



What You Will Learn in this Session



- ▶ What does the law require?
- ▶ What is a “review”?
- ▶ When does this go into effect?
- ▶ What are the objectives of a review?
- ▶ What is a material misstatement?
- ▶ How much assurance does a review provide?
- ▶ Can a review be done on a cash basis?
- ▶ How do I get ready for a review?
- ▶ What is done in a review?

AB 240 Requirement



- ▶ Last October, California Legislature passed Assembly Bill No. 240 ("AB 240").
- ▶ Requires "an annual review of the financial records and reports" of all mutual water companies that operate a public water system in the state of California" (Section 14306(b) of the Corporations Code of the State of California).

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What is an Annual Review



- ▶ An **annual review** is a level of service provided by CPAs that has existed since 1978
- ▶ The auditing profession (the AICPA) has put together a set of rules that define what must be done in an annual review
- ▶ It is similar to an **audit**, but less rigorous than an audit

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When Does this Requirement Go Into Effect



- ▶ AB 240 does not explicitly state which fiscal periods are first impacted by this new requirement
- ▶ All we have to go on is the effective date of the law (AB 240)
- ▶ AB 240 states that it went into effect on January 1, 2014

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When Does This Take Effect



Year End	General View – First effects years <u>beginning</u> on or after 1/1/14	Conservative Interpretation – First effects years <u>ending on</u> or after 1/1/14
June 30	Year ending June 30, 2015	Year ending June 30, 2014
December 31	Year ending Dec. 31, 2014	Year ending Dec. 31, 2014

Consult with your attorney and follow his or her advice on this issue.

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Who Is Allowed to Provide This Service



- ▶ AB 240 says that that the annual review must be performed by either a licensed *Certified Public Accountant* or a licensed *Public Accountant*.
- ▶ For the purposes of this presentation, I will refer to either of these credentialed professionals as a “CPA”.

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What Are the Objectives of the Review



- ▶ Are the company’s financial statements presented in accordance with accounting standards (“generally accepted accounting principles” or “GAAP”)
- ▶ No material misstatements in the financial statements

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What is a Material Misstatement



- ▶ A material misstatement is an amount in the financial statements that is so incorrect that the reader of the financial statements might be misled as to the financial status of the entity.
- ▶ Significance is a matter of the CPA's professional judgment.
- ▶ Many CPAs consider a misstatement of more than 1% of total revenues or assets to be "material".

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How Much Assurance Does a Review Provide



- ▶ "Limited assurance that the financial statements are free of material misstatement"
- ▶ "Not aware of material modifications that need to be made"
- ▶ Substantially less in scope than an audit

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Can a Review Be Done On a Cash Basis



- ▶ No
- ▶ “The review shall be subject to **generally accepted accounting standards**” (Section 14306(b) of the Corporations Code of the State of California)

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Getting Ready for the Review



- ▶ The review will be a lot more expensive if the CPA performing the review has to also make all of the adjustments required by the accounting standards
- ▶ Best practice is to engage a bookkeeper or consultant to help make those adjustments before the review starts
- ▶ Make sure that the person that you pick to do this has acknowledged their knowledge about the type of adjustments that typically are needed for GAAP financial statements
- ▶ Let the reviewing CPA know that you will be doing this in order to “clean up your books” so that he or she can factor that effort into his pricing

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What Will the CPA Expect



Cash and investments:

- ▶ He will expect that the cash and investment accounts in your accounting records agree with the total of your reconciled bank statements and your investment statements

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What Will the CPA Expect



Accounts receivable:

- ▶ The accounts receivable balances in your accounting records must agree with the total of your billing system report that shows the outstanding balance for each customer account

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What Will the CPA Expect



Accounts payable:

- ▶ Your accounting records must show a liability for “accounts payable” that includes all amounts owed for services rendered prior to year end (but paid after year end)
- ▶ If you don’t have an invoice yet, and the amount is fairly significant, it is better to book an estimated liability for that vendor than to not record anything at all
- ▶ The CPA might want to see a list of the invoices that total to what you have recorded for accounts payable in your accounting records.

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What Will the CPA Expect



Property, plant, and equipment (capital assets):

- ▶ The amount of property, plant, and equipment in your accounting records must agree with updated depreciation records that show the cost, location, description, and the year of acquisition for each asset owned by the company.

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What Does a Review Consist of



- ▶ Inquiries
- ▶ Analytical Procedures

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Inquiries



- ▶ CPA brings into play all of his or her experience and professionalism
- ▶ Asks questions about the amounts in the financial statements
- ▶ Looking to see if the company neglected to make the adjustments that are required by generally accepted accounting principles ("GAAP").
- ▶ Important for the CPA to have experience performing audits or reviews of other entities that provide similar services (i.e., the sale and deliver of water, etc.).

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Inquiries



- ▶ Have you reconciled your cash balances to the bank statements?
- ▶ Has the amount of accounts receivable reported in the financial statements been agreed to reports from your customer billing system?
- ▶ Does the property, plant, and equipment reported in the financial statements agree with detailed inventory records of the individual assets owned by the company?
- ▶ Has a liability been recorded for all goods and services delivered to the entity prior to the end of the year?
- ▶ Did any unusual or difficult to record activity take place during the year?
- ▶ Were there any unusual actions taken by the Board of Directors during the year?
- ▶ Has the entity entered into any new agreements with other entities (private companies, government agencies, etc.)?

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Inquiries



- ▶ There may be other questions that arise as the CPA looks over the financial statements and spots amounts that don't look right or that otherwise arouse his or her curiosity.
- ▶ The CPA's inquiries are answered by management of the company.
- ▶ Sometimes, the answers to these questions indicate that additional adjustments will need to be made to the financial statements.
- ▶ If so, then that possibility will need to be investigated by the CPA (this can increase the cost of the review).

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What is an Analytical Procedure



- ▶ A comparison involving financial statement amounts
- ▶ Every significant amount in the financial statements has to be evaluated in this fashion
- ▶ Every analytical procedure involves three steps

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First Step – Develop an Expectation



- Examples:
 - The CPA might expect that the financial statements amounts should be consistent with what was reported in the prior year,
 - Or what was in the budget for the current year, etc.
 - Or he might expect water sales divided by acre-feet sold to be roughly the same from year to year (unless there was a rate increase)

The CPA is given wide discretion to use an "expectation" that is appropriate for the company being reviewed.

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Second Step – Compare Financial Statement Amounts to Expectation



- **Examples:**
 - Compare financial statement amounts to prior year amounts
 - Compare financial statement amounts to budgeted amounts
 - Compare dollars of water sold to acre-feet of water sold

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Third Step – Evaluate the Difference



- The CPA evaluates any differences resulting from this comparison.
- If the difference is greater than what the CPA would expect, the CPA starts by asking management their opinion as to why the difference is so large.
- Based upon the information received from management, the CPA may have to investigate further to satisfy himself that the difference is not the result of an unrecorded transaction or a misrecorded transaction.
- This might involve looking at vendor invoices or other documentation, at the discretion of the CPA.

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How Much Will a Annual Review Cost



- ▶ About \$10,000 per year for a small water company
- ▶ Cost will be quite a bit more if the records aren't ready for the review or the CPA has to investigate and adjust amounts in the accounting records that are not in conformity with the accounting standards

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Questions?



Q&A

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