to ISA 520. As review engagements continue to gain acceptance throughout the world, certain practitioners will move away from performing audits. Those practitioners will not be well served by a reference to the auditing literature.

Question #12 – To what extent, if at all, do you think use of analytical review procedures in a review engagement should differ from that in an audit engagement?

The use of analytical procedures will differ in that they are used as a primary source of evidence in a review and may not be in an audit. In an audit, while substantive analytics may be used as a primary test for lower risk accounts, in many cases analytical procedures are used in conjunction with other substantive tests. Additionally, because the level of confidence differs in a review as compared to an audit, the precision of analytical procedures will differ. However, the procedure itself may be similar to that performed in an audit.

Question #13 – What situations might require a practitioner performing a review to consider, based on the results of procedures performed to obtain evidence for the conclusion on the financial statements, whether performance of additional procedures is necessary to ensure that the engagement risk is reduced to an acceptable level?

We agree with the statement in the International Framework that reads “if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the subject matter information (financial statements here), the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.” Any revision to ISRE 2400 should emphasize that although generally review engagements are limited to analytical procedures and inquiries – the practitioner should not issue a report unless he or she is able to reduce review risk (that is, the risk that the practitioner will express negative assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework when in fact there is a material misstatement) to an acceptable moderate level. Although there are numerous examples of situations in which the practitioner performing a review might consider performance of additional procedures, two of the more common examples would be:

- Concerns regarding an entity’s ability to continue as a going concern and
- Concerns regarding a potential material subsequent event.

Question #14 – What factors should the practitioner consider to determine the nature and extent of further procedures required to reduce the engagement risk sufficiently to be able to express the conclusion on the financial statements?

The considerations would vary by engagement and would necessarily be subject to the practitioner’s professional judgment. However, such consideration could include:

- The likelihood of the possible misstatement
- The potential magnitude of the possible misstatement
- The subjectivity and objectivity of accounting for the transaction or account in question

Question #15 – How, if at all, should a review of financial statements performed by a practitioner who is the entity’s auditor differ from a review of financial statements performed by a practitioner who is not the entity’s auditor?

We believe that extant ISRE 2400 and ISRE 2410 appropriately acknowledge that there is an inherent difference between a review performed by a practitioner with an audit base of knowledge and a review performed by a practitioner who is not the entity’s auditor. This knowledge cannot be ignored. Consequently, the extent and nature of review procedures can vary depending on that knowledge and whether the auditor chooses to test the effectiveness of controls in his or her audit.

However, we believe that the core of the review engagement should remain the same. Both engagements should generally rely on the performance of analytical procedures and inquiries of management as the basis for expressing negative assurance that the financial statements are free of material misstatement.

Question #16 – How, if at all, should the nature, scope and extent of the work carried out for an engagement to review financial statements differ depending on whether or not the report

issued for the review engagement will be made public, or published together with the financial statements reviewed?

We do not believe that there should be any difference in the performance requirements for a review when the report is expected to be made public or published together with the financial statements. However, whether the report is expected to be made public or published together with the financial statements may be a factor that the practitioner would consider when assessing review risk and therefore, may affect the nature, scope, and extent of the work carried out for an engagement to review financial statements. Such considerations should be left to the practitioner's professional judgment.

<u>Communication with those Charged with Governance</u>

Question #17 – What are the key matters a practitioner performing a review of historical financial statements should be required to communicate with those charged with governance of the entity?

Recognizing that generally there are inherent differences in the governance structures of entities whose financial statements are audited and entities whose financial statements are subjected to review procedures, we believe that required communications with those charged with governance with respect to a review engagement should be less than that ordinarily communicated during an audit. We believe that those charged with governance should understand the practitioner's responsibilities under the ISRE and how a review differs from an audit. Currently, that communication typically takes place through an engagement letter. Additionally, the practitioner should communicate potential fraud or illegal acts involving senior management that come to the practitioner's attention.

<u>Reporting and Communication with Intended Users</u>

Question #18 – How can a practitioner effectively communicate the concept of a level of assurance that is less than high, as obtained in a review engagement, to the intended readers or users of a review report, so that they will be able to properly estimate the level of confidence they can associate with the review conclusion?

We believe that the inclusion of an additional paragraph in the review report may be helpful to effectively communicate the concept. While ARSC has not debated or considered what this additional paragraph would need to say, within our standards we do explain the difference in the following manner:

> A review differs significantly from an audit of financial statements in which the auditor provides reasonable assurance that the financial statements, taken as a whole, are free of material misstatement. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, a review does not

provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit. Therefore, a review provides only limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework].

