Understanding Preparations, Compilations, Reviews, and Audits

Selecting the Best Financial Statement Service

PICPA
Pennsylvania Institute of Certified Public Accountants

When it comes to financial statements, many organizations are unsure if a preparation, compilation, review, or audit engagement best fits their needs. A CPA can perform any of these services and can let you know which one works best for your expected use of the financial statements.

CPAs can be engaged to prepare financial statements, even when an organization does not need or desire a compilation, review, or audit. Preparation can consist of a single financial statement – such as an income statement or a statement of cash flows – or a complete set of financial statements, with or without disclosures.

Compilations and reviews are financial statements that are generally needed by management, owners, financial institutions, or other creditors. Audited financial statements are required for all public companies. Certain regulatory bodies, governmental entities, or others may require some nonpublic companies, nonprofits, and pension plans to have an audit of their financial statements.

Communication between the owners and management, third-party financial statement users, and the accounting firm is critical in determining which level of service – preparation, compilation, review, or audit – is appropriate. Before any services are rendered, accounting firms are required to obtain a written understanding from the client's management, known as an engagement letter. The letter outlines the terms and objectives of the engagement, the nature and scope of the services to be performed, and management's responsibilities. It must also be signed by both the CPA and the client/management.

A HIGHER STANDARD

PICPA members must comply with both AICPA's and PICPA's codes of professional conduct, which require adherence to the Statements on Auditing Standards. PICPA members must exercise professional judgment and due care in the selection and application of a financial statement service.

Preparation

The CPA's objective when engaged to prepare financial statements is to base these statements on the financial reporting framework that has been adopted by management.

When a CPA is engaged to prepare financial statements – but not engaged to perform a compilation, review, or audit – those financial statements will be based on management's records, documents, explanations, and other information. The CPA will include a clear statement on each page of the financial statements indicating that no assurance is provided or will issue a disclaimer that the financial statements have not been audited or reviewed, and that no CPA expresses an opinion or a conclusion, nor provides any assurance on them.

A preparation of financial statements may be performed to assist management with its day-to-day duties and responsibilities; to support information for the organization's tax return; or to be presented alongside an organization's financial plan. It can be a single financial statement or a complete set of financial statements. The CPA does not have to be independent when performing a preparation service, and the financial statements can be with or without disclosures.

In a preparation engagement, the CPA does not provide an accountant's report (plain paper financial statements) unless the CPA issues a disclaimer report, and the CPA is not formally associated with the financial statements.

Compilation

With a compilation engagement, the CPA will apply accounting and financial reporting expertise to assist management in the presentation of financial statements and to report, without undertaking to obtain or provide any assurance, that there are no material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

A compilation is useful when limited, in-house capabilities for preparing financial statements exist. The most significant advantage of a compiled financial statement is that it allows a CPA to assist with financial statements at reduced cost to a client by limiting the CPA's efforts to the mechanics of putting information in the form of the financial statements. A CPA does not have to be independent from the client to issue compiled financial statements; however, if the CPA is not independent, that fact has to be disclosed in the CPA's compilation report. A CPA's understanding of the accounting principles and practices used in the client's industry should be sufficient to enable compilation of the financial statements in the appropriate form. In addition, the CPA should possess knowledge of the following matters:

- Nature of the organization's business transactions
- Form of the organization's accounting records
- Stated qualifications of accounting personnel
- Accounting basis (framework) on which the financial statements are to be presented
- Form and content of the financial statements

CPAs are not required to corroborate information supplied by management for compilations. CPAs should still be vigilant, however, in compiling statements. If, in their judgment, something seems odd, the CPA should investigate.

In addition, an accountant is not obligated to obtain an understanding of the organization's system of internal control designed to prevent and detect errors or fraud. However, a CPA is required to obtain additional or revised information if the CPA becomes aware that information supplied by management is inaccurate or incomplete. Such findings or issues that are significant in the CPA's judgment should be documented and should include a description of the issue and how management will resolve it.

A Review

When performing a review of financial statements, the CPA will obtain limited assurance as to whether any material modifications should be made to the financial statements to be in accordance with the applicable financial reporting framework. This will be done primarily through inquiry and analytical procedures.

A review engagement requires the accumulation of review evidence that will provide the CPA with a reasonable basis for obtaining limited assurance that no material modifications (both qualitative and quantitative) need to be made to the financial statements. There are some significant differences between a compilation engagement and a review engagement, one being that inquiry and analytical procedures must be performed and properly documented before the CPA can express limited assurance on the financial statements. In addition, a CPA must be independent of the client for review engagements. Also, unlike compilations, review engagements require footnote disclosures.

The CPA's inquiries should cover the following:

- Accounting principles and practices, and the methods followed in applying them
- Procedures for recording, classifying, and summarizing transactions, as well as the accumulation of information for disclosure
- Actions taken at stockholders', board of directors', and other meetings that may affect financial statements
- Inquiries of individuals having responsibility for financial and accounting matters

Analytical procedures – which often include trend analysis, ratio analysis, and reasonableness tests – identify relationships and individual items that may align with the organization's normal business practices. Results are evaluated by comparison to an organization's past performance, expected performance, and available industry data. If a CPA believes that fluctuations from expected amounts are significant, additional procedures must be performed and documented before limited assurance can be provided that no material modifications are necessary.

