Virginia Society of Certified Public Accountants

James W. Brackens, Jr., CPA, CGMA
Vice President
Ethics and Practice Quality
American Institute of CPAs
220 Leigh Farm Road
Durham, NC 27707

Michael P. Glynn, CPA
Senior Technical Manager
Audit and Attest Standards
American Institute of CPAs
1211 Avenue of the Americas, 19th Floor
New York, NY 10036

Dear Mr. Brackens and Mr. Glynn:

On behalf of the more than 11,000 members of the Virginia Society of CPAs (VSCPA), the VSCPA Accounting and Auditing Advisory Committee has reviewed and discussed the proposal by the American Institute of CPAs (AICPA) Accounting and Review Services Committee (ARSC) to permit accountants to prepare financial statements for third-party use without a report. We have also reviewed and discussed the proposal by the AICPA Professional Ethics Executive Committee (PEEC) that prompted ARSC to propose permitting these plain paper engagements. Under that proposal, preparation of financial statements would be deemed a separate, nonattest service.

We refer to the proposals together as the *plain paper proposal*. It is a change in a longstanding practice and would have a significant impact on accountants who prepare financial statements for small- and mid-sized nonpublic entities that are not audited or reviewed and are intended for third-party use, as well as the users themselves.

We are only commenting on the plain paper proposal, and not the entire ARSC and PEEC exposure drafts of which it is a part, because of the significance of the plain paper proposal to the members of the VSCPA. Since the ARSC and PEEC proposals are so closely related, we are sending a joint response to each of the committees.

The PEEC Proposal That Prompted the ARSC Proposal

Small- and mid-sized nonpublic entities that want audited or reviewed financial statements and the accountants who provide those services have typically viewed preparation of the financial statements as part of the audit or review engagement. They therefore view the preparation of the financial statements as part of the attest engagement and not a separate, nonattest service. Yet Interpretation 101-3 gives preparing financial statements as an example of a nonattest service.

Highly publicized instances of fraudulent financial reporting by Enron and others prompted PEEC to revise Interpretation 101-3 generally effective for attest services provided after 2003. Under those revisions, failure to document the understanding reached with the entity about responsibilities for nonattest services would impair independence.

That prompted practice questions as to whether the example in the Interpretation meant that preparing financial statements in connection with an audit or review should be viewed as a nonattest service and therefore subject to the Interpretation. PEEC responded in two ways. It made a failure to document the

4309 Cox Road
Glen Allen, VA 23060
p (804) 270-5344
f (804) 273-1741
vscpa@vscpa.com
www.vscpa.com

understanding reached with the entity a departure from Rule 202 instead of impairing independence and provided additional guidance through a series of questions and answers. Based on that guidance, it is clear that PEEC did not intend for Interpretation 101-3 to require viewing the preparation of financial statements as part of an engagement to review or audit those financial statements as separate from the attest engagement.

The revision to the Interpretation PEEC is currently proposing would change that position, clearly stating that preparing financial statements is a nonattest service and not a part of the attest engagement. To illustrate the effect of the proposed change, assume that the only service an accountant provides for an entity is reviewing its financial statements and preparing the financial statements. Under the present guidance, Interpretation 101-3 would not apply because the preparation of financial statements is considered to be part of the review engagement. However, under the proposed guidance, the Interpretation would apply because the preparation of financial statements would be considered a nonattest service and not part of the attest engagement.

The proposed revision to Interpretation 101-3 was intended to conform the guidance in the Interpretation with the guidance in *Government Auditing Standards* that states: "Activities such as financial statement preparation, cash to accrual conversions, and reconciliations are considered nonaudit services under GAGAS, not routine activities related to the performance of an audit." We do not believe PEEC needs to change well-established practice to extend that position to all audits and to reviews and compilations. GAGAS could easily continue to have a different view of the effect of nonattest services on independence in audits, and there is no counterpart to compilation and review in GAGAS.

Nevertheless, we believe:

a. Viewing preparation of financial statements as a separate service is conceptually sound. Statement on Standards for Accounting and Review Services (SSARS) 1 viewed compilation as the procedures required when an accountant prepared financial statements. If an accountant was engaged to prepare and review the financial statements, the compilation guidance in SSARS 1 applied to the preparation of the financial statements and the review guidance in SSARS 1 applied to the review of the financial statements. (The accountant would only report on the highest level of service, which was the review.)

b. The change in practice would not be onerous for accountants who prepare financial statements for small- and mid-sized nonpublic entities. Those accountants typically also prepare the entity's income tax returns and are already required to comply with Interpretation 101-3. (Separate understandings are not required for each nonattest service.)