Question #19 – Can the term 'moderate level of assurance' usefully be restated as a 'plain language' term in order to assist users of review reports to better understand the underlying message conveyed by the conclusion expressed in a review report?

We believe that a new structure to the review report should be considered. While we have no evidence that the negative assurance report is confusing, we do believe that now is a good time to debate other alternatives to see whether a clearer "plain language" report would be more useful to users.

Question #20 – What form of expression of the conclusion on the financial statements in the review report might increase the perceived usefulness of a review as an alternative form of assurance engagement? Would a different expression of the practitioner's conclusion other than in negative terms increase readers' or users' understanding of the level of assurance conveyed and, if so, how should the practitioner's conclusion be expressed?

As previously stated in our response to question #19, we have no evidence that the current structure of the review report is confusing. We believe one benefit to a negative assurance report is that it is clearly distinguishable from an audit report.

Question #21 – Given the limited work effort ordinarily undertaken for a review engagement (i.e. enquiry (inquiry) and analytical review procedures), what level of detail is appropriate to properly inform readers or users of the review report about the scope of the review engagement and the work undertaken for the engagement? Should practitioners be permitted to use a flexible format for their review reports to communicate the nature of the work undertaken?

We are unclear as to the meaning of a "flexible format" review report. With that said, we do not believe that a "flexible" or "free form" report would be in the public interest as such a report would result in diversity in practice and confusion amongst readers and users of the review report. We believe that any new standard should include minimum reporting elements but that a practitioner should never be precluded from adding additional language and clarification to his or her report.

<u>The International Standards on Review Engagements</u>

Question #22 – Do the review engagement standards need to be complete in themselves so that they 'stand alone' as standards separate from the ISAs? If so, which aspects of the ISAs should be incorporated into the review engagement standards?

We firmly believe that the review engagement standards should 'stand alone' as standards separate from the ISAs. In July 2007, we issued Statement on Standards for Accounting and Review Services No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*. We developed and issued the Statement as, for many practitioners, reviews represent the highest level of service performed and, therefore, those practitioners may be unfamiliar with the auditing literature. We determined that it would be in the best interest of practitioners performing reviews as well as in the public interest if certain references to the auditing literature were eliminated from the review standards. We believe that the IAASB will have the same experiences as we did – especially as the review engagement continues to gain acceptance internationally.

Other Matters for Consideration in a Revision of ISRE 2400

<u>*IAASB's scope clarifications for ISREs 2400 and 2410*</u>

We appreciate the efforts of the IAASB to clarify the respective applicability of ISRE 2400 and ISRE 2410 in differing engagement contexts. However, we have concerns with the stated applicability of ISRE 2400 and 2410. The applicability of the respective standards is as follows:

- ISRE 2400 applies "when the practitioner who is *not* the auditor of an entity undertakes an engagement to review financial statements" and "is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information"

- ISRE 2410 applies, adapted as necessary in the circumstances, "when the entity's auditor undertakes an engagement to review historical financial information other than interim financial information"

Our concern is that the stated applicability is overly simplistic and leaves room for confusion among practitioners as to when they can conclude that they are the auditor. The ARSC currently has exposed for public comment a proposed SSARS that would result in the applicability of SSARSs running to those engagements which we believe that the IAASB intends would be performed in accordance with ISRE 2400. The proposed applicability of SSARSs with respect to review engagements is as follows (please note that SSARSs run to both compilation and review engagements and that the applicability of SSARSs to compilation engagements has not been included below):

.01

b. *Review of financial statements*. If the accountant performs a review, see paragraphs .05 and .28 - .76 for performance and reporting requirements. Statements on Standards for Accounting and Review Services are not applicable to reviews of interim financial information if

(i) the entity's latest annual financial statements have been audited by the accountant or a predecessor;

(ii) the accountant has been engaged to audit the entity's current year financial statements, or the client has a continuing contractual or regulatory obligation to have its annual financial statements audited; and

(iii) the client prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.

Accountants engaged to perform reviews of interim financial information when the conditions in (i)–(iii) above are met should perform such reviews in accordance with AU section 722, *Interim Financial Information* (AICPA, Professional Standards, vol. 1).

