

It's my money and I want to recognize it now!

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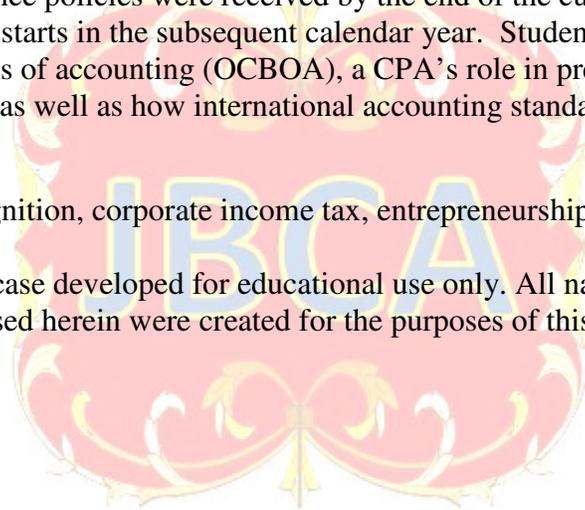
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ABSTRACT

The following case will help students determine when revenue is to be recognized for financial reporting purposes and for income tax purposes within a current accounting period or if it should be postponed until the forthcoming accounting period. The issue arises from an insurance agent's claim that most of his time and effort in estimating commercial insurance policies for a new large regional client should be claimed as income in the current period. Proceeds from the insurance policies were received by the end of the current calendar year; however, the policy term starts in the subsequent calendar year. Students are asked to explore other comprehensive basis of accounting (OCBOA), a CPA's role in preparation of financial projections and forecasts as well as how international accounting standards (IAS/IFRS) would impact their answers.

Keywords: revenue recognition, corporate income tax, entrepreneurship, lending, insurance.

Note: This is a fictitious case developed for educational use only. All names, numbers, percentages, dates, etc. used herein were created for the purposes of this case and should be interpreted as factual.



CASE SCENARIO

During high school Rusty Baines started working part time for his Uncle John's construction company, Stable & Sons Construction, Inc. (Stable.) Florida is a "right to work" state which means that union membership is not required to obtain employment. In fact, the normal practice in Florida is for construction contractors to be non-union, thus made it very easy for Rusty to start working in this industry.

Stable was licensed for both residential and commercial projects in the seven counties which comprise the Tampa Bay area of Florida. The company's niche was commercial strip centers, office buildings and light industrial buildings generally ranging from 10,000 to 20,000 square feet. Uncle John worked with several area architects who would ask him to bid on projects they had designed. Upon receiving appropriate governmental approvals for the plans, Stable became the general contractor for the construction phase of the project.

Rusty started out as a classic "gofer", filling in where ever he could. He worked part time during the school year and full time during the summers. In college Rusty majored in Environmental Science and minored in Business Administration. It was in one of his business classes that he met a woman who made his heart skip a beat! Ruby was majoring in finance. When Stable's accounts payable clerk took maternity leave, Rusty suggested that Ruby to fill in. She did a great job.

After graduation Rusty and Ruby got married and both took full time positions with Stable. Ruby's responsibilities included working with banks to produce documents required for loan approval, obtaining construction draws (progress payments) as well as developing budgeting and cash flow projections for internal use. Rusty reached the point that he could be the general contractor for any of Stable projects. Ultimately he became a licensed mechanical and electrical contractor. He was meticulous in making sure that the construction was done right and on time. Building inspectors loved him because he was so thorough and so honest. People in the business started referring to him as "Trusty Rusty."

The Plan

Uncle John had reached his mid-fifties and had started succession planning with his two sons and other family members. The next generation would begin to take over all phases of the business. Everyone felt that Trusty Rusty and Ruby should continue to work for Stable as well as get an ownership interest when Uncle John finally decided to retire. It was clearly time to share their own plan with the family before the succession plans were finalized.

Trusty and Ruby enjoyed being part of Stable. However, as Ruby explained to Trusty, the family needs some diversity in its "jobs portfolio." While the Stable had a long successful track record, having all of the family members working for one company might prove risky. Trusty agreed with her. Further, working for his mother's brother was okay but he wanted to prove to himself that he could succeed on his own.

