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"What We Do"

A surprising number of individuals and business owners do not understand what their accountant does. As a result, many people find that the services they engage their accountant to perform are not the services they expected to receive. In short, there is an "expectations gap."

This publication is intended to narrow the expectations gap by explaining some of the key services an accountant provides (and does not provide) in connection with financial statements, income tax returns, and consulting engagements. It is our hope that this publication informs you about what accountants do, and assists you in deciding what service is "right" for you. If you have any questions, give your accountant a call.

Whenever CPA is used in this publication, it means a sole practitioner CPA, or firm of CPAs, whose name is used to sign a report or tax return. CPA is designated an "auditing CPA" for auditing engagements, a "reviewing CPA" for review engagements, a "compiling CPA" for compilation engagements, and a "preparing CPA" for tax return preparation engagements.

A. Audits, Reviews, And Compilations

Management's Responsibilities In Connection With Financial Statements

Management is responsible for having a system of procedures and controls (safeguards and crosschecks), to enable the production of financial statements that are not materially misstated. The term "not materially misstated" is used rather than the term "correct" since many of the items in financial statements are estimates, and, accordingly, there are no accounting or auditing services offered to provide assurance that financial statements are "correct" or "exact."

Management is responsible for processing transactions and advocating a proper respect for its recordkeeping system, as well as enforcing a proper regard for recordkeeping and controls designed to keep recordkeeping reliable. Management assumes the responsibility for being totally open and honest with the CPA and for advocating such openness and honesty. This openness and honesty specifically includes knowledge of the possibility of the existence of errors (unintentional misstatements or omissions of amounts or disclosures), irregularities (intentional ones) and illegal acts (violations of laws or government regulations [including but not limited to embezzlement and fraud] made by or on behalf of the entity). Management is responsible for adjusting the company's financial statements to correct material misstatements and for affirming to the accountant in a representation letter that the effects of any uncorrected misstatements are immaterial to the financial statements taken as a whole.

The financial statements produced are management's, not the CPA's, because the transactions on which the financial statements are based are management's, not the CPA's. The CPA doesn't deposit the receipts, write the checks, make the sales or incur the expenses. Management does these things. Management owns the assets and incurs the liabilities. Management is supposed to keep records of its business activity. The CPA doesn't.

Though a coach may help an athlete train, critique and influence the athlete's techniques, and express an opinion of the athlete's abilities, the athlete's performance is his, not the coach's. Similarly, management's financial statements are management's statements, not the accountant's, even though the accountant may question or advise management, or express an opinion on

management's statements. Management is, therefore, responsible for identifying and ensuring that the company complies with the laws and regulations applicable to the activities, and for making all financial records and related information available to the accountant.

The CPA may process the transactions and/or produce the financial statements on his computer or cause adjustments, sometimes substantial, to be made so that the financial statements are not materially misstated. However, since the financial statements are based on management's transactions, they are still management's financial statements, not the CPA's.

This fundamental fact is emphasized in CPAs' reports. For example, the first paragraph of the auditors' standard report states: "These statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit." The first paragraph of the reviewers' standard report states: "All information included in these financial statements is the representation of the management." The second paragraph of the compilers' standard report states: "A compilation is limited to presenting in the form of financial statements information that is the representation of management."

When management includes an individual component (*e.g.*, inventories) in its statement of financial position, inherently it is making several assertions (positive statements or declarations) about the component. It is saying that the component is real (it exists), it is saying that it is priced right (it is valued properly according to the accounting rules), it is theirs (there are no liabilities except those disclosed), it is complete (there isn't any more or less), and that the words used to describe it are enough to meet the disclosure rules. For another example, when management includes sales at a certain figure in its operations statement, it is saying that sales actually occurred in that amount and that there were no other sales for the period.

Fundamental Differences In Audit, Review, And Compilation Engagements

In all three types of engagements, the CPA is supposed to sniff for anything that smells peculiar. As a matter of fact, in all his work the CPA is supposed to sniff. Sniffing is not a procedure. It is a pervasive requirement and attitude. It is called professional skepticism. It means an accountant should keep his wits about him.

In a compilation engagement, the compiling CPA is supposed to sniff. But he is not required to perform any procedures unless he smells something "fishy," or worse, in a financial statement. In that case he is supposed to look into what smells and get some more information or, as the need may be, cause management to make or agree to corrections. Otherwise, he is not required to go beyond keeping his wits about him as he uses management's numbers from its records and puts those numbers into familiar financial statement formats.