We believe that (i) and (ii) clearly establishes when an practitioner has an "audit base of knowledge" – which would be in the spirit of the IAASB's conclusion that ISRE would be applicable when the practitioner is the auditor of the entity's annual financial statements. In addition, we concluded to include (iii) above as the intent of interim financial reporting is to update the annual financial reporting. It is our position that if the interim financial reporting is not in accordance with the same financial reporting framework as that used to prepare the annual financial statements then, such interim financial reporting is not comparable to the annual financial statements and therefore cannot be considered an update of the annual financial reporting.

AU 722, *Interim Financial Information* is analogous to ISRE 2410.

We encourage the IAASB to consider the applicability paragraph that we developed when revising ISRE 2400. We also welcome your comments on our exposure draft. The exposure period ends on January 9, 2009. We have attached the proposed SSARSs for your convenience.

Reliable Financial Reporting

We understand that, similar to our Standards with respect to review engagements, in accordance with ISRE 2400 a practitioner is precluded from performing a review engagement for a client with respect to who the practitioner is not independent. However, many users of reviewed financial statements in the United States have asserted to us that the practitioner's integrity, expertise and objectivity are more important than whether the practitioner has maintained his or her independence with respect to a client for whom the practitioner performs certain internal control accounting services.

Recently, financial statement users and other stakeholder groups have suggested to us that the independence rules are, in some cases, an obstacle to helping smaller entities provide reliable financial statements. This situation happens because practitioners engaged in certain control activities for a company are precluded from performing moderate assurance engagements for that company. Yet the practitioner serves as a trusted adviser to many small businesses. Practitioners reviewing the financial statements of small- and medium-size businesses often also perform other services, such as bookkeeping, payroll or internal control projects. To reconcile the marketplace's expanded needs for practitioner's involvement in small companies' financial reporting with the high ethical standards that embody the accounting profession, the ARSC has begun the Reliability Project.

This project is not about eliminating the need for independence in a review. It is about repositioning the independence requirement with respect to a review engagement. The concept is simple: reliable financial statements should be the end focus, not independence. The need for a practitioner's involvement in small companies' financial reporting is becoming more prevalent because of the increased complexity of accounting standards. Because of these accounting complexities, some smaller entities can no longer prepare reliable financial statements without the practitioner playing an important role in certain internal control activities. However, practitioners cannot establish or maintain their clients' system of internal control without it affecting their independence. Once they cross that threshold of control activities, practitioners cannot review their clients' financial statements. Some smaller entities that need a review of their financial statements for bank financing or for other reasons need to hire a second practitioner to review their financial statements, even though their long-time practitioner is better suited for the job.

ARSC has just begun to study and debate the issues. What is clear so far is that ARSC is committed to making sure that any change continues to serve the public interest. Based on its preliminary discussions, the contemplated changes to review standards would continue to preclude review services when independence is impaired as a result of family or investment-related circumstances. For example, if a practitioner's independence is impaired because he or she has an investment in the client's business or because the practitioner has family relationships with the client, the practitioner would continue to be precluded from performing a review. But if independence is impaired because a practitioner performs control activities that add reliability to the financial statements, the practitioner could perform a review provided that the practitioner has appropriate evidence to support his or her review report and provided that the practitioner disclose in the report that control services were performed.

Any revised review standards will continue to treat independence as an important consideration. However, for impairments that are caused by the performance of limited services or activities that improve the reliability of the client's financial statements, the standards would not preclude a review engagement.

Like any standard, any proposed revisions for the ARSC Reliability Project will go through full due process and exposure. The ARSC is working towards exposing a new standard in the second quarter of 2009. We encourage the IAASB to join us in considering this change to review standards and would welcome an invitation to more clearly articulate the project to the IAASB.

We have attached a discussion memorandum that was prepared discussing the theory behind the project.

Additional assistance

As mentioned in the consultation paper, the review has a high degree of acceptance in the United States. The ARSC has been researching, developing, and issuing standards for review engagements since 1978. We would be happy to share further our experiences and knowledge with you as you consider revisions to ISRE 2400 and would welcome the opportunity to have a member of the ARSC serve on any Task Force. As with our auditing standards, we are committed to harmonizing our review standards with those of the

IAASB. Please let us know how we may assist you in your efforts to revise the International Standards on Review Engagements.

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Thank you for the opportunity to comment on this consultation paper. If you have any questions regarding the comments in this letter or would like to talk to us regarding our offer to assist in the revision of International Standards on Review Engagements, please contact Mike Glynn at +1 212 596 6250, mglynn@aicpa.org.