During their years with Stable, Ruby had developed relationships with a large number of commercial loan officers. Trusty knew all of the developers and landlords who were customers of Stable as well as every building inspector in the 7 county area. Trusty and Ruby proposed to the family that they wanted to open two businesses. One would perform building inspections & appraisals; the other would be an insurance agency. Trusty would take the point for building inspections. And Ruby would be the broker for the insurance agency. They would continue

their jobs at Stable while they obtained all of the necessary licenses and credentials and gradually transition to their new businesses.

Trusty Rusty wanted to run his inspection and appraisal business as a branch of Stable until he reached a sufficient volume to open his own business. Stable would bill the client, keep 10% then include the difference as part of gross wages in Rusty's next paycheck. Rusty anticipated that his revenue would come from 3 sources: building sales inspections, tenant building inspections and periodic loan inspections. A common lease clause is to periodically require property inspections as an assurance to the owner that the property was being maintained in conformance with lease requirements. Lessors would also hire Trusty to inspect their property when a tenant moved out.

In late 2010 Ruby and Trusty completed their property and casualty insurance licensing. As a broker, Ruby had to have her own office and legally couldn't run this business as a subsidiary of Stable. She also obtained signed agreements with more than a dozen insurance companies to sell insurance for them. Trusty obtained his insurance agent's license to sell insurance through Ruby's agency. This created another market for his inspection business. It's possible for insurance premiums to be significantly reduced if the property is physically inspected instead of simply sending pictures to the agency.

The Baines Insurance Agency, Inc. and The Baines Inspections and Appraisals Service, Inc. officially opened on January 1, 2011. Their CPA, Rosalie Lowe recommended that the business entities be organized as subchapter S corporations (S Corps.) These are entities that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S Corps report the flow-through of income and losses on their personal tax returns. However, any shareholder who actively participates in the business must be paid reasonable compensation as wages. Since their businesses were new, it was impossible to determine the amount of reasonable compensation. Therefore, Rosalie had them hire a payroll processing company and to pay themselves a salary of \$1,000 per month from each of the companies. At the end of the year Rusty would get two W2's: one from Baines Insurance for \$12,000; one from Baines Inspections for \$12,000. The same would be true for Ruby. They each owned 50% of the businesses and agreed to split the net profit or loss of each company equally. Rosalie emailed them her list of records they would need to keep. Trusty and Ruby knew most of this since they were already used to doing these things when they were with Stable. They kept mileage logs when using their personal vehicles for business purposes, they used their business credit cards only for business related purchases and when they took someone out for dinner or other entertainment, documented the circumstances. The IRS requires that the company keep a record of who attended the event and the business purpose. It was agreed that Ruby (would?) pay the bills and deposit customer checks using QuickBooks to keep those records. Ruby opened two bank accounts and kept two sets of books, one for each entity. Rosalie helped Ruby set up QuickBooks for each of the businesses. The QuickBooks program has standard templates for a wide variety of businesses, so it was really just a case of picking the correct template. Rosalie made sure that each company had a "drawings" account to use whenever money, other than their salaries, was taken out of the business checking account for personal use. She also included an equipment account for any expenditures for items expected to last more than a year and costing more than \$1,000. If equipment cost less than \$1,000 Ruby should put that expenditure in either a supplies or an office supplies account. Both businesses operated out of the same office which they rented in a small shopping center. For situations like this, Ruby would record the half of the rent expense in each company. Rosalie stressed that it

was important to keep each business as well as their personal banking activities all separate. And if they needed to use some of their own money to cover their business expenses, they should first write a check to the appropriate company an owner investment, not revenue. Then pay the expenses from the business account.