A review engagement requires a CPA to develop and perform analytical and inquiry procedures tailored to a client's specific industry, including the accounting principles and practices unique to that industry, and an awareness of the risk of material misstatement of the financial statements.

The CPA should also have a general understanding of the client's operating characteristics and the nature of its assets, liabilities, revenues, and expenses. A CPA is not obligated to obtain an understanding of the client's internal control structure.

An Audit

The purpose of an audit engagement is to provide management and financial statement users with the auditor's opinion on whether the financial statements are presented fairly, in all material respects, and in accordance with the organization's financial reporting framework. To express an opinion, the auditor obtains reasonable assurance through evidence-gathering activities about whether the financial statements are free from material misstatement.

An audit opinion is the highest level of assurance that the financial statements fairly represent the entity's financial position and results of operation in accordance with the organization's financial reporting framework. However, an auditor can only obtain reasonable, not absolute, assurance that a client's financial statements are fairly presented in all material respects because of the following limitations:

- Audit procedures involve selective testing.
- Evidence gathered during an audit is often suggestive rather than conclusive.
- Fraud typically involves efforts by the perpetrator to conceal it through collusion, falsification of records, and misinformation.

In addition to an unqualified audit opinion, there are several other opinions available to the auditor:

- Qualified opinions state that, except for the effects of the matters to which the qualification relates, the financial statements are presented fairly in all material respects in

Comparison of Preparation, Compilation, Review, and Audit Engagements

	Preparation	Compilation	Review	Audit
Obtain a signed engagement letter	Required	Required	Required	Required
Accountant's/ auditor's report	No report[1] – legend on all pages	Compilation report	Review report	Audit report
Assurance level	None	None	Limited	High
Industry knowledge	General	General	Enhanced	Extensive
Inquiry and analytical procedures	Not required unless provided information is inaccurate or incomplete	Not required unless provided information is inaccurate or incomplete	Required	Required in addition to other audit procedures
Accountant/ auditor independence	Not required, nor disclosure of such	Not required if disclosed in report	Required	Required
Internal control understanding	Not required	Not required	Not required	Required
Full disclosure/ footnotes	Not required	Not required if disclosed in report	Required	Required

[1] No associating report is required unless there is an election by the accountant to disclaim the prepared financial statements.

Note: Each type of statement in the table has its own standards and requirements, and it's important to adhere to those when completing the engagements.

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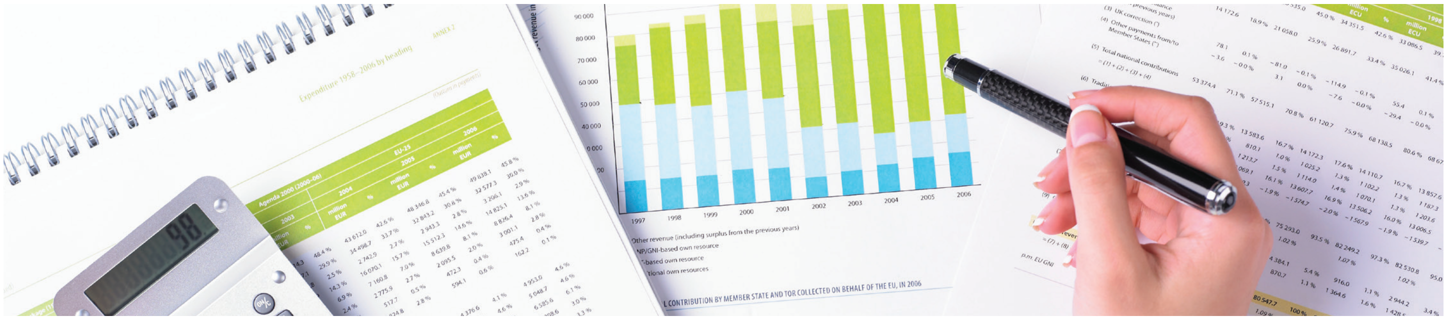

accordance with generally accepted accounting principles (GAAP).

- Adverse opinions state that financial statements are not presented fairly in accordance with GAAP.
- Disclaimers of opinions do not express an opinion on the financial statements to which they relate.
- Reports with additional explanatory language are unqualified opinions that highlight a matter related to the financial statements.

Audit engagements necessitate that auditors obtain a thorough understanding of the client's business and the industry in which it operates. The auditor must obtain an in-depth understanding of the client's internal controls, often documented in the form of questionnaires, flowcharts, or narratives, and assess the risk of fraud relating to the financial statements.

Choosing a CPA as Your Adviser

When you select a CPA adviser, it is important that you find one who you feel comfortable working with, who understands the laws (tax and regulatory), and who knows your industry. Today's CPAs provide services in many different areas, ranging from tax services to human resources consulting. Here are some other key points to consider when choosing the right adviser:

- What are his or her qualifications, educational background, special designations, areas of expertise, and peer review results?
- Accountant vs. CPA – A CPA is licensed by the state, which requires passing a rigorous examination; completing qualifying work experience that includes service or advice involving the use of accounting, attest, compilation, consulting, financial advisory, management advisory, or tax; and obtaining ongoing professional education to keep up with changing laws and regulations.

DECISION TIP: Because of the different uses for financial statements, discuss the matter with your CPA, your own management, and any outside third parties who will use your financial statements to determine the level of service that best meets your needs.

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