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## Notice to Practitioners: Audit, review, and compilation considerations : when a predecessor accountant has ceased operations

American Institute of Certified Public Accountants. Auditing Standards Division

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# **Notice to Practitioners**

February 1991

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## Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations

Auditing Standards Division

***AICPA*** \_\_\_\_\_

**American Institute of Certified Public Accountants**

## **NOTICE TO READERS**

This Notice to Practitioners is intended to provide guidance to accountants in situations in which the predecessor accountant has ceased operations. The guidance in this Notice does not apply to situations in which a firm of independent accountants assumes responsibility for the work of another firm in conjunction with, for example, a merger with, or acquisition of, the other firm.

This document has been prepared by the AICPA staff in consultation with members of the Auditing Standards Board, the Accounting and Review Services Committee, and the Technical Issues Committee of the Private Companies Practice Section. This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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# Audit, Review, and Compilation Considerations When a Predecessor Accountant Has Ceased Operations

## **1. Communications With a Predecessor Auditor Who Has Ceased Operations<sup>1</sup>**

**Question.** Paragraph 3 of Statement on Auditing Standards (SAS) No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315.03), requires a successor auditor to attempt certain communications with the predecessor auditor prior to acceptance of an engagement. How should a successor fulfill this responsibility when the predecessor has ceased operations?

**Answer.** Even when the predecessor has ceased operations, SAS No. 7 obligates a successor to attempt certain communications with the predecessor prior to acceptance of an engagement. The successor should attempt the required communications, about matters that the successor believes will assist him or her in determining whether to accept the engagement, with the individual who had final responsibility for the audit (for example, the engagement partner). If the successor is unable to communicate with that individual or receives a limited response, the successor should consider the implications in deciding whether to accept the engagement.

## **2. Unavailability of the Working Papers of a Predecessor Auditor Who Has Ceased Operations**

**Question.** A successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing an

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<sup>1</sup> Statement on Standards for Accounting and Review Services (SSARS) No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2, AR sec. 400), provides guidance to a successor accountant who decides to communicate with a predecessor accountant regarding acceptance of an engagement to compile or review the financial statements of a nonpublic company. In situations in which the predecessor has ceased operations and the successor decides to engage in such communications, the guidance in this Notice may be useful.

opinion on the financial statements under audit. The successor's audit may be facilitated by reviewing the predecessor auditor's working papers. What is the effect on the successor's audit when the working papers of a predecessor who has ceased operations are not available for review?

**Answer.** Sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements includes sufficient evidence about matters of continuing audit significance, such as beginning balances, consistency in the application of accounting principles, and contingencies. When the working papers of a predecessor who has ceased operations are not available, the evidence normally obtained by reviewing the working papers must be obtained by performing other audit procedures. If the successor is unable to obtain sufficient competent evidential matter to express an opinion on the financial statements, the successor should qualify or disclaim an opinion because of the inability to perform procedures that the successor considers necessary in the circumstances, not because of the unavailability of the predecessor's working papers.

### **3. Significant Audit Procedures Performed by a Predecessor Auditor Who Has Ceased Operations**

**Question.** If a predecessor auditor has performed significant audit procedures, such as the observation of inventory or the confirmation of accounts receivable, and subsequently has ceased operations, to what extent may this work be used by the successor auditor?

**Answer.** Because a report on the financial statements has not been issued by the predecessor and the successor cannot complete the procedures required by SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), the successor can neither assume responsibility for the work of the predecessor nor issue a report that reflects divided responsibility for the audit, as described in AU section 543. The successor must perform audit procedures sufficient to afford a reasonable basis for an opinion on the financial statements under

audit. However, review of the predecessor's working papers may have an effect on the nature, timing, and extent of those procedures.

#### **4. Part of Audit Performed by Another Independent Auditor Who Has Ceased Operations**

**Question.** If an auditor who has ceased operations audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in an entity's financial statements, may the principal auditor make reference in his or her report to the audit of that auditor or assume responsibility for that auditor's work in accordance with SAS No. 1, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543)?