Our primary interest in the proposed revision to Interpretation 101-3 is its effect on compilation. ARSC has taken the position that compilation must be restructured because of the proposed revision to the Interpretation. As discussed in the next section, we disagree.

ET 92.01 defines *attest engagement* as "an engagement that requires independence as defined in AICPA *Professional Standards*." We continue to believe that is the right definition. SSARS 19 added the statement (now in AR 60.05) that compilation is an attest engagement. Compilation was designed as the procedures for preparation of financial statements. It does not require independence; it only requires report modification for a lack of independence. Under the definition of an attest engagement in ET 92.01, compilation is not an attest engagement.

We believe that whether compilation is an attest engagement should be addressed in the authoritative compilation literature, and the Code of Professional Conduct should be silent. The only mention of compilation presently in Interpretation 101-3 is footnote 14, which states, "A member who performs a compilation engagement for a client should modify the compilation report to indicate a lack of independence if the member does not meet all of the conditions set out in this interpretation when providing a nonattest service to that client." That implicitly addresses whether compilation is an attest engagement and should be deleted.

The ARSC Proposal to Permit Plain Paper Engagements to Prepare Financial Statements for Third-Party Use

Whether to permit plain paper engagements to prepare financial statements for third-party use has been debated countless times for at least 45 years. The conclusion has always been the same: some form of report is required so users of the financial statements know the degree of responsibility the accountant is taking for the financial statements. (It has only been since the issuance of SSARS 8 in 2000 that reporting is not required when third-party use is not expected. However, in those engagements, the engagement letter clearly explains the limitations of the statements and restrictions as to their use.)

SSARS 19 changed the notion of compilation from the way it was originally designed when it stated (now in AR 80.01):

> The accountant is required to comply with the provisions of this section whenever he or she *is engaged to report* [emphasis added] on compiled financial statements *or submits* [emphasis added] financial statements to a client or to third parties. [AR 60.04 defines *submission of financial statements* as, "Presenting to management financial statements that an accountant has prepared."]

That established the notion that compilation could be something other than preparation of financial statements.

However, compilation was designed as the minimum requirements whenever an accountant prepared financial statements. An informed reading, which was essentially a requirement to exercise due professional care, was a preparation procedure. It was never thought of as an engagement in and of itself.

Compilation was designed to protect the accountant: it was mandatory, not voluntary. A compilation was required whenever the accountant was engaged to prepare financial statements. The engagement was to prepare financial statements, and the compilation was how that engagement was performed. The report was designed to say that, although the accountant prepared the financial statements, no assurance was being expressed and to communicate departures that were noted. It was designed to minimize the risk that users of the financial statements would infer assurance and to make them aware of departures of which the accountant is aware.

Taking preparation out of compilation generally leaves only reading. An entity would likely ask an accountant to read financial statements it prepared and issue a report stating that no assurance is being expressed only if the entity thought there would be implied assurance.

We continue to disagree with the notion that a compilation could be something other than preparation of financial statements and believe that compilation should be structured to accomplish what it was originally designed to accomplish. Looking at what compilation was originally designed to accomplish requires going back 45 years to Statement on Auditing Procedure (SAP) 38, *Unaudited Financial Statements*, which was issued in 1967 and later codified into AU 516 when Statement on Auditing Standards (SAS) 1 was issued in 1973. SAP 38 stated:

a. Although the [accountant] may have prepared, or assisted in preparing, unaudited financial statements, the statements are representations of management, and the fairness of their representation is management's responsibility.

b. When [the accountant] submits to [the] client or others, with or without a covering letter, unaudited financial statements which [the accountant] has prepared or assisted in preparing, [the accountant] *is deemed to be associated with such statements* [emphasis added].

Under AU 516 (which has since been superseded) preparation of unaudited financial statements required only a *brief* communication:

> The accompanying balance sheet of X Company as of December 31, 19__, and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by us and accordingly we do not express an opinion on them.

No procedures were required.

Accountants approached unaudited engagements differently, with some performing virtually no procedures and others performing a variety of procedures. SSARS 1, issued late in 1978, was designed to address that difference for nonpublic entities, with compilation designed for engagements in which virtually no procedures were performed and review designed for engagements in which comprehensive inquiries and analytical procedures were performed.

