
New standards for compilation and review engagements: some implications for real-estate developers

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Abstract

The Accounting and Review Services Committee of the American Institute of Certified Public Accountants recently issued three authoritative pronouncements relating to the compilation and review engagements of the CPA. These standards apply to all certified public accountants (CPAs) performing such compilation and review engagements. Statement on Standards for Accounting and Review Services numbers 9–11 affect parts of their practice that will be of interest to real-estate developers, who generally do not receive audited financial statements. Instead, they normally receive compilations (which focus on the form of the financial statements and provide no assurances of the conformity of the financial statements with generally accepted accounting principles) or reviews (which use inquiries and analytical procedures to provide limited assurances that the financial statements conform with generally accepted accounting principles). The new standards require CPAs to be much more rigorous in preparing compilations and reviews, which will force developers to provide CPAs with additional information, and almost certainly to pay higher fees, given the extra time and documentation involved. The purpose of this paper is to summarize these new standards and to highlight their impact on real-estate developers.

Keywords:

compilation, non-audit CPA engagements, real estate engagements, review

NEW STANDARDS FOR COMPILATION AND REVIEW ENGAGEMENTS FOR CERTIFIED PUBLIC ACCOUNTANTS: SOME IMPLICATIONS FOR REAL-ESTATE DEVELOPERS

The Accounting and Review Services Committee (ARSC) of the American Institute of Certified Public Accountants (AICPA) recently

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issued three authoritative pronouncements relating to the compilation and review engagements of Certified Public Accountants (CPAs). Statement on Standards for Accounting and Review Services (SSARS) numbers 9–11 affect parts of their practice that will be of interest to real-estate developers, who generally do not receive audited financial statements. Instead, they normally receive compilations (which focus on the form of the financial statements and provide no assurances of the conformity of the financial statements with generally accepted accounting principles [GAAP]) or reviews (which use inquiries and analytical procedures to provide limited assurances that the financial statements conform with GAAP). The new requirements will force developers to supply additional information to their CPAs, and almost certainly to pay higher fees, considering the additional time and documentation required. The purpose of this paper is to summarize these new standards and to highlight their impact on real-estate developers.

SSARS NO. 9

SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002*, requires additional disclosures by developers and other companies using compilation and review procedures. Amending SSARS No. 1, *Compilation and Review of Financial Statements*, and SSARS No. 4, *Communications between Predecessor and Successor Accountants*, SSARS No. 9 covers five general areas relating to compilation and review engagements:

1. CPAs signing the compiled or reviewed reports;
2. Disclosures relating to the Statement of Retained Earnings and Comprehensive Income;
3. Developing management representation letters; and
4. Enhancing communications between predecessor and successor CPAs/accountants.

Signing compiled or reviewed reports

SSARS No. 9 requires CPAs manually or electronically to sign all compiled and reviewed reports. Thus, developers e-mailing their preliminary financial statements and data necessary to develop compiled reports must obtain the signatures of the CPAs on the returned reports.

Disclosures relating to the Statement of Retained Earnings and Comprehensive Income

To help to simplify the financial reporting processes, ‘standard’ compilation and review reports no longer require separate Statements of Retained Earnings or Statements of Comprehensive Income. Developers can disclose required information regarding retained earnings as part of the statements of equity or in the footnotes. However, the compilation and review reports of the CPAs should make reference to any (optionally) disclosed Statements of Retained

Earnings or Statements of Comprehensive Income. SSARS No. 9 thus recognizes that GAAP require the disclosure of changes of equity, but not necessarily in a separate financial statement. However, CPAs should modify their reports when a Statement of Retained Earnings is not separately presented, but changes in retained earnings during a period are reported in a Statement of Changes in Equity or the required information is included in a note to the financial statements, and a separate Statement of Comprehensive Income is presented.