Respectfully submitted,

/s/ Carolyn H. McNerney
Chair, AICPA Accounting and Review Services Committee

/s/ Michael P. Glynn
Technical Manager, AICPA Audit and Attest Standards Team
Staff Liaison, AICPA Accounting and Review Services Committee

EXPOSURE DRAFT

PROPOSED STATEMENT ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

APPLICABILITY OF STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

NOVEMBER 17, 2008

Prepared by the Accounting and Review Services Committee
American Institute of Certified Public Accountants

Comments should be sent by electronic mail to Michael Glynn at mglynn@aicpa.org and received by January 9, 2009.

November 17, 2008

Accompanying this letter is an exposure draft, approved by the Accounting and Review Services Committee (ARSC), of a proposed Statement on Standards for Accounting and Review Services (SSARS), *Applicability of Statements on Standards for Accounting and Review Services.*

A summary of the significant provisions of the proposed SSARS follows this letter. The proposed statement is being issued to revise AR section 100, *Compilation and Review of Financial Statements*, to revise the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1), apply. The revisions to AR section 100 have been drafted based on the comment letters received on the proposed Statement on Auditing Standards (SAS), *Interim Financial Information,* and the views of the task force working on the proposed auditing standard. The proposed SSARS may have to be further revised based on the final SAS as voted by the Auditing Standards Board.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the ARSC's consideration of responses, comments should include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA and will be made available for public inspection for one year at the offices of the AICPA after February 9, 2009. Comments should be sent via the Internet to Michael Glynn at mglynn@aicpa.org and received no later than January 9, 2009.

Sincerely,

Carolyn H. McNerney
Chair
Accounting and Review Services Committee

Charles E. Landes
Vice President
Professional Standards

Accounting and Review Services Committee
(2008–2009)

Carolyn H. McNerney, *Chair*
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SUMMARY

WHY ISSUED AND WHAT IT DOES

The proposed Statement on Standards for Accounting and Review Services (SSARS) is being issued to revise the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1), apply. The revisions have been drafted based on the comment letters received on the proposed Statement on Auditing Standards (SAS), *Interim Financial Information*, and the views of the task force working on the proposed auditing standard. The proposed SSARS may have to be further revised based on the final SAS as voted by the Auditing Standards Board (ASB).

The proposed SAS that was exposed for public comment is available at www.aicpa.org/download/auditstd/ED_Interim_Financial_Information.pdf. Please note that the applicability, as stated in paragraph .05 of the proposed SAS, is inconsistent with the applicability as stated in the proposed SSARS because the proposed SAS does not include those changes made based on the comment letters received. Other changes are expected to be made to the proposed SAS as part of its consideration by the ASB. Upon final issuance of the SAS and the SSARS, the language used in the applicability paragraphs will be consistent.

Background

In 2007, a joint Accounting and Review Services Committee (ARSC) and ASB task force was established with the charge of considering and developing guidance with respect to the performance of review engagements on condensed interim financial information for nonissuers. That task force concluded that such interim financial reporting is intended to provide a periodic update to year-end reporting and, therefore, the engagement to provide limited assurance on such financial reporting is considered an extension of the annual audit. The task force concluded that the requirements and guidance for the performance and reporting on such an engagement should reside in the auditing literature. On September 2, 2008, the ASB exposed a proposed Statement on Auditing Standards, *Interim Financial Information*, for public comment. The comment period on that proposed statement ended on November 3, 2008.

In order to avoid confusion, the task force recommended that the ARSC revise AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), to make clear that SSARSs do not apply when the provisions of AU section 722 apply.

EFFECTIVE DATE

The proposed SSARS would be effective for compilations and reviews of financial statements for periods ending on or after June 15, 2009. Early application would be permitted.

HOW IT AFFECTS EXISTING SSARSs

The proposed statement would amend AR section 100.

PROPOSED STATEMENT ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

APPLICABILITY OF STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

Amendment to AR Section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100 par. .01)

1. The purpose of this amendment is to revise AR section 100 so that Statements on Standards for Accounting and Review Services (SSARSs) do not apply when the provisions of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1) apply. New language is shown in boldface italics; deleted language is shown by strikethrough.

Introduction

.01 This statement ~~sets forth the performance and communication requirements when an accountant submits unaudited financial statements of a nonissuer to his or her client or third parties.~~ ***establishes standards and provides guidance on compilations and reviews of financial statements.*** The accountant should not submit unaudited financial statements of a nonissuer to his or her client or a third party unless, as a minimum, he or she complies with the provisions of this section applicable to a compilation engagement.