In a review engagement, the CPA goes beyond this and is required to perform so-called inquiries and analytical procedures, *i.e.*, he is supposed to ask some questions and compare this year's numbers in the financial statements with other numbers. If the answers to his questions, or the comparison of the numbers, cause him to wonder about some of the figures in the financial statements, he is supposed to follow through with other procedures and, if need be, cause management to make or agree to corrections. Following through may consist only of asking some more questions. On the other hand, if he doesn't get good answers, it may cause him to perform some verification procedures. But these additional procedures are performed only in connection with the figures he is wondering about. Otherwise he is only required to ask questions and compare numbers. At the conclusion of a review engagement the accountant issues a review report, stating that the accountant is unaware of any material modifications required in the financial statements. This is "negative assurance," and is not an expression of an opinion on the financial statements.

In an audit engagement, the CPA also sniffs around, as would be the case in a compilation, and asks questions and compares numbers, as would be done in a review. But, in addition, an auditor

has to feel, touch and taste, so to speak. He has to examine the evidence; he has to get the facts. But, for the greatest part, he will examine a portion of the evidence, a sample of it, sometimes a very small sample. He must do some testing. For examples: usually he reconciles (tests the reconciliations of) some bank accounts; he asks some customers to verify their balances; he observes and test-counts some inventory items; he searches for some unrecorded liabilities; he examines and compares with the accounting records, some sales invoices, some purchase invoices and some expense invoices. When he performs these types of auditing procedures, sometimes he may be required to dig deeper, depending on his findings.

Fundamental Differences Between Audit, Review, And Compilation Reports

Upon completion of his engagement, the CPA renders his report. This report broadly states what he has done and the conclusions he has reached. In an auditors' standard report, the auditing CPA expresses his opinion and that opinion provides ***reasonable assurance*** about whether the financial statements are free of material misstatement. The auditing CPA expresses ***reasonable assurance*** because he cannot express absolute assurance since he has only examined a portion of the evidence, sometimes a very small portion.

In a reviewers' standard report, the reviewing CPA only expresses ***limited assurance*** that insofar as he is aware, the statements do not require any material modifications. The assurance is limited because the procedures are so limited.

In a compilers' standard report, the compiling CPA expresses ***no assurance*** because he has performed no procedures upon which any assurance can be based.

None of these reports offers **complete or absolute assurance** that the financial statements are fairly presented. Such a complete or absolute assurance is beyond the scope of an accountant's work.

Audit Engagements

The second paragraph of the auditors' standard report states:

> We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

The key phrases are "reasonable assurance," "material misstatement," "test basis," and "reasonable basis."

Auditing is a testing-samples-of-items business. That's the way it must be because no one can afford a 100% comprehensive audit in which every transaction and every item of business would be audited. An audit of financial statements is entirely different from an audit by the IRS which may make the taxpayer prove with documentation every single item in a tax return. Also, unlike the IRS, which may assume at the outset that the taxpayer's return is incorrect, the auditing CPA does not assume that management's financial statements are incorrect.

Using generally accepted auditing procedures, the auditing CPA selects a sample, sometimes a very small sample, of the population, and tests that sample. If the sample is supported by the evidence, then he can conclude that the entire population is supported by similar evidence. It's like sampling to predict the outcome of an election. Sometimes even a few minutes after an election, the

outcome is known based on the returns of a minute portion (a sample) of the voters. That sample of voters is attributed to the entire population of voters.

In a test basis audit, the auditing CPA evaluates the effectiveness of certain matters (so-called risk assessments) and their consequent effect on the degree of his testing. Does management tend to override its own controls? Is the Company's performance erratic? How stable is the industry? How inherently risky is an item (inventories vs. property)? How good are the system and controls?

There's a pretty long list of matters to be evaluated and there is substantial guidance in the profession's Statements on Auditing Standards. Generally speaking, the greater the tendency of management to override, the more testing required. The better the system and controls, the less testing required.

Each auditor exercises his own judgment as to risk assessment. An auditing CPA's evaluations may differ from other CPAs' evaluations and still be within an acceptable range. Assuming all these risk assessments turn out to be low-risk, then the auditor's testing will be at the low end. But the auditor can still only provide "reasonable assurance" because the audit is still based on tests of samples. Furthermore, for virtually the same reason, he can only provide reasonable assurance that the financial statements are free of "material" misstatements.

The auditor's testing of inventories may show an inventory of $97,000 whereas the Company's financial statements show $100,000. He may conclude "that's close enough"; *i.e.,* that's not a material misstatement. The same kind of conclusion may be reached with something like depreciation, which is always an estimate so CPAs' evaluations may differ and both of them can still be right.

