

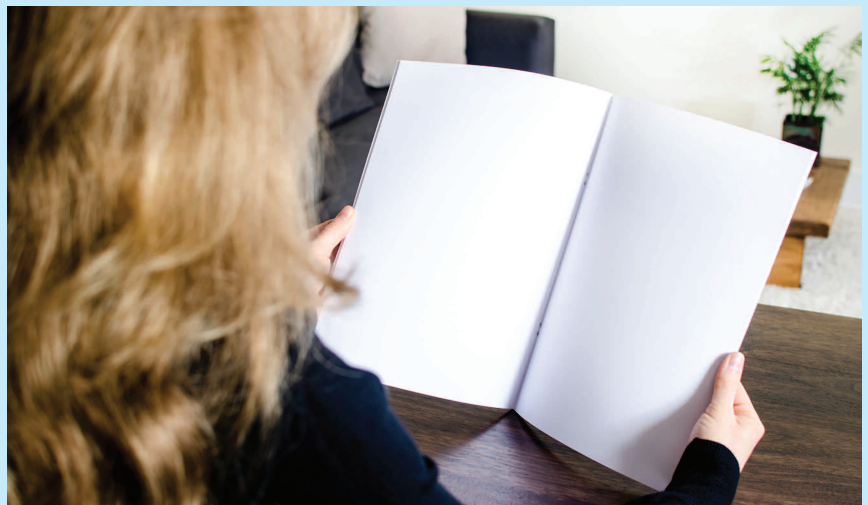
## ‘Plain Paper’ Financial Statements Made Not So Plain: An Overview of SSARS 21

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We are what we pretend to be, so we must be careful what we pretend to be.  
—Kurt Vonnegut,  
*Mother Night (Introduction)*

For most of the last quarter of the 19th century, accounting practice consisted mostly of making original entries for transactions and preparing financial statements for owners. Continuing into the early part of the 20th century, the work of accountants and the greater need for accurate financial information raised accounting to a profession with legal status and resulted in the formation of various self-regulatory organizations. A variety of standards (e.g., Statements on Auditing Procedure 23, 33, and 38) issued by the American Institute of Accountants (AIA), and later its successor the AICPA, in the middle of the century addressed the preparation of unaudited, unverified financial statements, called “plain paper” statements, attempting to correct misconceptions about CPAs’ attestation (or lack thereof) to the information in such statements.

But it was not until the judgment in *1136 Tenants’ Corp. v. Max Rothenberg & Co.* [36 A.D.2d 804 (N.Y. App. Div. 1971)], however, that the need for professional standards for accounting and review services became apparent. The trial court in *1136 Tenants’ Corp.* ruled that a CPA firm was negligent in its duties when it used “inadequate, incomplete, and improperly deployed” procedures when providing its services. Moreover, the



appeals court found that “even if defendant were hired to perform only ‘write-up’ services, it is clear, beyond dispute, that it did become aware that material invoices purportedly paid by [the building management company] were missing, and, accordingly, had a duty to at least inform plaintiff of this.” This case, as well as studies sponsored by professional associations that included an analysis of the perception of the users of unaudited financial statements prepared by CPAs, eventually led the profession to develop the Statements on Standards for Accounting and Review Services (SSARS).

SSARS 1, *Compilation and Review of Financial Statements*, issued in December 1978, established the standards for CPAs reporting on a client’s unaudited financial statements. It prohibited CPAs from issuing a report on the unaudited financial statements of a nonpublic entity unless either compilation or review procedures were applied to those statements. In addition, a report addressing the procedures applied and the level of assurance given, whether limited or none, was required to accompany the financial statements. SSARS 1 explicitly precluded the preparation of financial statements unless the CPA “complies with the provisions of [SSARS 1] applicable to a compilation engagement.”

Therefore, preparation of plain paper financial statements was prohibited.

Subsequent to SSARS 1, many leaders in the profession lobbied for standards that would allow the preparation of financial statement services that did not require even the application of compilation procedures. This was needed, they argued, to serve small entities that did not have the internal capability to prepare their own financial statements, and it could be accomplished if certain safeguards were in place.

In October 2000, SSARS 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements*, was issued. It addressed the performance and communication requirements for financial statements of nonpublic entities that were not intended for third-party use, but rather for sole distribution to individuals in management with sufficient knowledge to understand the statements in their proper context. There was a requirement that each page of the financial statements contain a legend indicating that they were “Restricted for Management’s Use Only” or similar language. This change to the SSARS did not completely resolve the issue, since some in the profession believed that there still existed a need to help smaller clients pre-

pare their financial statements for distribution outside of management.

### **SSARS 21**

SSARS 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, allowed CPAs to prepare financial statements from the unaudited financial books and records. Section 70 of SSARS 21 “applies when an accountant in public practice is engaged to prepare financial statements.” It also states that the procedures may be used and adapted to the specific engagement circumstances in the preparation of other prospective or historical financial data. (SSARS 26, *Statements on Standards for Accounting and Review Services: Omnibus Statement*, did not significantly change SSARS 21; it clarified it and added prospective financial statements to the list of information that can be prepared without applying any audit, review or compilation procedures.) This essentially allowed a CPA to perform the same nonattest services on financial data that were a part of many practices during the early days of the profession. There are, however, some important concerns and issues that CPAs should consider before providing such services.