Compilation was designed as the procedures required for preparation of financial statements. Conceptually, if an accountant prepared financial statements as part of a review engagement, the compilation procedures would be performed for the preparation piece of the engagement, and the review procedures would be performed for the review piece of the engagement. (Only a review report would be issued because that was the highest level of service.)

Since no assurance was to be expressed in a compilation, it was designed as a low level of service, with some of the members of the original ARSC referring to it as "lower than a snake's belly." Generally, it only required an informed reading and a brief communication:

> The accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended have been compiled by me (us).
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

There was no mention of standards in the original compilation report, even though the report on a review engagement mentioned standards. (SSARS 5 added the reference to standards in a compilation report.) The only procedures required were generally to establish an understanding of the engagement with the client and to perform an informed reading of the financial statements. There were no documentation requirements. For example, there was no requirement to document the understanding with the client.

The SSARS 1 approach to compilation was generally the same as the former AU 516 but added reporting flexibility for omission of substantially all disclosures and the statement of changes in financial position (that was before the statement of cash flows) in financial statements for third-party use. SSARS 1 also required disclosure of a lack of independence (the former AU 516 did not require disclosure of a lack of independence). In addition, SSARS 1 added the requirement to establish an understanding with the client and to perform the informed reading. As a practical matter, however, the members of the original ARSC believed that was already being done in practice.

The SSARS 1 guidance on compilation was developed by seasoned practitioners, and *it worked*. SSARS 1 only required an informed reading and a very modest communication. Those limited procedures were in response to the care the *public expects* of CPAs. The modest communication was to avoid any misunderstanding by users of the financial statements as to the degree of responsibility the accountant was assuming.

Under the ARSC proposal, an accountant would have three alternatives for preparing financial statements for third-party use:

a. Do not permit use of the accountant's name and request that the entity clearly indicate that the financial statements were not compiled, reviewed, or audited. There would be no requirement to communicate material departures from the financial reporting framework of which the accountant becomes aware.

b. Permit use of the accountant's name, read the financial statements, and consider whether they appear free from material inconsistencies with the accountant's knowledge and either:

   (1) Request that the entity clearly indicate that the financial statements were not compiled, reviewed or audited.

   (2) Attach a report stating that the financial statements were not compiled, reviewed, or audited and no assurance is being expressed. The example of a report ARSC gave in the proposal (The financial statements of XYZ Company as of and for the year ended December 31, 20XX, were not compiled, reviewed, or audited by me (us) and, accordingly, I (we) do not express an opinion or any form of assurance on them.) is similar to the former AU 516 report.

   There would be no requirement to communicate material departures from the financial reporting framework of which the accountant becomes aware.

c. Perform a compilation, which would require generally the same procedures that are now required in a compilation except that preparation of the financial statements would no longer be part of a compilation:

   (1) Obtain an engagement letter.

   (2) Perform an informed reading.

   (3) Prepare documentation in sufficient detail to provide a clear understanding of the work performed. (The documentation requirement is similar to the documentation requirement added by SSARS 19.)

   The reporting requirements would generally be the same as they are now, but the compilation would be described differently. Instead of saying that preparation of financial statements is the objective of a compilation, the report would say that the objective of a compilation is to read the financial statements and consider whether they are free from obvious material misstatements and appear to be appropriate in form.

We believe:

a. Nothing has changed to warrant moving away from the longstanding notion that preparation of financial statements requires a minimum level of performance and reporting. That continues to be necessary because:

   (1) The users of financial statements expect a level of care whenever an accountant prepares financial statements.

   (2) It is important that the users understand that the accountant is expressing no assurance on the financial statements.

(3) To protect accountants and users, it is important that accountants be required to communicate departures.

b. A compilation should not be viewed as an attest engagement. It does not require independence; it only requires disclosing a lack of independence in the report.

c. Compilation should not be engagement-driven but instead should be required when an accountant prepares financial statements for third-party use.

d. Compilation should not be permitted for engagements in which the accountant does not prepare the financial statements.

e. Performance and reporting requirements for a compilation should be at a low level, along the lines of those prescribed by the original SSARS 1.

Thank you for the opportunity to comment on these proposals. We would be pleased to provide any additional information that may be helpful to you or to assist with any revisions. Please direct any requests, questions, or concerns to VSCPA Government Affairs Director Emily Walker at ewalker@vscpa.com or (804) 612-9428.

Sincerely,

Mike Wagner, CPA, CGFM
Chair

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