Further, a misstatement may be material standing alone but not material in relation to the financial statements taken as a whole. For example, a $15,000 misstatement in a $100,000 inventory is material in relation to the inventory but is not material in relation to a $1,000,000 stockholders' equity in the same statement. An undiscovered $25,000 embezzlement may sound like a material irregularity but may be immaterial in relation to both cash balance and stockholders' equity.

The concept of reasonable assurance applies not only to errors but also to irregularities and illegal acts. Errors are unintentional mistakes whereas irregularities are intentional ones. An audit is designed to provide reasonable assurance of detecting material irregularities. However, because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. An audit is also not designed to detect errors or fraud that is immaterial to the financial statements.

Here are some examples of irregularities that may well not be detected by an auditing CPA. Forged signatures (or the unauthorized use of a signature stamp) of key officials like check signers, credit approvers, or purchase order approvers. Collusion between a cashier and an accounts receivable clerk. Collusion among several individuals involved in ordering and maintaining inventory records and handling inventories. Theft of items from inventory, or cash from a cash drawer.

These types of irregularities may never be detected or may not be caught until some time after an engagement has been completed. That does not necessarily mean that the CPA performed inadequate audit procedures. Similarly, a material error may not be caught until after the engagement. That also does not necessarily mean the CPA did not follow generally accepted auditing standards.

A company may separately engage an accountant, for an additional fee, to provide services which specifically focus on identifying and addressing weaknesses in internal controls and searching for the existence of fraud. However, these services are <u>not</u> part of an audit engagement.

Review Engagements

The second paragraph of the reviewer's standard report states:

> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

The third paragraph states: "Based on our review, 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 generally accepted accounting principles."

In these paragraphs, the reviewing CPA is stating that, based only on the very limited (compared to an audit) procedures performed, he is not aware that the financial statements need to be adjusted materially.

The standards do require him, however, to perform additional procedures if, in the course of conducting his inquiries and analytical procedures, he encounters items or matters which are "incorrect, incomplete or otherwise unsatisfactory." The additional procedures can run the gamut from simply asking some more questions to, given unsatisfactory answers, performing some audit-type procedures.

Typical inquiries follow. What are your procedures for recording, classifying and summarizing information? Was $xxx in the bank? Were the receivables valued properly (take into account bad debts)? Did you own the vehicles? Were all accounts payable recorded? Sometimes the CPA doesn't have to ask questions if he already knows the answer from other experience. But he always has to ask some questions in a review engagement.

Typical analytical procedures follow. Compare this year's sales with last year's and explain the difference. Compare this year's gross profit with the last year and explain the difference. Compare this year's interest expense with average outstanding debts to see if it makes sense.

The standards do not require a reviewing CPA to design his review to provide reasonable assurance of detecting material errors, irregularities, and illegal acts. Nor do the standards require reviewing CPA to design his review to provide any assurance of detecting error or fraud that is immaterial. The only items he is responsible for are those that are discoverable in the ordinary conduct of his review and follow-up. Even so, he would not be responsible if he received satisfactory answers to his follow-up questions.

Compilation Engagements

The second paragraph of the standard report for compilation engagements states:

> A compilation is limited to presenting in the form of financial statements information which is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express any form of assurance on them.

Compilation engagements do not require the performance of any procedures. They do require the compiling CPA to read the financial statements to see if they are "appropriate in form and free

from obvious material mistakes" in accounting and disclosures. This means that he must sniff the financial statements to see if anything material smells funny. But that's all.

He might find apparent inconsistencies; for example, that the company has large receivables but no allowance for doubtful accounts. He might find that inventories are up substantially but accounts payable are down substantially and there has been no change in bank debt. He might find that the disclosures on long-term debt are insufficient. His course of action is to ask questions about these items and, if necessary, take further steps. Since he has performed no procedures, he has no responsibility for uncovering material errors, irregularities and illegal acts.

B. Preparation Of Income Tax Returns

Accountants may also be retained to "prepare" federal, state and/or local tax returns for individuals or businesses (*i.e.*, partnerships, S Corporations, C Corporations, etc.) (collectively the "Taxpayer"). You might ask what does an accountant do as the "preparer" of my income tax return? What are my responsibilities in connection with the tax return? Does the preparing CPA verify the information I provide? Does the preparing CPA retain documentation supporting assertions in my tax return? This section examines these questions, among others, to help you better understand what your accountant does as the "preparer" of your tax returns, and what your obligations are as the Taxpayer.