Rusty already had a steady income stream from the business he developed while part of Stable. He was at least able to cover their business expenses. Through their efforts and community networking their businesses grew exponentially in 2011 and by the end of the year their economic status was strong, but not as strong as they would have wanted it to be. Then one day in September Rusty walked into the office to see Ruby chatting with a former contracting client, Larry Pinder, who smiled and exclaimed, "Office life sure does agree with you Trusty!" Rusty was happy to see Larry and asked him how they could be of service. Larry explained that he wanted Rusty to give him a bid for a one year casualty insurance policy on a commercial shopping center which would go into effect on October 1, 2010. Larry explained to Rusty that he was shopping for property and casualty insurance coverage. He pays the taxes and insurance on his rental property and a portion of the tenants' periodic lease payments include an amount to cover these items. Sometimes leases refer to these as executory costs. Another phrase which describes this practice is "triple net" leases. After the preliminary interview with Larry, Rusty had the necessary information needed to bid out the insurance policy. Rusty had also mentioned to his friend that due to the building's age it would behoove Larry to get a building inspection of the property. "What is the cost?" Larry asked, and Rusty replied for this type of property an inspection would \$600. And if this doesn't save you more in insurance premiums than the cost of the inspection, the inspection is free. Larry exclaimed, "Go for it Trusty" and handed him his credit card to process for the inspection fee. It took Rusty a couple of hours to perform the inspection. Pinder had done a great job of maintaining the property. The roof, HVAC systems, etc. were in much better shape than what he typically saw in structures of this age. Rusty spent a lot of time writing-up the insurance proposal, and preparing his presentation for Larry. On the day of the presentation Rusty showed Larry the findings of the inspection, thoroughly discussed the policy coverage, and finally that the insurance premium would be \$9,000 (and the Baines commission was \$540.) Larry awe-struck by Rusty's work and the fact that his bid was 22% lower all of the other bids he had received. Larry signed the check for the insurance premium and Rusty handed him his insurance policy. Rusty said "Larry, just remember that we here for you. If anything comes up, you know where to find us." Ruby deposited the premium check as \$540 Commission Revenue and the net amount as Accounts Payable (to the company insuring the property.)

At the end of October Larry returned to the office and wanted to take Rusty and Ruby to lunch. During lunch, Larry told Rusty and Ruby that he wanted them to bid on all of his 25 of his commercial properties. Larry explained to Rusty that he needed an insurance agent who was proactive and wanted to save his client's money. You're that agency for me. With a grin and a hand shake Rusty told Larry that he will have his bids for all of Larry's properties by December 15th. Larry agreed and said, "Trusty Rusty, the game is afoot."

After coordinating the logistics of the property inspections, Rusty and Ruby worked at a feverish pitch on Larry's properties as well as servicing their other clients. There were a lot of nights and weekends when the office lights were on. Rusty had just had enough time to prepare his presentation for Larry by December 15th.

Again, Rusty hit the proverbial ball out-of-the-park. All but one of the insurance bids were lower than the previous year's policy premiums! Further, the savings were greater than the

charge for the inspections. Rusty told Larry that his Seminole Heights area property's sprinkler system is obsolete and the electrical system has to be replaced because it was in violation of building codes. "This will not be a quick fix," Rusty said, "but if you can have the work completed by the end of next your insurance premium on that property will drop significantly." Larry said with a smile, "No problem, think your Uncle's company could handle the repairs?"

The next day Rusty called Rosalie's to schedule a telephone conference to answer some accounting questions he had. Rosalie was able to take the call. Rosalie agreed to Rusty's request to put her on speaker so that Ruby could participate as well. Rusty explained that the Insurance Agency might receive a large premium check at the end of the year resulting in \$36,000 of commissions, which fell within the normal 10% to 20% range of the premiums on commercial property and casualty insurance. This is based upon a premium for insurance policy coverage starting on January 1, 2012. The premium had to be paid by December 31, 2011 for Larry Pinder's insurance to go into effect on the desired date. What he wanted to know was if this money received in December would it be considered income for the 2011 accounting period or the 2012 accounting period? Rosalie said that there might be some flexibility about that. Since Baines Insurance hadn't yet picked an accounting method, the tax code allows small corporations to use either accrual or modified cash accounting. Rosalie said that with a new business she evaluates the circumstances and, after discussing it with her client, chooses the method that result in the lowest tax for the client. Then Rosalie cautioned, "Once an entity picks a method, it has to use the same one for year to year until it gets so big that the IRS requires the entity to use accrual accounting."

Rusty said, "Rosalie, keep in mind that we will have finished all of the requirements to earn this commission revenue. It's our money, and we want it in income now!" Rusty added the real issue is that they may need to show higher income because they wanted to refinance their home. They planned to build an attached income property. Then if it became necessary, simple alterations would allow Ruby's parents to move in with them. Presently they were in perfect health. Ruby said, "It's my understanding that the bank will want to see our 2011 tax returns – in the best possible light - to help us qualify for the loans."

Rosalie told Rusty that he since he had no flexibility on when he was going to receive the insurance commission; she suggested that as soon as possible after December 31 the Baines upload the following information into the CPA firm's cyber file cabinet. She needed the QuickBooks files, the mileage logs and a list of any equipment that they brought from home and were using in the business. Rosalie added that this time of year she normally reminded clients to buy any equipment they needed prior to December 31. This would reduce their taxable income. Rusty shot a look to Ruby that said "reduce income? I wonder if our CPA understands the issue?!"