> *a. Compilation of financial statements*.[1] If the accountant performs a compilation, a communication to management is required. The type of communication depends on the following.
>
> > 1. If the accountant is engaged to report on compiled financial statements or submits financial statements to a client that are or reasonably might be expected to be used by a third party, see paragraphs .13–.23 ***and .54–.76*** for reporting requirements.
> >
> > 2. If the accountant submits financial statements to a client that are not reasonably expected to be used by a third party, see paragraphs .24–.27 for required communications to management.
>
> In deciding whether the financial statements are or reasonably might be expected to be used by a third party, the accountant may rely on management's representation without further inquiry, unless information comes to his or her attention that contradicts management's representation.
>
> In each of the above circumstances, the performance requirements in paragraphs .05 and .09–.12 apply.
>
> *b. Review of financial statements*. If the accountant performs a review, see paragraphs .05 and .28~~–.53~~ ***.76*** for performance and reporting requirements. ***Statements on Standards for Accounting and Review Services are not applicable to reviews of interim financial information if***
>
> > ***(i) the entity's latest annual financial statements have been audited by the accountant or a predecessor;***
> > ***(ii) the accountant has been engaged to audit the entity's current year financial statements, or the client has a continuing contractual or regulatory obligation to have its annual financial statements audited; and***
> > ***(iii) the client prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements.***

[1] See appendix A [paragraph .97], "Compilation of Financial Statements," for a flowchart regarding the requirements of Statements on Standards for Accounting and Review Services (SSARSs) for a compilation engagement.

> ***Accountants engaged to perform reviews of interim financial information when the conditions in (*i*)–(*iii*) above are met should perform such reviews in accordance with AU section 722,* Interim Financial Information (*AICPA,* Professional Standards*, vol. 1*).**

2. This amendment is effective for compilations and reviews of financial statements for periods ending on or after June 15, 2009. Early application is permitted.

Recommendations of the Reliability Task Force

Consideration of an Alternative Framework for
Compilation and Review Engagements

March 2008

I. Background

In September 2003, *Accounting Horizons* published a paper entitled "A Proposed Framework Emphasizing Auditor Reliability over Auditor Independence" coauthored by Mark H. Taylor, F. Todd DeZoort, Edward Munn, and Martha Wetterhall Thomas. While written as an auditor reliability framework, the authors believe that the framework applies equally to any assurance or attest service.

In their paper, the authors distinguish among independence, integrity, and expertise as key ethical constructs needed to achieve objectivity which in turn leads to reliability. They contend that while independence is important, it should not be the end game – reliability should. The authors' assert that CPAs cannot be completely independent regardless of any rules because the client pays the audit fee. Further, CPAs can provide reliable services even though they are not entirely independent because reliability results from objectivity which in turn results from independence, integrity, and expertise.

The authors define reliability as a condition where stakeholders consistently find the CPA's work credible and dependable, even after acknowledging the engagement's inherent limitations. Such framework (which has been amended from that previously published) is illustrated below (figure 1):

