

UNDERSTANDING COMPILATION, REVIEW AND AUDIT

Prepared by:
American Institute of Certified Public Accountants

Reporting on Financial Performance

Almost every organization whether it's a privately held business, a publicly owned corporation, or a nonprofit organization must prepare reports on its financial performance. Such reports help owners and managers make operating decisions, enable creditors to evaluate loan applications, and provide individuals with information to make investment decisions.

The accounting profession recognizes that different entities have different accounting needs. Acknowledging these differences, the profession has developed standards that enable CPAs to offer a range of financial statement services.

Diverse Accounting Services for Diverse Needs

A CPA may provide a client with three distinct services involving financial statements. Each is designed to meet a different need.

A **compilation** is useful to small, privately held entities that need help in preparing their financial statements. A **review**, on the other hand, may be adequate for entities that must report their financial positions to third parties, such as creditors or regulatory agencies. Reviewed financial statements may also be useful to business owners who are not actively involved in managing their companies. An **audit** is the third and most extensive service. An audit is appropriate for entities that must offer a higher level of assurance to outside parties. An unqualified opinion from a CPA after an audit provides reasonable assurance to outside parties that the entity's financial statements fairly present its financial position and results of operation in accordance with certain accounting principles.

COMPILATION *Preparing financial statements of private entities based on information provided by the entity's management.*

Through compilation services, a CPA prepares monthly, quarterly, or annual financial statements. However, he or she offers no assurance as to whether material, or significant, changes are necessary for the statements to be in conformity with generally accepted accounting principles, the cash basis, or the income tax basis of accounting. During a compilation, the data is simply arranged into conventional financial statement form. No probing is conducted beneath the surface unless the CPA becomes aware that the data provided is in error or is incomplete.

However, before agreeing to perform a compilation, a CPA will take a "common sense" look at the entity to decide whether the client needs other accounting services, such as help in adjusting the accounting records.

Here's what a compilation entails:

The CPA becomes familiar with the accounting principles and practices common to the client's industry, and acquires a general understanding of the client's transactions and how they are recorded.

After compiling the financial statements, the CPA is obliged to read them and consider whether they are appropriate in form and free from obvious material errors. The CPA then issues a standard report that says, in effect, that the financial statements were compiled, but because they were not audited or reviewed, no opinion is expressed.

Compilation standards permit an accountant to compile financial statements that omit footnote disclosures required by generally accepted accounting principles or another comprehensive basis of accounting (cash or income tax). This is allowable as long as the omission is clearly indicated in the report and there is no intent to mislead users. However, when footnote disclosures have been left out, the CPA adds a paragraph to the compilation report stating that management has elected to omit disclosures. This paragraph lets the user know that if the financial statements contained this information, it might affect the user's conclusions.

A compilation is sufficient for many private companies. However, if a business needs to provide some degree of assurance that its financial statements are reliable, it may be necessary to engage a CPA to perform a review or an audit.

Here is an illustrative compilation report:

Accountant's Compilation Report

Stockholders and Board of Directors
XYZ Company

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 19X5, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Able, Baker and Charlie, CPAs
February 15, 19X6

REVIEW *Inquiry and analytical procedures applied to financial statements of private entities.*

A private entity may engage a CPA to perform a review of its financial statements and issue a report that provides limited assurance that material changes to the financial statements are not necessary. With respect to reliability and assurance, a review falls between a compilation, which provides no assurance, and the more extensive assurance of an audit.

Before a review, the CPA may have to compile the financial statements; however, in all cases, the financial statements are management's statements, not the CPA's. Management must have a sufficient understanding of the financial statements to assume responsibility for them.

Two other factors differentiate a review from a compilation. The CPA must remain independent of the client during a review, and all appropriate footnotes must be included in the reviewed statements.

Here's what a review entails:

The CPA obtains a working knowledge of the industry in which the entity operates and acquires information on key aspects of the organization, including operating methods, products and services, and material transactions with related parties.

The CPA will then make inquiries concerning such financial statement-related matters as accounting principles and practices, recordkeeping practices, accounting policies, actions of the board of directors, and changes in business activities. Then the CPA will apply analytical procedures designed to identify unusual items or trends in the financial statements that may need explanation. Essentially, a review is designed to see whether the financial statements "make sense" without applying audit-type tests.

Keep in mind that during a review, a CPA does not confirm balances with banks or creditors, observe inventory counting, or test selected transactions by examining supporting documents. However, in many instances, a review with its limited assurance may be adequate for a business or its creditors. If more assurance is necessary, the organization may need to engage a CPA to perform an audit.

Here is an illustrative review report:

Accountant's Review Report

Stockholders and Board of Directors
XYZ Company

We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19X5, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of

Certified Public Accountants. All information included in these financial statements is the representation of the management of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

Able, Baker and Charlie, CPAs
February 15, 19X6

AUDIT *Includes such procedures as confirmation with outside parties, observation of inventories, and testing selected transactions by examining supporting documents.*

A public or private company may engage a CPA to audit its financial statements and to issue a report that provides the highest level of assurance that the financial statements are presented fairly in conformity with generally accepted accounting principles.

In an audit, as in a review, the CPA must be independent of the client and the financial statements must contain all required footnotes.

Here's what an audit entails:

To gather evidence on the reliability of the financial statements, the CPA performs "search and verification" procedures. In an audit, the CPA generally confirms balances with banks or creditors, observes inventory counting, and tests selected transactions by examining supporting documents. In addition, the CPA contacts sources outside the client organization to gather information that may be more objective than that obtained from internal sources. For example, the CPA usually obtains written confirmation from a client's customers about amounts owed to the client at a specific date. By accumulating this type of evidence, the CPA tries to reduce the risk that the financial statements will be materially misstated.

The auditor then issues a report stating that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

An audit is planned and performed with an attitude of professional skepticism; that is, the auditor designs the audit to provide "reasonable assurance" that material errors or fraud are detected. However, fraud concealed through forgery or collusion may not be found because the auditor is not trained to catch forgeries, nor will customary audit procedures detect all conspiracies.

An audit provides a reasonable level of assurance that the financial statements are free of material errors and fraud. An audit does not, however, provide a guarantee of absolute assurance.

Here is an illustrative audit report:

Independent Auditor's Report

Stockholders and Board of Directors
AU Company

We have audited the accompanying balance sheet of AU Company as of December 31, 19X5, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of AU Company as of December 31, 19X5, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Able, Baker and Charlie, CPAs
February 15, 19X6

What Services Do You Need?

Compilation CPA prepares financial statements from information provided by management. A compilation is useful when limited in-house capabilities for preparing financial statements exist.

Review CPA applies inquiry and analytical procedures to financial statements provided by management to determine if they are reasonable. A review provides limited assurance that no material changes need to be made to the financial statements.

Audit CPA examines financial statements by conferring with outside parties, completing physical inspections and observations, and testing selected transactions by examining supporting documents. An audit provides the highest level of assurance that the financial statements fairly represent the entity's financial position and results of operation in accordance with generally accepted accounting principles.