Rusty had just hung up with his CPA when his phone rang again. It was Larry. He asked "Do you guys do work in the Orlando area?" Rusty said, "Yes we're licensed to do business anywhere in the state." Larry said "Great! I have 10 properties there that I'd like for you to work on. The only problem is that the insurance on those properties expires on March 31. While I've only had insurance coverage for 75% of the policy year, my current insurance company will not refund the 25% balance of the premiums I've paid. So the Orlando property insurance will be a project for the first quarter of 2012." Then Larry added, "My golf foursome has a 9 am tee time tomorrow. The other three are also developers. Wait until they hear about Baines Insurance! Better print up some more business cards!"

On December 29th Larry entered Rusty's office with two checks. One check was for the building inspections totaling \$15,000. The second check was for annual policies on the 25 commercial properties totaling \$222,000. Rusty said "Are you sure that you want to pay 100% of your premiums now?" Larry said "Yes, the installment payment option would have cost me approximately 5% in interest. The banks aren't paying any significant interest on money market accounts so it makes sense to pay of the premium all in one lump sum." Rusty said, "Okay, if that's the way you want it. And you understand that just like your previous insurer, while you are paying \$18,500 a month for insurance coverage, they retain around \$32,000 a month for refund calculation purposes." Larry nodded and then said, "Don't return the \$600 inspection fee because you are worth every dollar." Rusty enthusiastically shook Larry's hand, thanked him then wished him and his family a happy new year.

The following Monday they went to work pulling together the information for their CPA. They emailed her that their banker suggested that, in addition to their tax returns, their loan application should include something called a financial statement compilation for 2010 and a financial statement forecast for 2011. The banker referred to using other comprehensive basis of accounting (OCBOA) and told Rosalie that they had no idea what he was talking about.

On January 20 they arrived for a meeting at Rosalie's accounting office. The Baines each accepted a cup of coffee then everyone sat down to get the meeting started. Rosalie said, "You guys did a great job of record keeping which is going to really help me prepare your tax returns. This will involve returns for your two S Corps's and your personal returns. You should be getting some more Form 1099's for brokerage and banking account interest. And thank you for signing and uploading your tax return engagement letter to your cyber file cabinet. Do you have any questions?"

Rusty chimed in, "We're pretty confused about the other reports that our banker recommended. Is there a book somewhere explaining OCBOA to dummies?" Rosalie laughed saying that there wasn't any book that she knew of, but that she'd give it a try. She reminded Ruby and Rusty that her CPA firm audited Stable and Sons, Inc. and that those financial statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP) which is what they studied in school years ago.

"When you took accounting in school what you learned was GAAP accrual accounting. With accrual accounting, revenues are recorded when services are performed, not when the cash is received. Until the revenue is earned, the money involved is in a liability account generally called something like unearned revenue. By the same token, expenses are matched to revenues and recorded as an expense when the service is received. If cash is paid prior to receiving the services, the dollars involved are shown as a prepaid asset. Does this sound familiar?" Again her clients nodded, although less enthusiastically. "Okay, let me give you an example. Suppose we agree that you want me to: (1) do your taxes; (2) prepare a compilation; and (3) prepare a forecast. If you paid me for all three in December, under accrual accounting you would record the entire amount as something like prepaid accounting fees. Then when you get your tax returns, you transfer part of that the prepaid amount to accounting fees expense. You'd do that a second time when you get the compilation and a third time when you get the forecast."

She could tell from the look in their eyes that they understood, so she continued. "Whereas when my firm receives your check, under accrual accounting that amount would be recorded as unearned revenue. Once the tax return is sent out, the fees for that service are transferred from unearned to revenue." Rusty interjected "and then when the compilation is finished that portion of the unearned fees become revenue?" "Exactly!" said Rosalie. "This is a

situation where the components can be identified and accounted for separately.” I noticed that your insurance agency has a billboard on the interstate close to the industrial area of town and that you paid \$6,000 for it on November 1. How long is the contract for?” Ruby responded “Six months.” Rosalie continued, “Okay, assuming the cost to design the billboard was part of the total contract, under accrual accounting there’s no way to identify components so the expense for you and the revenue for the billboard company are both allocated on a straight line basis.” She asked, “How much revenue will the billboard company record in 2011 and how much in 2012?” “\$2,000 in 2011 and \$4,000 in 2012?” asked Ruby. Rosalie said, “Precisely! And your insurance agency would mirror that by having \$2,000 of expense in 2011 and \$4,000 of expense in 2012.” And finally, there are expenses like your printing costs for business cards and brochures. Those are expenses immediately because there’s no way to predict when you will hand those out or when they will play a role in actually generating revenue.”