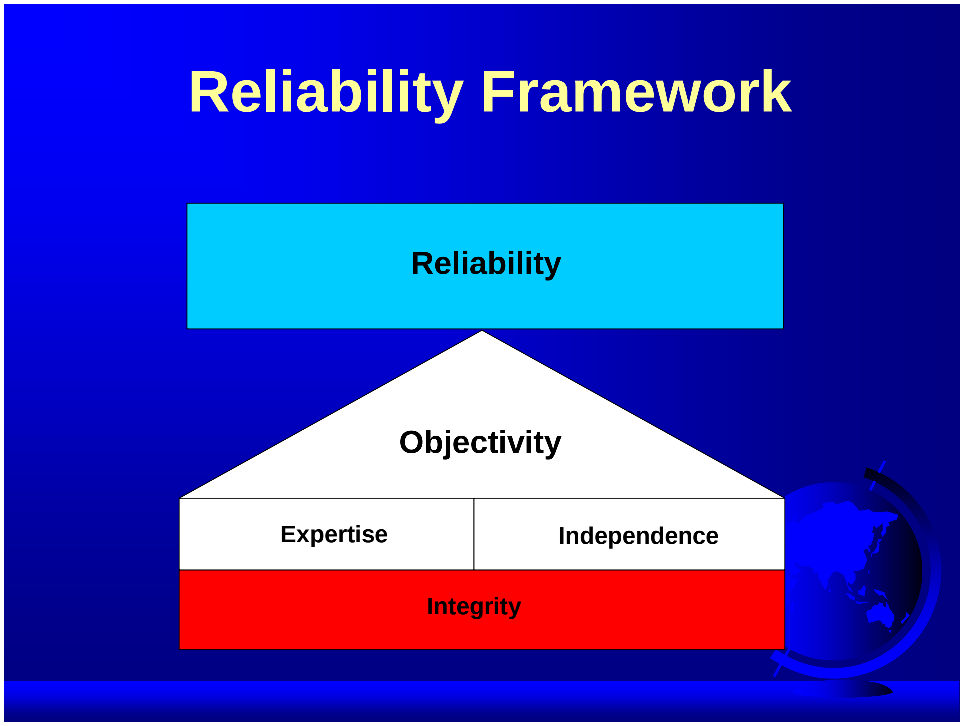

Figure 1

This research paper came to the attention of the AICPA's Audit and Attest Standards Team, who in turn held several meetings with the two primary authors in order to better understand their research and resulting conclusions.

As a result of these various meetings, including discussions with senior AICPA management, the Audit and Attest Standards Team asked the Accounting and Review Services Committee (ARSC) whether ARSC would be interested in pursuing this framework within the context of a compilation or review engagement. Subsequently, the Reliability Task Force was formed, consisting of a cross section of practitioners, preparers and users to study reliability issues and to make recommendations.

The purpose of this paper is to set forth the recommendations of the Task Force and the reasons therefor.

II. Task Force Consideration of the Issue

In February 2008, a meeting of the Reliability Task Force was held. The Task Force, chaired by David Morgan, Chair of the AICPA's Private Companies Practice Section (PCPS), consisted of practitioners, preparers, and third-party users of compiled and reviewed financial statements. The two primary authors of the academic research paper also attended the Task Force meeting to share their thoughts and ideas.

As part of its consideration, the Task Force first considered the assurance continuum (figure 2) to better understand the responsibilities of ARSC and the scope of their authority:

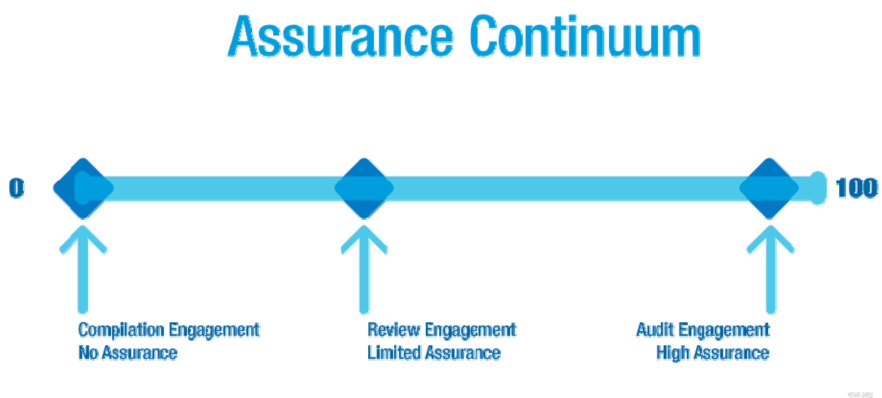

Figure 2

The Task Force then discussed the current independence framework and how that framework was used by the current Statements on Standards of Accounting and Review Services (SSARSs). SSARSs currently permit a CPA to perform a compilation when the CPA's independence has been impaired but not a review. If an accountant performs a compilation for a client to whom he or she is not independent, the accountant should disclose the lack of independence in his or her accountant's report. The accountant is precluded from disclosing the reasons for the lack of independence in his or her report.

The Task Force's discussions produced an interesting distinction and hypothesis. Specifically, there is a difference between independence impairment caused by financial or relationship interests and independence impairments caused by the external CPA's performance of certain services. This distinction had previously been communicated to ARSC by other users. For example, it is common for many small to medium firm CPAs to perform nonattest services for their business clients where the CPA performs certain internal control activities on behalf of their client. Many users perceive these types of services to be extremely valuable to many businesses that otherwise would be incapable of preparing accurate accounting books and records and quality financial statements. However, even though these services improve the reliability of the issued financial statements they might impair the CPA's independence and disqualify the CPA from issuing a review report under current SSARSs requirements.