**Answer.** The principal auditor may make reference to the audit of another auditor, or assume responsibility for that auditor's work, only if the other auditor has issued an audit report and the principal auditor has completed the procedures required by AU section 543 prior to the time that the other auditor ceased operations. The procedures described in AU section 543 cannot be appropriately performed after the other auditor has ceased operations. In situations in which the principal auditor cannot use the work of the other auditor in accordance with AU section 543, the principal must perform audit procedures sufficient to afford a reasonable basis for an opinion on the financial statements under audit. However, review of the other auditor's working papers may have an effect on the nature, timing, and extent of those procedures.

#### **5. Successor Auditor Becomes Aware of Information That Leads Him or Her to Believe That Financial Statements Reported On by a Predecessor Auditor Who Has Ceased Operations May Be Materially Misstated**

**Question.** What actions should a successor auditor take when he or she becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor auditor who has ceased operations may be materially misstated?

**Answer.** When the successor becomes aware of information that leads him or her to believe that the financial statements reported on by a predecessor who has ceased operations may be materially misstated, the successor should advise management of the information and request that management determine whether the financial statements require restatement. In making such a determination, management may find it useful to discuss the information with the individual who had final responsibility for the audit of those financial statements (for example, the engagement partner). If management determines that the financial statements require restatement, the successor should request that management disclose the information to the party responsible for winding up the affairs of the predecessor firm. The successor also should request that management consider whether action should be taken to prevent future reliance on the financial statements.

If, in the successor's judgment, management does not respond appropriately to his or her requests, the successor should advise the audit committee, or others with equivalent authority and responsibility, regarding the information and management's response. If, in the successor's judgment, the audit committee does not respond appropriately to his or her communication, the successor should consider resigning as the entity's auditor. The successor would be well advised to consult with his or her attorney in determining an appropriate course of action.

## **6. Reports on Audited Financial Statements Presented With Prior-Period Financial Statements Audited by a Predecessor Auditor Who Has Ceased Operations**

**Question.** If the prior-period financial statements audited by a predecessor auditor who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

**Answer.** The answer depends on (1) whether the prior-period financial statements have been restated and (2) whether the entity files annual financial statements with the Securities and Exchange Commission (SEC).

*a.* If the prior-period audited financial statements *are unchanged*, the successor should indicate in the introductory

paragraph of his or her report (1) that the financial statements of the prior period were audited by another auditor who has ceased operations, (2) the date of the predecessor's report, (3) the type of report issued by the predecessor, and (4) if the report was other than a standard report, the substantive reasons therefor. Paragraph 83 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.83), indicates that the successor should not name the predecessor in the report. An example of the reference that would be added to the introductory paragraph of the successor's report is presented below.

The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

A reference to the predecessor's report should be included even when the predecessor's report on the prior-period financial statements is reprinted and accompanies the successor's report, because reprinting does not constitute reissuance of the predecessor's report in accordance with paragraph 80 of SAS No. 58.

- b. If the prior-period financial statements *have been restated*, the successor should follow the guidance in the preceding point *a*, indicating that the predecessor reported on the financial statements of the prior period before restatement. In addition, the successor should consider the guidance in question 5 of this Notice.

If the successor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor may report on the adjustments in accordance with the guidance in paragraph 83 of SAS No. 58, as amended by SAS No. 64, *Omnibus Statement on Auditing Standards—1990*, "Reports on Audited Financial Statements." In determining the nature, timing, and extent of procedures, the successor should consider that a predecessor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").



If the successor does not perform sufficient procedures to satisfy himself or herself as to the restatement adjustments, the note to the financial statements describing the restatement adjustments should be marked *unaudited*.

- c. If the entity files annual financial statements with the SEC, the SEC staff has indicated that, in annual reports (on Form 10-K and to shareholders), the predecessor's report on the prior-period financial statements should be reprinted with a legend, in lieu of the manual signature, indicating (1) that the report is a copy of the report issued by the predecessor and (2) that the predecessor has discontinued performing auditing and accounting services and, if applicable, that it has filed for protection from creditors under the Bankruptcy Code. A sample legend, for cases in which the predecessor has filed for bankruptcy, is presented below.

The report that appears below is a copy of the report issued by the company's previous independent auditor [*name of firm*]. That firm has filed for protection from creditors under Chapter 11 of the Bankruptcy Code on [*date*], and has discontinued performing auditing and accounting services.

The successor should refer to the predecessor's report in his or her report, as described in the preceding point *a*. If the prior-period financial statements have been restated, the SEC staff has indicated that it is ordinarily sufficient for the successor to audit only the restatement adjustments and report on them in accordance with the guidance in the preceding point *b*; in unusual circumstances, the restated prior-period financial statements may have to be audited.