“The other extreme is cash basis. Under cash basis accounting, the general case is that when the cash is received it is revenue and when cash is paid it’s an expense. Usually accountants use the phrase modified cash basis because if a business were to purchase a new office building for cash, it simply doesn’t make sense to call that an expense in one year when they will be using the building for 30 or more years. So even under cash basis accounting, items of property, plant and equipment are recorded as long term assets and depreciated. There are other exceptions like making loans or receiving loans. So there’s GAAP, and then there are several other ways of presenting financial information, that’s where OCBOA comes from. Modified cash basis is one of those. Income tax basis is another. Remember that a business picks either cash or accrual basis to use for its first tax filing and then continues using that method until it gets millions of dollars of revenue. I normally have all of my business clients on accrual basis accounting. As a general rule it results in lower taxes.” Ruby concluded, “You may not realize it, but I’ve just described 3 kinds of OCBOA methods: (1) modified cash basis; (2) Income tax – modified cash basis; and (3) Income tax – accrual basis.”

Rusty said, “What? There are two versions of modified cash basis?”

Rosalie responded, “Yes. What they have in common is that almost all of the expenses for the modified cash basis are also deductions for the tax version. However the tax code allows additional deductions which would not be expenses otherwise. An example would be an expensive piece of equipment that you buy for your inspection business which you expect to last for 5 years. Under the modified cash basis that equipment would be recorded as an asset and depreciated. The tax code allows companies to deduct the cost of any equipment in the year of purchase as long as certain criteria are met, and your company does.”

She continued, “I suspect that this is why your banker suggested that you have me prepare a compilation for your businesses, it will probably show higher income than your tax return. The American Institute of CPAs (AICPA) has rules that I am required to follow when preparing compiled financial statements. I will email a separate engagement letter for you to sign which will then permit me to work prepare these financial statements for both businesses. You will notice that the engagement letter will state that the compilations will consist of only an income statement (called a statement of revenues and expenses – modified cash basis) and a balance sheet (called a statement assets, liabilities and retained earnings – modified cash basis) and that all disclosures are omitted. There’s also a standard cover letter that I am required to prepare. I’ve worked with your banker frequently and in my experience that it’s all that is required to help him to evaluate your businesses’ performance for 2011. Are you okay with

that?” Both Ruby and Rusty nodded. Ruby promised to email the engagement letter within 48 hours.

Looking to the future

Ruby asked them to tell her what was currently going on with their business to give her a foundation for the forecast. They told her about Larry Pinder, the 26 new commercial insurance policies, the potential for 10 more, just from him. They told her about Pinder marketing their services to all of his buddies so they could be looking at an explosion of revenue in both businesses. Basically we expect revenues to more than double in 2012. They were thinking about hiring an administrative assistant to handle appointment scheduling, taking over other office functions like the bookkeeping to free up Ruby to be more active generating leads and selling insurance policies.

Rosalie said, “Just like with compilations, the AICPA has rules for forecast engagements. I’ll have to get an engagement letter from you. I’ll forward a copy of the cover letter from my firm that will be attached to the forecast. The forecast can be limited to the income statement. And here’s a key point: The AICPA requires that you have sufficiently objective basis for the assumptions used to develop the amounts for each of the key factors –and these assumptions have to be disclosed.”

Rosalie indicated that the Baines could expect to receive the compilation report and tax returns within a month. She also suggested that they consider talking to your banker to get a preliminary evaluation as to whether you might qualify for the re-fi of if the bank will still need the forecast.

Case Questions:

1. How much revenue will Baines Inspections and Appraisals, Inc. recognize for the inspections performed for Pinder and justify your answers?