What An Accountant Does When Preparing An Income Tax Return

What the CPA "does do" in preparing an income tax return is evaluate and recommend tax positions, and complete the necessary documents for filing with the appropriate taxing authorities.

As part of the tax preparation process, the CPA identifies the questions that must be answered to complete the tax return and/or determines whether a particular tax position is appropriate. The CPA establishes relevant background facts necessary to answer these questions by communicating with the Taxpayer and/or reviewing documents the Taxpayer produces. The CPA may also search for and evaluate authority (such as federal or state statutes, opinions issued by tax authorities, or judicial opinions) to help the CPA arrive at a conclusion.
The accountant then prepares each return in compliance with the Statements on Standards for Tax Services issued by the American Institute of Certified Public Accountants.

In determining whether a certain tax position is warranted, the Statement on Standards for Tax Services requires the CPA to exercise professional judgment to determine whether there is a "realistic possibility" that a particular tax position will be sustained administratively or judicially on the merits. The "realistic possibility" standard is often quantified as a 33% chance or more of being sustained, although there is no definitive rule in this regard.

However, unless the accountant concludes that the tax position is "more likely than not" going to be sustained, he will likely require that the tax position be disclosed as part of the return before signing as the preparer. The Small Business and Work Opportunity Tax Act of 2007, imposes penalties on paid preparers of certain tax returns where an *undisclosed* tax position is asserted on a return for which the preparer cannot reasonably say in good faith that the position is more likely than not going to be sustained. The more likely than not standard is frequently quantified as a 50% chance or more of being sustained.

Sometimes the determination of whether a particular position meets the "realistic possibility" or "more likely than not" standard is not clear. For example, in exercising professional judgment, the accountant may conclude that competing tax positions both have a realistic possibility of being sustained. This situation may exist, for example, when a tax rule is ambiguous and no authority has resolved the ambiguity. In this circumstance, the CPA may discuss the competing positions with the Taxpayer, including the likelihood that each position might cause the Taxpayer's tax return to be

examined or result in a penalty. But, while the preparing CPA may provide advice or recommendations concerning a particular tax position, it is the Taxpayer's ultimate responsibility to decide whether to assert the position on the income tax return.

What An Accountant Does Not Do In Preparing An Income Tax Return

Understanding a CPA's role as the "preparer" of your income tax returns also requires understanding what services the CPA does not perform. What the CPA "does not" do in preparing income tax returns is audit, examine or verify the accuracy or completeness of information the Taxpayer provides, although when necessary the CPA may ask for clarification.

What this means is that the CPA will not ignore the implications of the information provided. If information appears incorrect, incomplete or inconsistent on its face or on the basis of other known facts, the CPA may bring them to the Taxpayer's attention and ask for clarification. If necessary, the CPA may discuss or assist the Taxpayer to correct inaccurate or incomplete information. This, however, should not be confused with any procedures designed to detect errors, defalcations or other irregularities. The preparing CPA does not conduct any procedures designed to detect such problems.

The preparing CPA makes a reasonable effort to obtain from the Taxpayer information necessary to provide appropriate answers to questions on a tax return before signing as the preparer. But, it is ultimately the Taxpayer's obligation to provide accurate, complete and timely information necessary to complete the tax return. For example, the CPA may ask questions or provide worksheets to guide the Taxpayer in gathering necessary information, but the CPA will not assist in gathering the information, and will rely on the information the Taxpayer provides.

The CPA also does not retain documents or data necessary to prove the accuracy and completeness of the returns to a taxing authority. Such documentation may become necessary if the Taxpayer's return is selected for review by a taxing authority. The CPA cannot, and generally will not, consider whether such a review is likely to occur, except when there is a realistic possibility that two competing tax positions may be sustained.

As discussed above, the CPA may evaluate and make recommendations concerning the applicability of a particular tax position. The CPA may also provide other advice related to preparing the tax return. However, sometimes events may occur which affect the CPA's previously provided advice. If there is such a change in advice, and the advice is associated with a plan or procedure for which the CPA is assisting the Taxpayer in implementing, the CPA will inform the Taxpayer of his or her change in position. But, if an event occurs that causes the CPA to change his advice and the Taxpayer is no longer implementing plans or procedures associated with that advice, the CPA has no obligation to communicate with the Taxpayer concerning the change in advice unless he or she has otherwise agreed to do so. This means that a preparing CPA's advice at one time or during one taxable year may not be applicable at another time or during another taxable year.

