

LITTLE GAAP METAMORPHOSIS OF THE COMPILATION ENGAGEMENT

Submitted by Garry Mudryk CA CFE CPA

1.1 Overview

The current “little GAAP/big GAAP” controversy appears to be rooted in the needs of small to medium sized private businesses as it relates to the current GAAP requirements. Cost/benefit and the complexity of reporting requirements are major contributors to the concerns expressed. Although differential reporting may have alleviated the problem somewhat, I do not believe that it is the silver bullet as it comes with its own array of problems since it allows reporting to stray from GAAP. For instance, the reporting of income taxes on a payable basis can potentially result in nonsensical outcomes from a reader’s point of view. A business can very conceivably have a large loss and an income tax provision or alternatively a large profit and an income tax recovery. This example shows that GAAP deviations can be perilous. GAAP has the wisdom gained by the judgement and work of all those great minds that contributed to its development over a very long period of time.

Practitioners, in response, have moved to reporting on a compilation basis. It is paramount to understand that placing financial statements on a professional firm’s letterhead in and of itself provides unsophisticated readers with assurance, no matter what the “notice to reader” states. External users appear willing to accept the NTR report as providing sufficient perceived assurance related to small businesses. This may be because they do not expect to receive misleading information from a professional firm. In addition, most external users also rely on many other indicators of performance and risk.

I do not believe that a new conceptual framework for GAAP is required. Perhaps the needs of small business can best be met by development of a new conceptual framework for the compilation engagement instead. It appears that the client and external users may be ahead of the profession in this regard.

I envision the development of a new report that I refer to as the “INDEPENDENT ACCOUNTANTS LIMITED ASSURANCE ENGAGEMENT REPORT” (LAE).

1.2 Conceptual framework for the LAE

Some principles that I consider important to the concept:

- 1.2.1 The LAE would offer less assurance than a RER
- 1.2.2 GAAP should underpin the engagement.
- 1.2.3 Differential reporting on a sanctioned basis should not be allowed.
- 1.2.4 Professional judgement should determine the application of GAAP.
- 1.2.5 The client should disclose the foreseen external users of the report prior to commencing the engagement. Consideration of foreseeable and unforeseen users would be an overextension of the ability to apply professional judgement given the limited assurance provided. Although possible, perhaps it is desirable that the LAE not produce a general purpose financial statement.
- 1.2.6 The select application of GAAP should be governed by the practitioner's judgement related to the significance of the application in view of the needs of the foreseen external user. Practitioners would not disregard or modify GAAP but merely limit its application to the important aspects based on judgement. For instance if accounting for income taxes on a payable basis does not result in material distortions, then based on a judgement call, it could be used. If in the future, it introduces a material distortion, GAAP compliance would be required.
- 1.2.7 The equity stakeholder(s) and external users are in the best position to determine the level of assurance required (LAE, RER or Audit as alternatives).
- 1.2.8 Use of the compilation engagement report should be revoked due to the implied assurance previously discussed. Practitioners offering compilation assistance should not, in the future, be associated with those financial statements. Preferably, financial statements which a practitioner provided compilation assistance should be on the client's letterhead. In the absence of evidence of a professional firm's involvement, it is much less likely that an external user would attribute undue assurance.
- 1.2.9 The LAE should be used only related to for profit private entities.
- 1.2.10 Remuneration of equity stakeholders should be disclosed on a line basis.
- 1.2.11 File preparation, the financial statements and related disclosure should be solely determined by the practitioner's professional judgement with the guidance and within the confines of GAAP. This judgement should not be unduly influenced by the client or external users.
- 1.2.12 The LAE communication should state that the limited assurance is directed to foreseen users who should, where practicable, be identified. Further, the

- communication should indicate that the foreseen users were identified by the client.
- 1.2.13 Since professional judgement is paramount to this concept, a lack of independence should be prohibited.
 - 1.2.14 The LAE would rely very much on client representations. Consequently, a representation letter should be required and should address all client provided information of significance that was relied upon.
 - 1.2.15 Consideration should be given to requiring that the practitioner obtain a “waiver of liability” signed by the client.
 - 1.2.16 Negative assurance should not be provided.
 - 1.2.17 The application of complex accounting standards to complex transactions can be accommodated based again on professional judgement.

I have cobbled together what I believe that an “Independent Accountants Limited Assurance Engagement Report” might look like. Undoubtedly, it would require revision by those much more experienced at drafting this type of communication. It borrows somewhat from the current NTR and RER, as in my mind, the assurance level lies somewhere in between. It would presumably meet the needs of many small businesses and the external users of their financials.

1.3.1 (On the basis of information and representations provided by management I have prepared, without audit or review, the balance sheet of “client” as at December 31, 2007 and the statements of income, retained earnings and cash flow for the year then ended.

These financial statements were prepared for use by the foreseen external users as identified by the management of “client”. Management has indicated that the Bank of XXX is a foreseen external user. As these financial statements are not general purpose, other readers are cautioned that they may not be appropriate for their purposes.

These financial statements also may not be, in all respects, in accordance with generally accepted accounting principals. Departures from generally accepted accounting principles occur where, in my professional judgement, the departure is not likely to mislead the foreseen external users.

Readers are warned that since these financial statements rely on information and representations by management of “client” without corroboration, analysis or other verification, they may be in error or incomplete.)

CONCLUSION

I will not go, in any great detail, into all the frustrations that the small businesses and many practitioners feel regarding the quickly evolving GAAP when applied to small businesses. The "Discussion Paper" touches on most comments that I might have related to these frustrations. The year end financial statement does not have the same priority for small business as it does for larger concerns. When I refer to small business, I refer to the vast number of businesses that have modest revenue and say less than 50 employees. Running their day to day business on a hands on basis is their first concern. Understanding the complexities of accounting and income taxes holds little interest for them. Certainly they are concerned with profit and especially income taxes, but beyond that, their concentration reverts quickly to more ground level matters. Given the relative simplicity of their affairs and limited resources, it is very important that they get relief from full blown GAAP without resorting to a compilation engagement. To my mind, this can be done by relying on the use of professional judgement in the application of GAAP in circumstances where full blown current GAAP offers little cost effective utility to the client and external users do not require it. I have virtually converted my practice to a compilation basis for the last 10+ years and have not once been asked to upgrade a statement to a RER by anybody. In fact this is the case over the past 25 years that I have practiced in the service of small businesses. You may therefore be wondering why I have submitted this paper since compilations do not offer assurance and are essentially unregulated. That is the reason; some degree of regulation by the profession in this regard is needed but not to the extent of a RER. Professional judgement needs to be held in high regard and once again relied upon, especially in less complex engagements.

Thank you