	2011	2112
Cash Basis		
Accrual Basis		

2. How much revenue will Baines Insurance, Inc. recognize for the policies sold to Pinder and justify your answers?

	2011	2112
Cash Basis		
Accrual Basis		

3. The IRS requires that owners of S Corporations who are actively participating in the business receive reasonable compensation. While there are no specific rules as to what constitutes reasonable compensation, courts have included: duties and responsibilities; time devoted to the business; pay for similar services in comparable business. Develop some suggestions for the Baines to consider using to update their compensation formula.

4. You have been given a print out of the QuickBooks file for 2011 and for 2012 to date. How many months of activity in 2012 would the CPA need in order to meet the AICPA requirement of having “have sufficiently objective basis for the assumptions?”

TEACHING NOTE FOR INSTRUCTOR

Case Overview

This case helps the student to analyze and determine the recognition of revenue from both an accrual and tax accounting perspective and Other Comprehensive Basis of Accounting (OCBOA). The primary stakeholders of this case are owners of both an insurance agency and a building inspection business. One of the owners prepares the largest bid of his entire career at the end of his current accounting period for policies to cover properties next fiscal year. All funds are received and are unencumbered at the end of the current period. The owners want to present financial information for a loan application which will reflect the massive amount of new business. The question is whether to claim this cash as revenue in the year when the money is received. Secondly the case raises issues associated with closely held family businesses, such as succession planning which makes the case interesting to entrepreneurial students.

Learning objectives and suggested use of the case are as follows:

1. Understanding and implementation of the principle of revenue recognition.
2. Understanding the differences between accrual basis and cash basis and (OCBOA) accounting. And how this might change under international accounting standards (IAS) which may be reflected when convergence to IFRS occurs.
3. Understand the higher borrowing requirements faced by self-employed loan applicants.
4. Understand the role that a CPA can play in the loan application process by preparing forecasts and projections.
5. Expose students to operating issues in a variety of industries including construction, insurance, commercial lending, and small business succession planning.

Suggested Audience

This case is intended for a variety of classes including entrepreneurship, finance, financial accounting, and individual/corporate tax.

Suggested Answers to Case Questions

1. How much revenue will Baines Inspections and Appraisals, Inc. recognize for the inspections performed for Pinder and justify your answer? (\$600 x 25) + \$600. Paid in 2011 and all of the work was performed in 2011.

	2011	2112
Cash Basis	\$15,600	0
Accrual Basis	\$15,600	0

2. How much revenue will Baines Insurance, Inc. recognize for the policies sold to Pinder? Keep in mind that Revenue recognition is in transition; however the treatment shown here is the same as the revenue recognition rules under International Accounting Standard (IAS) No. 18.

	2011	2112
Cash Basis	\$540 + \$36,000	0
Accrual Basis	$(3/12) \times \$540 = \135	$[(9/12) \times \$540] + \$36,000$

3. The IRS requires that owners of S Corporations who are actively participating in the business receive reasonable compensation. While there are no specific rules as to what constitutes reasonable compensation, courts have included: duties and responsibilities; time devoted to the business; pay for similar services in comparable business. Develop some suggestions for the Baines to consider using to update their compensation formula.

There is no correct answer to this question. The instructor may wish to suggest that for each of the companies Ruby and Rusty receive a salary for their management responsibilities plus half of any of the revenue they bring to the company. The other half would presumably go to cover the organizational overhead. Since both Ruby and Rusty know some of the same people, there may be times when there is a question of which person was responsible for the sale. There might be a banker they both know who refers a customer to the business. Perhaps under these circumstances the Baines both get credit for the insurance sale and split that commission. If the referral is for an inspection or appraisal, Rusty is the owner who will do the work. Should Ruby get any credit for this business in the proposed formula?

4. You have been given a print out of the QuickBooks file for 2011 and for 2012 to date. How many months of activity in 2012 would the CPA need in order to meet the AICPA requirement of having “have sufficiently objective basis for the assumptions?”

Realistically the CPA firm would not be able to complete a forecast engagement until after tax season. Assuming they completed the forecast for the 2012 calendar year on May 1. It would be possible to determine how many insurance policies were renewed for a second year. If 90% of the policies were renewed to date, that amount could be used to forecast most of the revenue for the balance of 2012, exclusive of Pinder. If Larry Pinder does contract for insurance of his Orlando properties on April 1, it will be safe to assume that he will be renewing the insurance on the 26 properties arising in 2011. Further it will be possible to monitor to what extent additional new business has been obtained. If to date in 2012 they’ve experienced a 20% growth, then that growth rate can be used to predict revenue for the year.

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