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The difference between an audit, review and compilation

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With the tightening of the credit market, banks and other credit grantors are scrutinizing financial statements more then in the past. In some instances, non-public companies are being required to provide financial information with a higher level of assurance then was required in the past. If a company was only required to provide internal statements or tax returns to their banks in prior years, they may now be required to provide financial statements that have been compiled or reviewed by an independent accountant. Where compilations or reviewed financials were acceptable in the past, reviews and audits are now being required. Additionally, when companies are looking to increase their lines of credit or obtain additional financing, these increased requirements may be necessary.

Since the landscape is changing, it is important to understand the significant differences between these levels of services - compilation, review and audit. This article summarizes the different requirements for each level of service.

The compilation is the lowest level of service that a CPA can provide for a client's financial statement. A compilation basically involves presenting information, consistent with management's representation, in the form of financial statements, without expressing any assurance on them. During a compilation engagement, the CPA is not required to verify or corroborate the amounts included in the financial statement that is presented by the client. If the accountant becomes aware that the information that is supplied by the client is incorrect or misleading, the information must be revised or additional information must be obtained.

A review requires an accountant to perform more procedures than is required with a compilation. During a review engagement, an accountant is required by the governing standards to make inquiries of the client and perform analytical procedures related to the amounts and disclosures in the financial statement. By performing inquiry and analytics, the accountant is able to provide limited assurance that there is no material modification that should be made to the financial statement. A review typically does not require tests of accounting records or the need to obtain corroborating evidential matter.

Accountants must have knowledge of the client and their industry to formulate the necessary inquiries. Credit grantors are increasingly assessing the CPA's specific industry knowledge in determining the level of assurance they require. The importance of this assessment cannot be overemphasized. Is your CPA a specialist in the industry or a general practitioner? The inquiries should include industry specific questions. Are the financial statements prepared in conformity with generally accepted accounting principles? What are the procedures to ensure that the accounting information has been recorded, classified and summarized properly? Has the company performed reconciliations to determine the information is appropriate? The accountant will inquire if there are any allegations or suspicions of fraud or illegal acts within the company. Have there been any significant changes in the business activity? The accountant will inquire regarding specific significant assets and liabilities to determine if the amounts are complete and accurate. Analytic procedures will assist the accountant in identifying amounts that are unusual and will require additional inquiry. Based on the results of the inquiry and analytical procedures, the accountant will determine if any adjustments are necessary to the financial statements.

An audit provides the highest level of assurance and, as such, requires much more work by the CPA than is required for a compilation or review. The most significant difference between an audit engagement and other financial statements is that the auditor is required to corroborate the amounts and disclosures included in the financial statements through test of the accounting documents, physical inspection, the use of third party confirmations or other procedures deemed appropriate. The auditor must also understand the company's internal control structure and evaluate its effectiveness. The auditor report provides an opinion that the financial statements present fairly in all material respects, the financial position of the company and the results of operations in conformity with generally accepted accounting principles. An audit engagement is planned and performed by an auditor with an attitude of professional skepticism and obtains various types of evidence to reduce the risk that the financial statements are materially misstated.

As indicated above, depending on the level of service, additional time may be required to complete the necessary engagement if the credit grantor is requiring a higher level of service. Companies that are in these situations need to plan ahead. Increasing the service requires more planning and effort then is needed with a lower level of service.

Companies that have provided financial information to credit grantors in the past should have a conversation with these individuals prior to their year-end to allow for sufficient time to make the necessary changes. It may not be easy to just change from one service to another without the proper planning. Certain procedures need to be performed at or near the year-end, while reconciliations or schedules may need to be produced that were not prepared in the past.

The best approach is to make sure that companies have a discussion with their CPA firm early in the process. This will go a long way to ensure the proper engagement is completed timely and efficiently.

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