Revised management representation letters

SSARS No. 9 requires CPAs to obtain representation letters for all review engagements, and provides updated illustrative representation letters for such reviews to reflect recent revisions required in such audit representation letters. These representation letters should now contain, for example, representations for Financial Accounting Standards Board Statement No. 142, *Goodwill and Other Intangible Assets*, and Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. CPAs should now also ascertain that such letters include management acknowledgement of:

1. Its responsibility for fair presentation (per GAAP or Other Comprehensive Basis of Accounting [OCBOA]) of the financial statements;
2. Belief that the statements are fairly presented (again, per GAAP or OCBOA);
3. Complete and truthful responses to inquiries made during the review;
4. Specific representation that information provided to the accountant is complete; and
5. All information and comments regarding subsequent events.

Moreover, management should date such letters no earlier than the dates of the reports of the CPAs and cover all (i.e. comparative) periods covered by the review report(s)—even where current management was not present during all periods covered in the financial statements.

Appendix I contains an example of such a representation letter from a developer.

Enhanced communications between predecessor and successor CPAs

In parallel with recent revisions in management representation letters for audit engagements, *successor* accountants (i.e. those considering accepting the engagement) should now inquire (orally or in writing) of the *predecessor* accountants (i.e. those who have reported on the most recent compiled or reviewed financial statements or resigned from the engagement, declined to stand for reappointment or otherwise will not complete such engagements) about matters that will assist the successor accountant to ascertain whether to accept the engagement. While recommended (but not required in all engagements), such key information should include:

1. Knowledge of fraud or illegal acts and an understanding of the reasons for changing CPAs;
2. Information that could influence the assessment of the integrity of management;
3. Disagreements with management about accounting principles or the need to perform certain procedures; and
4. The cooperation of management in providing requested, additional or revised information.

Successor CPAs must obtain the client's permission to obtain such representation letters; inquire about the reasons for clients refusing to grant such permission; and consider the implications of clients refusing to grant such permission. For example, did interpretations or violations of GAAP or unpaid accounting fees lead to such rotation of accountants? However, the predecessor CPA may decide that potential litigation or other unusual circumstances could preclude their making such disclosures to the successors. Upon obtaining the client's permission, the predecessor accountant may also agree to allow the successor to use its client's workpapers. Appendix II contains an illustrative communication letter between predecessor and successor CPAs.

SSARS NO. 10

The ARSC also recently issued SSARS No. 10, *Performance of Review Engagements*, to provide additional guidance for CPAs performing review engagements, which, in turn, are based upon CPAs performing inquiries and analytical procedures. Briefly, SSARS No. 10:

1. Expands guidance on analytical procedures, inquiries and other review procedures;
2. Clarifies and provides guidance regarding workpaper documentation;
3. Provides inquiries regarding fraud in a review engagement; and
4. Requires representations regarding fraud in the management representation letter.

An elaboration of these points appears below.

Expanded guidance and documentation on analytical procedures and other review procedures

Given the importance that accountants place on expectations in performing analytical review procedures, including their predictions of recorded accounts or ratios, they should now investigate and otherwise follow up (e.g. to ascertain if misstatements have occurred) on significant unresolved or unexplained differences between such expectations and recorded amounts. Accountants should identify key, plausible relationships for such expectations—for example, square footage and property taxes—relative to the client's developing and developed property. Such data sources can include prior-period information (adjusted for expected changes), management's budgets or forecasts, industry data and non-financial data (e.g. employee

turnover). Accountants can also use information developed in performing monthly or quarterly compiled financial statements to develop expectations associated with reviewed financial statements.

SSARS No. 10 creates no new review standard, but merely reinforces the long-term requirement of SSARS No. 1 that accountants develop expectations before or during (but not after) performing analytical procedures. Accountants should also document significant expectations and factors that they considered in performing review procedures. For example, a CPA performing a review of a real-estate developer could consider factors that affect the relationship between current- and prior-year operations:

1. Increased state development of wetlands should increase revenues by 10–15%; and
2. This increase in revenues should also increase accounts receivables by a similar amount.