Times have changed. What was available to the profession and its clients in the industrial age is far different than what is available in the information age. In addition, the legal climate is drastically different. Finally, the public perception of, and expectation concerning the work-product delivered by, CPAs has changed drastically.

SSARS 21, while ostensibly requiring no verification similar to that required in an audit or review, does require some procedures similar to those for a compilation, and failure to follow them can lead to allegations of insufficient performance. The standard also sets the stage for third parties to profess that they

placed greater reliance on the financial statements because a CPA was involved in their preparation.

Section 70.04 states that “an engagement to prepare financial statements does not require the accountant to verify the accuracy or completeness of the information provided by management or otherwise gather evidence to express an opinion or a conclusion on the financial statements or otherwise report on the financial statements.” In the following sections, however, SSARS 21 addresses the need for an engagement letter, including management’s agreement that either each page of the financial statements will include a statement that no assurances are given on those statements

This is more than simply labeling the service as “high risk.” The risk cannot be mitigated by extending procedures, because a preparation engagement does not require any verification procedures. Consequently, if verification procedures are used, they may significantly increase a CPA’s exposure to liability. The CPA or the firm will be associated with the financial statements, no matter what legend or report is used to disclose the lack of any verification of the underlying transactions and balances displayed on the face of the statements or the sufficiency of any note disclosures. CPAs must also consider whether the level of work is so far below the expertise attached to the CPA designation that it

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or the CPA will be required to issue a disclaimer that makes the lack of such assurances clear. Moreover, section 70 requires the accountant to comply with section 60, “General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services.”

A reading of sections 60 and 70 leads one to realize that several matters are critical to consider when performing a financial statement preparation service under SSARS 21. The most important business consideration when deciding whether to offer financial statement preparation services is the risk involved.

lowers the professional image of the CPA or firm providing the service.

Client acceptance and continuance is another factor. As stated above, the information given to the CPA will not be verified. Furthermore, clients desiring this service will tend to be smaller and less sophisticated, which presumably means that the data is more susceptible to error (and manipulation). CPAs should therefore exercise greater scrutiny of the character and integrity of the prospective or continuing client before a preparation engagement is accepted. The client’s behavior should be considered throughout the relationship, and if there is any doubt

about management’s integrity, serious consideration should be given to withdrawing from the engagement.

CPAs also need to have an understanding of the client’s business, structure, its accounting system, environment, and the financial reporting framework being used, including the acceptability of that framework. Because clients may not have the ability to prepare their own financial statements, CPAs should consider whether the necessary information and data will be available and reliable. If additional data is needed, this could be construed as evidence that the CPA was aware that a higher-level service than preparation was needed. This could expose a CPA to greater exposure if the financial statements turn out to be fraudulent or contain material errors.

Certain representations are needed to prepare financial statements. In other services, these are contained in a “representation letter.” Here, they need to be included in a client-signed engagement letter. The letter should state that the client is responsible for—

- the selection of the reporting framework used,
- the internal controls related to the preparation and presentation of the financial statements,
- the prevention and detection of fraud,
- compliance with relevant laws and regulations,
- the accuracy and completeness of the underlying financial records and documents and the significant judgments required for the preparation of the financial statements,
- providing the CPA with access to information needed to prepare the financial statements, and
- unrestricted access to client personnel.

In essence, the engagement letter becomes a representation letter, and CPAs must remember that all of these representations are coming from a client

who may be unable internally to prepare its own financial statements.

Finally, CPAs are expected to exercise professional judgment throughout the preparation engagement, and the basis of that judgment should be appropriately documented in the working papers. SSARS 21 also requires CPAs to discuss the judgments reflected in the financial statements with management so that management understands the significant ones and accepts responsibility for the judgments used. This may not absolve the CPA from any liability, however, as those judgments are made by management that might not even have the financial knowledge necessary to prepare its own financial statements.

SSARS 21 further states that if the CPA “becomes aware that the records, documents, explanations, or other information, including significant judgments” are not complete or accurate, she should bring that to management’s attention and request additional or corrected information. This requirement does place some burden on CPAs, even while they do not have to verify the data. With hindsight, a case could sometimes be made that a CPA should have known of the problem and asked for additional or corrected data. There is also the question of whether the fact that the necessary information is incomplete or inaccurate reflects on the character and integrity of the client.

### **The Profession and What It Represents**

CPAs are required to adhere to one or more of the AICPA, state society, or regulatory codes of conduct and their general standards or provisions when performing any service, such as professional competence, due professional care, planning and supervision, and obtaining sufficient relevant data. The vast majority of state societies use the AICPA Code of Professional Conduct or one with essentially the same provisions. All of them recognize the

need to place integrity and the public good above commercial considerations.