The Taxpayer's Responsibilities In Connection With Income Tax Returns

The Taxpayer bears ultimate responsibility for the final tax return filed, including any income, deductions, or credits claimed, as well as any other representations asserted. The return is the Taxpayers, not the CPA's, because the transactions and information upon which the tax return is based are the Taxpayer's, not the CPA's.

In a business, it is the company who owns the assets, makes sales, and incurs expenses. Therefore, management is responsible for properly recording transactions in the books of accounts, safeguarding assets and for the substantial accuracy of the company's financial records.

In the case of an individual, it is the individual who recognizes income, invests money, and incurs expenses in purchasing a home, raising a child, or paying for an education. It is the individual's responsibility to monitor and document these transactions completely and accurately.

Because it is the Taxpayer who monitors and documents their transactions, it is the Taxpayer's responsibility to ensure that the information provided to the preparing CPA is complete and accurate. The Taxpayer effectively enables the CPA to complete the return and evaluate the applicability of available tax positions by providing all necessary information to complete the return. The preparing CPA relies on the Taxpayer's oral and written representations. The preparing CPA does not audit or verify the Taxpayer's representations.

The preparing CPA cannot predict whether the Taxpayer's return will become the subject of review by taxing authorities. However, if the Taxpayer's return does become the subject of a review the Taxpayer will need to produce the necessary information to prove the accuracy and completeness of the tax return. While the accountant will be available to advocate the Taxpayer's position, it is the Taxpayer's responsibility to retain documentation and other data necessary for this purpose.

C. Consulting Services

The accountant's role when performing management or business consulting services varies widely depending on the nature and scope of the work involved, which is determined solely by agreement between the CPA and the client. For this reason it is impossible to define the roles of the accountant and management for all types of consulting engagements. However, a general understanding of the types of consulting services a CPA provides and the analytical approach involved in providing such services may be helpful when considering what consulting services may serve to benefit your company's needs.

Consulting services differ fundamentally from a CPA's function in an attest engagement, such as an audit or review. In an attest engagement the CPA expresses conclusions (in the form of reasonable or limited assurance) about written assertions that are the responsibility of another party, the asserter. In a consulting engagement, the CPA *develops* the findings, conclusions, and recommendations presented by utilizing his technical skills, education, observations, experience and knowledge of the "consulting process."

The consulting process involves some combination of activities relating to determining the company's objectives, independent fact-finding, defining problems and/or opportunities, evaluating alternatives, forming a proposed action plan, communicating results, and implementing a plan and/or following-up on an implemented course of action. These activities are generally performed only for the use and benefit of the company.

Consulting services can come in many different forms, including consultations, advisory services, implementation services, or transaction services, among others. In a consultation engagement, the CPA's role is typically to provide, in a short time frame and based primarily on his or her personal knowledge about the client, information and analysis concerning technical matters, the intent of the parties, and/or client representations. Examples of consultations include a CPA's review and comment on a client-prepared business plan, or suggestions about computer software for further investigation.

When providing advisory services the CPA develops findings, conclusions and recommendations for management's consideration and decision making. An analysis about a company's accounting system or a review of a company's operations are two examples of advisory services that a CPA might provide.

When a consulting CPA provides implementation services, the CPA's function is to put an action plan into effect. The CPA may utilize both his own resources, as well as those of the client to

achieve the client's objectives. Examples of implementation services include assisting with the implementation of steps to improve a company's productivity or assisting with the merger of organizations.

Finally, in a transaction consulting service the CPA provides services related to a specific transaction. For example, the CPA may provide an analysis of a potential merger, or may provide litigation services, including the rendering of an opinion based on conduct of another party or business.

Because there is such a wide variation in the types of available consulting services, hiring a CPA to provide business and management consulting services is unlike hiring an accountant to perform an audit, review, or compilation, or to prepare a tax return. The roles and responsibilities of both the accountant and client are less defined at first, but they are also more flexible. It is up to the accountant and management to develop a mutual understanding of the responsibilities of the parties, as well as the nature, scope, and limitations of services to be performed.

Conclusion

What level of service does your accountant perform for you? Do these services meet your expectations or business needs? You may wish to consider whether basic tax return preparation is enough, or whether you need specialized consulting services to address a particular business problem. You may also wish to consider whether you are content with receiving no assurance (compilation), limited assurance (review), or reasonable assurance (audit) as to whether your financial statements are presented fairly. Further, if you need services intended to identify internal control weaknesses, or possible fraud, you should speak with your accountant about additional procedures necessary for these purposes. If you have any questions about whether you may need different or additional services, please give your accountant a call.