Similarly, the accountant should realize that a shopping mall client operating in a poor economy lost several tenants during the year, which, in turn, should cause expected revenues to decrease (compared to last year). Using its knowledge of the client, its business and the industry in which it operates, the accountant expects a 5–10% decrease in revenue during the year; moreover, general and administrative expenses should increase due to the costs of site plans, and management fees should decrease due to a decrease in tenants in the building.

Similarly to all other types of professional services, accountants should document the above procedures, such as factors considered, documents analysed, persons interviewed, statements received, areas investigated and conclusions reached. They could also include analytical procedures performed, the results of compared expected and recorded amounts, and additional procedures and results performed in response to significant unexpected differences arising from the analytical procedures. They could document the trend analysis results (e.g. compare prior and current sales), ratio analysis (e.g. liquidity, leverage, activity and profitability calculations for the client and its major competitors) and other model-based procedures (e.g. combining industry-specific and general economic information to develop expectations for recorded amounts).

Inquiries regarding fraud engagements

CPAs should now consider making such inquiries from management as:

1. How it prepared its financial statements in conformity with GAAP or OCBOA;
2. Its accounting principles and practices, methods in applying them and procedures for recording, classifying and summarizing transactions and accumulating information;
3. Unusual or complex situations that may have an effect on the financial statements;

4. Significant transactions occurring or recognized near the end of the reporting period;
5. Status of uncorrected misstatements identified during the previous engagement;
6. Questions that have arisen in the course of applying the review procedures;
7. Events past the date on the financial statements which could materially affect the statements;
8. Management's knowledge of any actual or suspected fraud; and
9. Significant journal entries and other adjustments.

Of course, CPAs should delve adequately (e.g. go beyond asking questions mechanically from a pre-printed audit program) and ask pertinent follow-up questions to such inquiries, especially when the responses contradict the expected results. For example, a developer should not be complaining about large interest costs during periods with low interest rates.

SSARS NO. 11

SSARS No. 11, *Standards for Accounting and Review Services*, tells CPA practitioners of the appropriate literature and authoritative hierarchy for SSARS, interpretive publications and other compilation and review publications. It also amends Footnote 9 of SSARS No. 2, *Reporting on Comparative Financial Statements*, to conform with Footnote 29 of the Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, which states that successor auditors who purchase or otherwise acquire a predecessor's practice may name the predecessor auditor as the successor auditor.

Specifically, SSARS No. 11 sets the following hierarchy for authoritative support:

LEVEL I

Statements on Standards for Accounting and Review Services

LEVEL II (Equally strong support within this level)

Interpretive publications

Compilation/review interpretations

Appendices to the SSARSs

AICPA Guides/Statement of Positions (SOPs) [e.g. SOP 93-5/April 1993/Common Interest Realty Associations (CIRAs)]

LEVEL III (Equally strong support within this level)

Other compilation/review publications

Compilation/review alert

Articles in professional journals

Continuing Professional Education (CPE) program materials

Textbooks, guide books, checklists, etc.

SUMMARY AND CONCLUSION

The provisions of SSARS Nos. 9–11 should clarify and improve the responsibilities of the CPAs in performing compilation and review

engagements. However, they are also going to cost real-estate developers time and money, and bring to the fore their responsibilities in making public their financial standing. Since bankers traditionally depend on compilations, reviews and financial statements in making loan decisions, the changes in standards can have significant effects. The standards clearly require increased interaction between CPAs and their real-estate clients—and documentation of this interaction.

Developers should be prepared for more rigorous questioning by CPAs. Some questions may be easily answered. For example, the answer to why interest costs for a project have grown in an economy that has lowered overall interest rates may be that the developer's other projects have not done well, and bankers now require higher rates. The answer to why the number of title searches for development property has risen may be that the City has enacted more rigorous zoning requirements. The answer to why property taxes for development policies have fallen may be that the City has enacted enterprise or renaissance zones, allowing reduced property taxes for ten years. The answer to why costs for lumber have risen greatly may be that a spate of forest fires has driven up the price of lumber. However, other questions will not be answered so easily, such as when a CPA is now required to inquire carefully into why a developer has switched CPAs, or when previous documents show that developers have committed to unrealistically high profit targets in order to renew a large loan. These days, CPAs are being urged in scores of ways to suspect fraud in sudden improvements or declines.

