PacificCPE

COURSE

20458A

Financial Statement and Trial Balance Comparisons

Understanding the differences between financial statement and trial balance presentations is essential for practitioners performing compilation and review engagements. This course walks through a detailed comparison of the two, highlighting key distinctions that affect how engagements are scoped and reported. With continued observations throughout, participants gain practical clarity on when and how these differences matter—making this course especially valuable for CPAs who regularly work with clients at varying stages of their accounting cycle.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify examples of simpler reporting options to issuing GAAP financial statements.
- Identify provisions to incorporate into engagement letters to protect the accountant against liability claims.
- Recognize the privity standard as it relates to the accountant's liability to third parties.

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Section 1

Chapter Objective

After completing this chapter, you should be able to:

- Identify examples of simpler reporting options to issuing GAAP financial statements.
- Identify provisions to incorporate into engagement letters to protect the accountant against liability claims.
- Recognize the privity standard as it relates to the accountant's liability to third parties.

H. SIMPLIFYING THE REPORTING PROCESS

With each passing change to GAAP, accountants are torn by the pressure placed on them to balance enhanced accounting disclosure requirements with the needs of their cost-conscience clients.

The fact is that most of the changes required by GAAP have little usefulness to smaller, nonpublic businesses. Yet, accountants still must comply with the changes.

Examples of GAAP changes that are typically not meaningful for nonpublic businesses include:

- Goodwill and other intangibles amortization: ASC 350, *Intangibles- Goodwill and Other*, requires that goodwill and indefinite lived intangibles not be amortized. Instead, an annual test for impairment on goodwill and certain other intangible assets must be made. For most smaller businesses, it is preferable to continue to amortize such intangibles and avoid performing the impairment test.
- Consolidation of real estate leasing entities: ASC 810, Consolidation, requires a lessee operating company to consolidate a real estate lessor company if the real estate lessor is a variable interest entity and the operating company is the primary beneficiary. Most third parties, including lenders, do not find the operating company's consolidation of the real estate leasing entity meaningful even though, in certain situations, GAAP requires such a consolidation.
- Depreciation: Many small businesses do not find the maintenance of two depreciation methods useful. Yet such businesses are precluded from using tax return depreciation (including Section 179 and bonus depreciation) as their GAAP depreciation unless the difference is not material.

For many small business owners, the issuance of financial statements is nothing more than a necessity to satisfy the bank or other third-party user. Although the small business client may be willing to pay higher fees to accountants for effective tax planning or management consulting, most

owners are unwilling to pay for a high-priced compilation or review engagement that is perceived as a commodity rather than a value-added service.

An accountant may wish to consider existing reporting options that offer practitioners a means to reduce the time spent on completing an engagement. Here is a list that may be useful depending on the client's needs and circumstances:

1. Compile tax-basis financial statements.
2. Compile GAAP financial statements with no footnotes and statement of cash flows.
3. Issue prepared financial statements in accordance with SSARS No. 21 [prepared financial statements issued without a report].
4. Issue prepared financial statements on a monthly basis and issue compiled, reviewed or audited financial statements for the annual financial statements.
5. Issue a compilation report on financial statements that include selected footnotes:
   a) SSARS No. 21 permits an accountant to report on financial statements under which only a few disclosures are included, provided the notes are labeled:

      "Selected Information- Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States Are Not Included."
6. Issue a compilation report for interim periods that list the departures from GAAP.

   Example: Assume that an accountant prepares monthly financial statements for a client, and these statements consistently have certain GAAP departures, such as missing accruals, allowance for bad debts, etc. The accountant may issue a standard compilation report that refers to the GAAP departures and can use this report, without modification, from month to month.

   At year-end, the accountant may adjust the departures to GAAP and issue a standard compilation or review report.
7. Compile only one financial statement (e.g., balance sheet), and not the full set of financial statements.
8. Apply options that are excluded from SSARS No. 21 for which a compilation or review report is not required:
   a) Provide selected monthly information requested by the client, such as account balances (e.g., cash or accounts receivable) or operating information (e.g., number of meals served for the month).

   b) Provide a client or other third-party users with a copy of the client's tax return. An accountant is not required to report on a tax return.
9. Issue financial statements with one or more GAAP departures.

What are the best options for a company that wishes to avoid some of the more laborious GAAP changes?

From the list of options noted above, the author suggests accountants consider one or two options as the means to provide a "little GAAP" for their small business clients.

1. Issue GAAP statements with one or more GAAP departures, or
2. Issue tax-basis financial statements.

Issue GAAP Statements with One or More GAAP Departures

Perhaps the best approach to simplify reporting for small businesses, and thereby avoid many of the more difficult GAAP pronouncements, is to issue GAAP statements with one or more GAAP departures.