## **7. Reports on Audited Financial Statements of a Nonpublic Entity Presented With Prior-Period Financial Statements Compiled or Reviewed by a Predecessor Accountant Who Has Ceased Operations**

**Question.** If the prior-period financial statements that have been compiled or reviewed by a predecessor accountant who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

**Answer.** The answer depends on whether the prior-period financial statements have been restated.

- a. If the prior-period financial statements *are unchanged*, the successor's report should make reference in a separate paragraph to the predecessor's report on the prior-period financial statements. This paragraph should include (1) a statement of the service performed in the prior period, (2) a statement that the predecessor has ceased operations, (3) the date of the report on the service performed, (4) a description of any modifications of that report, and (5) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole. Reference to the predecessor's report should not include the name of the predecessor. Examples of additional paragraphs for compiled and reviewed prior-period financial statements are presented below.

*Compiled Prior-Period Financial Statements*

The 19X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 19X2, stated they did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

*Reviewed Prior-Period Financial Statements*

The 19X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 19X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

- b. If the prior-period financial statements *have been restated*, the restated prior-period financial statements should be compiled, reviewed, or audited and reported on accordingly. In addition, the successor should consider the guidance in question 5 of this Notice.

**8. Reports on Compiled or Reviewed Financial Statements Presented With Prior-Period Financial Statements Compiled, Reviewed, or Audited by a Predecessor Accountant Who Has Ceased Operations**

**Question.** If prior-period financial statements that have been compiled, reviewed, or audited by a predecessor accountant who

has ceased operations are presented for comparative purposes with current-period compiled or reviewed financial statements, how is the successor accountant's report affected?

**Answer.** The answer depends on whether the prior-period financial statements have been restated.

- a. If the prior-period financial statements were *compiled or reviewed and are unchanged*, the successor should add a paragraph to his or her report on the current-period financial statements that includes (1) a statement that the financial statements of the prior period were compiled or reviewed by another accountant who has ceased operations, (2) the date of the predecessor's report, (3) a description of the standard form of disclaimer or limited assurance, as applicable, included in the report, and (4) a description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements. Reference to the predecessor's report should not include the name of the predecessor. Examples of additional paragraphs for compiled and reviewed prior-period financial statements are presented below.

*Compiled Prior-Period Financial Statements*

The 19X1 financial statements of XYZ Company were compiled by other accountants who have ceased operations and whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

*Reviewed Prior-Period Financial Statements*

The 19X1 financial statements of XYZ Company were reviewed by other accountants who have ceased operations and whose report dated March 1, 19X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

If the prior-period financial statements were *audited and are unchanged*, the successor should add a paragraph to his or her report on the current-period financial statements that indicates (1) that the financial statements of the prior period were audited by another accountant who has ceased operations, (2) the date of the predecessor's report, (3) the type of opinion issued by the predecessor, (4) if the opinion was other than unqualified, the substantive reasons therefor, and

(5) that no auditing procedures were performed after the date of the predecessor's report. Reference to the predecessor's report should not include the name of the predecessor. An example of such a paragraph is presented below.

The financial statements for the year ended December 31, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

- b. If the prior-period financial statements *have been restated*, the restated prior-period financial statements should be compiled, reviewed, or audited and reported on accordingly. In addition, the successor should consider the guidance in question 9 of this Notice.

## **9. Successor Accountant's Responsibilities Under SSARSs When He or She Becomes Aware That Prior-Period Financial Statements Reported On by a Predecessor Accountant Who Has Ceased Operations May Require Revision**

**Question.** Paragraph 10 of SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2, AR sec. 400), provides guidance to a successor accountant who, during an engagement to compile or review current-period financial statements, becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor accountant may require revision. That paragraph states that the successor should request that his or her client communicate this information to the predecessor. How may the successor fulfill this responsibility when the predecessor has ceased operations?

**Answer.** When the successor becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor who has ceased operations may require revision, the successor should request that the client advise the party responsible for winding up the affairs of the predecessor firm. If the client refuses to communicate with the predecessor or if the successor is not satisfied with the predecessor's course of action, the successor would be well advised to consult with his or her attorney.