The bright side of the new standards—for developers—is that they can place greater confidence in using CPA services, and that bankers, investors and other users of such reports can make more informed decisions in providing and managing debt and equity capital given to developers as they perform their tasks.

Appendix I. Illustrative representation letter.

January 31, 2005 [*Note: This date must be no earlier than the date on the review report.*]

Mr. John Smith
Smith & Jones, CPAs
Detroit, Michigan 48202

Dear Mr. Smith:

We are providing this letter in connection with your review of our balance sheets as of December 31, 2004 and December 31, 2003, and our statements of income and statements of cash flows for the years then ended, for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements of Ann Wholesale in order for them to be in conformity with generally accepted accounting principles. We confirm that we are

responsible for fair presentation in the statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, as of May 15, 2004 [*Note: This date must be no earlier than the date on the review report.*], the following representations made to you during your review.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all:
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
5. There are no material losses [e.g., from obsolete inventory or purchase or sales commitments] that have not been properly accrued or disclosed in the financial statements.
6. There are no:
 - a. Violations or possible violations of laws or regulations, where the effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board [FASB] Statement No. 5, entitled *Accounting for Contingencies*. [*Note: This representation needs to be modified in circumstances where the client has not consulted an attorney.*]
 - c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
7. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on these assets, nor has any asset been pledged as collateral. [*Note: This representation needs to be modified when assets have been pledged as collateral.*]
8. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

9. The following have been properly recorded or disclosed in the financial statements:
 - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which the company is contingently liable.
 - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, entitled *Disclosure of Certain Significant Risks and Uncertainties* [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*].
[Add additional representations that are unique to the reporting entity's business or industry.]
10. To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
11. We have responded fully and truthfully to all inquiries made to us by you during your review.

Sue Beasley

Chief Executive Officer and President, Newport Development Company

William R. Sims

Chief Financial Officer, Newport Development Company

Note: This is a sample letter. Modify it as necessary, e.g., if the client has not consulted with an attorney, modify Section 6b.

Appendix II. Illustrative successor accountant acknowledgement letter.

[Date]

[Successor Accountant]

[Address]

We have previously reviewed (compiled), in accordance with Statements on Standards for Accounting and Review Services, the December 31, 2004, financial statements of ABC Real Estate Development Company (ABC). In connection with your review (compilation) of ABC's 2004 financial statements, you have requested access to our working papers prepared in connection with that engagement. ABC has authorized our firm to allow you to review those working papers.

Our review (compilation), and the working papers prepared in connection therewith, of ABC's financial statements were not planned or conducted in contemplation of your review (compilation). Therefore, items of possible interest to you may not have been specifically addressed. Our use of professional judgment for the purpose of this engagement means that matters may have existed that would have been assessed differently by you. We make no representation about the sufficiency or appropriateness of the information in our working papers for your purposes.

We understand that the purpose of your review is to obtain information about ABC and our 2003 results to assist you in your 2004 engagement of ABC. For that purpose only, we will provide you access to our working papers that relate to that objective.

Upon request, we will provide copies of those working papers that provide factual information about ABC. You agree to subject any such copies or information otherwise derived from our working papers to your normal policy for retention of working papers and protection of confidential client information. Furthermore, in the event of a third-party request for access to your working papers prepared in connection with your reviews (compilations) of ABC, you agree to obtain our permission before voluntarily allowing any such access to our working papers or information otherwise derived from our working papers, and to obtain on our behalf any releases that you obtain from such third party. You agree to advise us promptly and provide us a copy of any subpoena, summons, or other court order for access to your working papers that include copies of our working papers or information otherwise derived therefrom.

Please confirm your agreement with the foregoing by signing and dating a copy of this letter and returning it to us.

Very truly yours,
[Predecessor Accountant]

Accepted:
[Successor Accountant Date]