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# Compilation And Review Reports

## Are They Understood?

By Thomas P. Edmonds, Mattie C. Porter, and Ira R. Weiss

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With the issuance of the first Statement on Standards for Accounting and Review Services, *Compilation and Review of Financial Statements*<sup>1</sup>, the AICPA provided new standards for reporting for the CPA who is associated with the financial statements of a privately held company on which an audit was not performed. Now, a privately held company may engage a CPA to perform one of three types of services with respect to the company's financial statements:

1. Compilation services in which the CPA's report gives *no* assurance,
2. Review services in which the CPA's report gives *limited* assurance, or
3. Audit services in which the CPA's report gives *positive* assurance.

SSARS No. 1 has been called "revolutionary" and it has been predicted that it will "affect the conduct of practice related to nonpublic companies more than any other pronouncement in recent years."<sup>2</sup> Yet the question has been raised as to whether the users can understand the differences between the three different reports.<sup>3</sup> If users do not understand the differences in the nature of the accountant's services and therefore cannot correctly dis-

cern the level of assurance in the accountant's report, then confusion could exist. As noted by Libby,<sup>4</sup> if the user does have misperceptions of the message which the CPA intends to communicate, then perhaps the user will make different decisions than those that would be made if the report were correctly perceived. Thus the user might place unwarranted reliance on the compilation or review report. Additionally, the accountant's legal liability might be increased due to the miscommunication.

To discern whether users can interpret and understand the two new reports, a survey was conducted of preparers (CPAs) and users (bankers) of the reports. The objective of this article is to summarize the results of this research and its implications for practitioners.

### THE SURVEY GROUPS

The accountant's report is the primary means of communication between the accountant and the users of the financial statements which accompany the report. In order to determine if there were perceptual differences between the preparers and users of the reports, we surveyed a random sample of 250 CPAs and 250 bankers. Responses were received from 102 CPAs

(forty-one percent) and 122 bankers (forty-nine percent).

Bankers were selected as the survey user group since the compilation and review reports may only be issued in connection with financial statements of nonpublic entities. The primary users of these financial statements were assumed to be credit oriented users (i.e., banks and financial institutions). All of the bankers in the survey had experience in making lending decisions. The relative experience levels of the survey respondents are summarized in Table 1.

### THE SURVEY

The CPAs and bankers were given copies of four different accountant's reports:

1. A disclaimer of opinion.
2. An unqualified opinion.
3. A review report.
4. A compilation report.

Each report was followed by a series of statements concerning various aspects of the report. The participants were asked to agree or disagree with the statements utilizing a seven point scale where 1 indicated complete agreement with the statement, 4 indicated the participant was undecided and 7 indicated complete disagreement. These statements were designed to determine the respondent's perceptions of each report in four general areas:

1. The extent of the accountant's examination,
2. The level of assurance given by the accountant,
3. The usefulness of the report, and
4. The accountant's legal liability.

The perceptions of the CPAs and bankers in each of these areas were compared utilizing the mean response of each group to determine if their perceptions of each report were consistent. In other words, did the CPAs and bankers perceive the compilation report the same way? Their responses were then compared across the reports to determine if they consistently ordered the reports in the four areas listed above. In other words, did the CPAs and bankers consistently view the accountant's examination as being the lowest for the disclaimer and compilation, somewhere in the middle for a review, and at its highest level for an unqualified opinion?

## Can the Reports be Distinguished?

The survey reflected that, in general, the CPAs and bankers can distinguish between the reports. This was shown by the fact that both groups consistently recognized that the extent of the accountant's examination was lowest for a compilation or disclaimer, in the middle for a review and highest for an unqualified opinion. This ordering of the reports was also consistent in their perceptions of the level of assurance and the usefulness of the reports. It is interesting to note that, in most cases, both the CPAs and bankers ranked the compilation report below the disclaimer report although the differences in the rankings were not significant. This might result from the fact that the compilation report is couched in more wary terms than the disclaimer and that the procedures applied by the accountant are very limited. In any case, both groups appear to view these two reports with the caution that they deserve.