The CPA designation is earned only after education and experience criteria are met and a difficult examination is passed. It is a license to practice using the title of Certified Public Accountant. There are continuing education requirements that must be met to remain licensed, as well as requirements to comply with regulatory and self-regulatory organizations’ ethics and performance criteria. These requirements, which center on the CPA’s exclusive right to report on financial statements, have raised the public’s image of the financial competency of the CPA to a very high level. Unlike other organization-conferred designations, which ostensibly only demonstrate a special skill, the CPA designation is an exclusive, government regulatory authority–granted license to practice and perform certain services.

Given the high esteem in which the profession is held, why should CPAs perform services that could be performed extremely well, and at lower cost, by a good bookkeeper or even a computer program? As mentioned above, a legend stating that the financial statements were not audited may still put a third-party reader on notice that a CPA was involved in the preparation of the financial statements, even if the CPA’s name is not included in the legend. SSARS 21 does not preclude a CPA from including his name in the legend, but this offers a greater risk of liability and could imply that the preparer is trading on the trust the public has in the CPA designation. It is far more sensible for a CPA to serve as a consultant, setting up the computer system and controls necessary for the client to achieve its internal reporting objectives. For reporting to third parties, the compilation engagement should, in the authors’ view, be the lowest level of reporting, especially since its limitations are already recognized by the legal system. What is the differ-

ence in cost between the two services, even considering a lack of independence disclosure in the compilation report?

The high regard the public has for the profession is best protected by keeping the CPA's name off of plain paper financial statements. Eli Mason, an active critic of his profession when he believed it was going astray, said in a letter to the AICPA Accounting and Review Services Committee in 1997:

I have heard that your committee may reconsider "plain paper financial statements." As a long-time practitioner, I have had a negative feeling about such so called financial statements, as I believe they demean the professionalism [sic] of certified public accountants. These statements are intended to avoid responsibility by those who prepare and are associated with said financial statements, but to the contrary, clients have historically submitted such statements to banks and credit grantors despite caveats, footnotes, and "poison warnings" appended thereto. ("No Plain Paper Please," *The CPA Journal*, May 1997, <http://bit.ly/2pyW2Q8>.)

### Legal Considerations

The legal liability of CPAs who purport to perform SSARS 21 services could turn on whether those CPAs actually performed procedures beyond what the standard contemplates—in which case they will be beyond the legal protection that the standard attempts to create. This is precisely what occurred in *1136 Tenants' Corp.* In that case, the accountant's testimony that certain services performed went beyond the scope of "write-up" work and the time records revealing that the accountants examined bank statements were sufficient to create an issue of fact as to the scope of services actually performed, with the accountants ultimately being held to the standard of having been engaged to perform an audit.

By SSARS 21's own terms, CPAs who undertake to do more in terms of verification or analysis could find themselves being measured against the higher standards applicable to compilation or review engagements. This is particularly a concern in jurisdictions where privity rules allow negligence suits to be brought against CPAs by non-clients, as those non-clients would not be subject to the argument that their signatures on the engagement letters prevents them from arguing that a higher level of service was actually intended. It is entirely foreseeable that an opportunistic creditor or bankruptcy trustee would advance such an argument to establish a CPA's liability.

As was the case in *1136 Tenants' Corp.*, a CPA's own billing and engagement documentation is likely to be the key evidence militating against the argument that he only performed limited-scope clerical services. If a CPA undertakes to provide such services, extra care must be taken not to create the appearance that a higher level of service was actually performed. In the past, similar arguments have been made by litigants trying to establish that a CPA did more than was required for a compilation.

Another factor that will weigh against any CPA is the "expectations gap." The public expectation that CPAs are learned, careful, and thorough professionals is challenged by the notion that a CPA can assemble a client's financial statements without some level of professional analysis or responsibility. As experience has proven, juries and judges harbor these expectations.

### In Summation

SSARS 21 once again gives CPAs the authority to issue plain paper financial statements. In this regard, the profession has come full circle—but have CPAs learned from history? Hopefully, CPAs will take the steps necessary to reduce

engagement risk to an acceptable level and to protect the profession's public image.

CPAs who decide to proceed with a financial statement preparation engagement should consider the following steps to reduce the engagement risk and comply with the standards:

- Perform and document client acceptance and retention procedures
- Adhere to engagement quality control standards
- Obtain a written engagement letter clearly setting forth the client's and the CPA's responsibilities
- Meet with management to be sure that the representations are clearly understood, and document the meeting
- Follow up on any unusual or suspicious balances, activity, or unavailable data encountered
- Avoid including the name of the CPA in the legend required on each page of the prepared "plain paper" financial statements.

Financial statement preparation engagements are risky and can be performed adequately, effectively, and at a lower cost by non-CPA bookkeeping firms or computerized accounting systems for many smaller clients. CPAs who decide to perform financial statement preparation engagements should ask themselves if it is in the client's best interest, if they want to accept the engagement risk, whether they have complied with all of the procedures required by the standards, and whether the engagement will increase or decrease their and the profession's public image. □

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