III. Real World Issues with Current Framework

The traditional model for the performance of financial reporting engagements is as follows (figure 3):

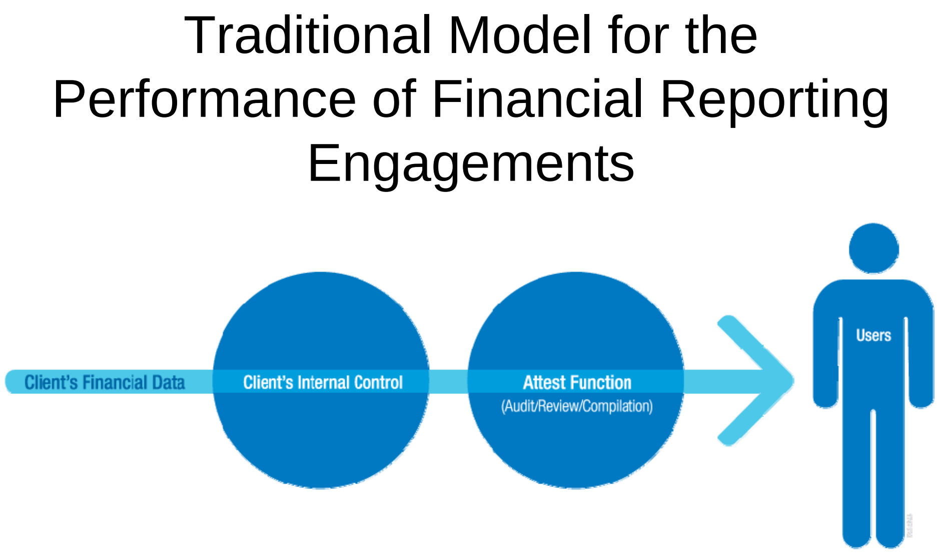

Figure 3

In this model, the client's financial data are first processed through its internal control over financial reporting. The end result of that process is the preparation of financial statements. Those financial statements are then subjected to the CPA's performance of audit, review, or compilation procedures. Third parties are then able to use the resulting report and financial statements in making decisions such as whether to make a loan or extend surety bonding.

However, in the "real world" the above model is extremely difficult to achieve especially for smaller clients because they need their accountant to do more than simply compile, review, or audit their financial statements. To achieve reliable financial reporting, these clients need their accountant to perform certain nonattest services such as bookkeeping, payroll or other accounting services or certain other activities with respect to internal control over financial reporting. The result, in reality, looks like (figure 4):

Reality

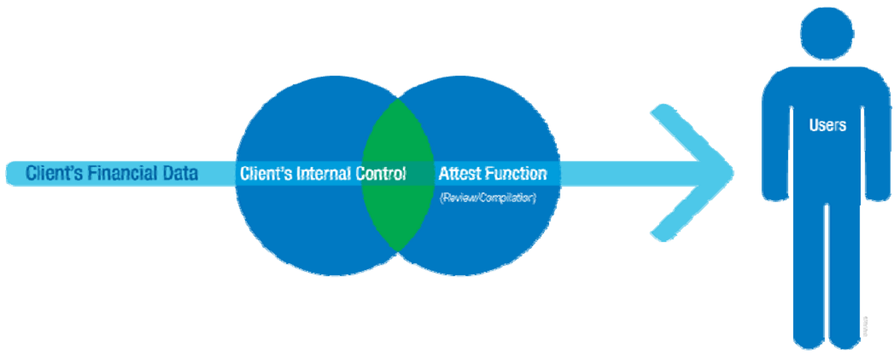

Figure 4

In this case, the external CPA's service has intersected with some of the internal control functions that were reserved for the client in the traditional model. When this occurs the CPA's independence, by definition, is impaired.

IV. Task Force Recommendations

The Task Force believes that, for compilation and review services, the public would be better served by a framework that focuses on the reliability of the financial statements. The financial reporting process may be enhanced by the performance of nonattest services by CPAs for their clients including those where the CPA performs control activities or other internal control procedures for their client. Maintaining a stance that accountants cannot express some level of assurance if they do not comply with the existing independence model (in which they play no role in the client's internal control) is not practicable for some smaller entities.

The reliability framework stresses integrity as the foundation upon which all other ethical considerations follow. If the accountant has integrity, then he or she can assess the relationship with the client and whether he or she has the appropriate expertise to perform the applicable attest engagement. The Task Force believes that maintaining "relationship-based" independence (for example, an immediate family member of the CPA is not in a key management position at the client) and "financial-interest" independence (for example, no direct investments in the client) should, at a minimum, trigger reporting requirements in compilation engagements and should continue to be a precondition to performing a review level service. On the other hand, the Task Force believes that if independence is impaired because the accountant performs certain nonattest services such as bookkeeping, payroll or other accounting services, or certain other activities with respect to internal control over financial reporting, the accountant should be able to still express limited assurance on the client's financial statements provided they can demonstrate how they maintained their objectivity and provided reliable services. The Task Force also believes ARSC should be provided flexibility and latitude in its consideration of the appropriate performance and reporting requirements for compilation and review engagements.