Many third parties appear to favor this option when compared with the alternative of issuing tax-basis financial statements. Moreover, by having one or two departures, the essence of the statements is still GAAP, while tax-basis financial statements may have many differences when compared with GAAP.

The most common GAAP departures that may help simplify the effort required to prepare GAAP statements include:

1. Amortizing goodwill and indefinite lived intangibles:ASC 350 precludes such goodwill and indefinite-lived intangibles from being amortized and, instead, requires that an annual impairment test be performed.[1]
2. Not testing and consolidating a real estate leasing company with the operating company: ViolateASC 810, which requires testing and possible consolidation of a real estate leasing company into its operating company lessee.[2]
3. Using income tax depreciation: Including the section 179 deduction and bonus depreciation, instead of GAAP depreciation.
4. Not recording deferred income taxes: Violates ASC 740, Income Taxes by not recording deferred income taxes.

Although there are numerous GAAP departures that can simplify engagement time, the above four departures are the most common for mainstream companies.

Example:

Company X is a small manufacturing company.

Details regarding X follow:

- X has approximately $1.5 million of goodwill.

- X leases its primary manufacturing facility from Company R, a related party real estate lessor.

X decides that the cost of implementing certain GAAP standards is too costly and decides on the following GAAP departures:

1. Amortization of goodwill: X will amortize goodwill over the 15-year tax life, resulting in amortization expense of $100,000, which, net of the tax effect, is $60,000. GAAP (ASC 350) does not permit goodwill to be amortized and, instead, requires goodwill to be tested annually for impairment.
2. Avoid test for consolidation of real estate leasing company: X will not test Company R to determine whether R is a variable interest entity, nor will it consider consolidating R as R's primary beneficiary.ASC 810 requires X to test R to determine whether R is a variable interest entity and whether X is R's primary beneficiary that should consolidate R.

Following are the reports that would be issued to address the GAAP departures noted in this example.

Sample Report: Compilation with GAAP Departures: Substantially All Disclosures and Cash Flow Statement Omitted

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX and the related statements of income and retained earnings for the year then ended in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement 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 nor was (were) I (we) 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, a conclusion, nor provide any form of assurance on these financial statements.

Management has elected to omit substantially all the disclosures and the statement of cash flows required by accounting principles generally accepted in the United States of America. If the omitted disclosures (and the statement of cash flows, if applicable) 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. Accordingly, the financial statements are not designed for those who are not informed about such matters.

Accounting principles generally accepted in the United States of America do not permit the amortization of goodwill and, instead, require a company to perform an annual test of goodwill for impairment. Management has informed us that the company has recorded amortization

expense related to goodwill and that, if accounting principles generally accepted in the United States of America had been followed, goodwill would have increased by $100,000 and net income and stockholders' equity would have increased by $60,000, net of the tax effect.

Accounting principles generally accepted in the United States of America require that the company test another company from which the company leases its manufacturing facility, to determine whether the leasing company is a variable interest entity that should be consolidated into the Company's financial statements. Management has informed us that the Company has not performed a test for consolidation and has not determined whether consolidation is warranted. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

James J. Fox & Company

Burlington, Massachusetts

March 31, 20X1

GAAP Departures- Review Engagement

If there is a GAAP departure in a review engagement, the accountant's review report should include a modified conclusion, as authorized by SSARS No. 25.

A modified conclusion is either a qualified conclusion or an adverse conclusion.

1. The accountant should express a modified conclusion (either a qualified conclusion or an adverse conclusion) in the accountant's review report on the financial statements as a whole when the accountant determines, based on the procedures performed and the review evidence obtained, that the financial statements are materially misstated.
    a) The determination of whether a qualified conclusion or adverse conclusion should be issued depends on the degree to which the financial statements are materially misstated.
2. If the accountant, having obtained sufficient appropriate review evidence, determines, or is otherwise aware, that the financial statements are materially misstated, the accountant should express one of the following modified conclusions:

    Qualified conclusion: When the accountant concludes that the effects of the matter or matters giving rise to the modification are material but not pervasive to the financial statements.

    Adverse conclusion: When the effects of the matter or matters giving rise to the modification are both material and pervasive to the financial statements.

Illustration: An Accountant's Review Report on Comparative Financial Statements Disclosing a Departure from U.S. GAAP

Facts:

- Review is performed on a complete set of comparative financial statements.
- The financial statements contain a departure from U.S. GAAP.

Independent Accountant's Review Report

[Appropriate Addressee]

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 engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. 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.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews. **(NEW per SSARS 25)**