Therefore, the Task Force recommends that ARSC proceed with the development of a Statement on Standards for Accounting and Review Services (SSARS) that would be based on a framework for the performance and reporting of compilation and review engagements where the maintenance of independence would not necessarily be a prerequisite[2]. Instead, the new SSARS should stress that the accountant remains objective and strive to achieve reliable financial reporting (figure 5).

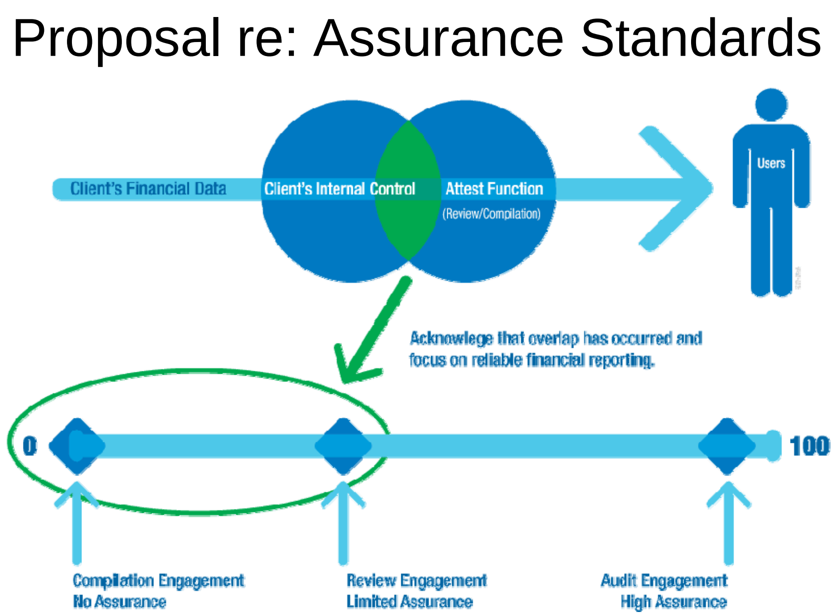

Figure 5

Given the nature of the audit engagement and the high level of assurance provided by the performance of audit procedures, the Task Force concluded that it would not be appropriate to make a similar recommendation to the Auditing Standards Board at this time.

Finally, the Task Force considered whether the current independence standards as promulgated by the AICPA's Professional Ethics Executive Committee (PEEC) should be revisited. The Task Force concluded that no changes are needed to the current Independence Standards for the proposed reliability framework to be utilized by ARSC. However, the Task Force did conclude that the current thinking that independence is an all or nothing concept may need to be reconsidered in light of the ARSC project. The Task Force further notes that PEEC may deem it necessary to reconsider current and future independence standards in light of the reliability project.

The Task Force noted that there are emerging differences between accounting and auditing standards for issuers and nonissuers. Therefore, the Task Force concluded that PEEC should consider the current independence standards with respect to nonattest services and consider whether such standards remain appropriate for smaller nonpublic company engagements.

V. Summary

[2] This relates to the maintenance of independence that may be impacted by the performance of a service, including internal control services. Independence impacted by financial or relationship interests should continue to be treated as it is currently.

While we are mindful of ARSC's senior technical status and that it must come to its own conclusions, the Task Force believes that the profession would be well served if ARSC considers a new standard that would permit a limited assurance engagement even when a CPA's independence is impaired by the performance of "control services." Such services will improve the reliability of financial statements that are relied upon by management and outside users. By basing such a service on integrity, expertise and some level of independence, objectivity is maintained and the reliability of financial statements is improved. In summary:

- Our recommendations would not preclude following existing compilation and review performance standards.
- We recommend that ARSC enable a review service where it may currently be precluded.
- We believe precluding an assurance service when independence is impaired by financial or relationship interests should not be changed. However, we understand that ARSC may consider permitting a practitioner to state in his or her compilation report that independence has been impaired for a financial or relationship matter so a user understands the cause.
- We recommend that the ARSC consider differentiating the compilation and review reports to reflect whether the accountant has maintained independence. Neither the maintenance of independence nor the performance of a "control service," should be reflected as a negative.

We anticipate and look forward to presenting these recommendations to ARSC at its May meeting. The Task Force stands ready to assist ARSC in any way possible as it moves through its deliberations.

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