Both groups appeared to be able to recognize the review report as being a form of assurance which is unlike the other three reports. However, the report does not appear to be as well understood and consistently interpreted as the other three forms of report. This conclusion is supported by several survey results.

First, recall that a mean answer of 4 on the questionnaire would indicate an undecided position. A mean answer of 4 could result for two reasons. First, the participants could be truly undecided with respect to the question and thus a mean of 4 could result if most of the survey participants responded with an answer of 4. Second, part of the group could perceive the report one way (for instance agree with the statement and answer 1 or 2) and another part of the group could perceive the report the opposite way (for instance disagree with the statement and answer 6 or 7). The total group answers would then average around 4. A standard deviation of 2 or more would indicate the second explanation was exhibited in the responses. Both CPAs and bankers responded to more questions concerning the review report with a mean answer grouped around 4 than to any of the

Years of Experience	CPAs' Public Accounting Experience	Bankers' Commercial Lending Experience
1 to 3	0.0%	20.7%
4 to 6	8.9	21.5
7 to 9	18.6	12.4
10 or more	72.5	45.4
	100.0%	100.0%

	Similar	Undecided	Dissimilar
Disclaimer vs. Unqualified	_____	_____	_____
Disclaimer vs. Review	_____	_____	_____
Disclaimer vs. Compilation	_____	_____	_____
Unqualified vs. Review	_____	_____	_____
Unqualified vs. Compilation	_____	_____	_____
Review vs. Compilation	_____	_____	_____

\_\_\_\_\_ = CPAs response mean  
 \_\_\_\_\_ = Bankers response mean

other reports. Additionally more questions had a standard deviation of 2 or more for the review report than for the other three forms of reports.

Second, the groups were asked to compare the reports as to the degree of similarity and dissimilarity. These results are presented in Table 2 and, once again, it appears that both groups were undecided as to how to interpret the review report in comparison to the other three reports. This indecision was also indicated by an inspection of the standard deviation of the responses to comparisons summarized in Table 2. The responses of both groups had larger standard deviations for the three comparisons involving the review report than for the other three report comparisons tabulated.

The indecision or uncertainty pertaining to the review report is not surprising. This report is new and it reflects a *limited* form of assurance which is very much unlike that given in the forms of reports which were generally available before SSARS No. 1 (i.e., the unqualified, qualified and disclaimer reports). It therefore

could be expected that it will take time for both preparers and users to become familiar with the limitations associated with the review type of engagement.

The CPAs and bankers also differed with respect to the *degree* to which they rely upon each report. For instance, the CPAs and bankers consistently felt financial statements were comparatively less reliable when accompanied by a disclaimer or compilation than when accompanied by an unqualified report; but the bankers felt the statements were less reliable than the CPAs for all four forms of reports. These differences are discussed in the following paragraphs.

## The Extent of the Accountant's Examination

Table 3 summarizes the general perceptions of the CPAs and bankers as to the procedures performed by the accountant for each type of report. The respondents appeared to have a good grasp of the differences in the accountant's examination in each of the four cases. Both groups agreed that the review

**TABLE 3**  
**Procedures Performed in the Examination**

Procedures Performed	Disclaimer		Compilation		Review		Unqualified	
	A	B	A	B	A	B	A	B
The report is based primarily on inquiry and analytical procedures such as financial ratio analysis.	5.0	5.6	6.1	6.1	2.0	3.0	5.9	4.2
The report indicated that the public accountant performed verification tests of the accounting records and other necessary procedures in order to insure that the financial statements adequately represent the financial condition of the company.	6.6	6.6	6.7	6.6	5.9	5.5	1.1	1.2
The report implies that the public accountant has reviewed and evaluated the adequacy of the system of financial internal controls.	6.6	6.4	6.6	6.6	5.8	4.8	1.4	1.4

**TABLE 4**  
**Level of Assurance**

Procedures Performed	Disclaimer		Compilation		Review		Unqualified	
	A	B	A	B	A	B	A	B
The report indicates that the public accountant has expressed confidence that the financial statements reflect the financial condition of the company.	6.3	6.5	6.5	6.6	4.7	5.0	1.3	1.4
The financial statements referred to in the report are the representation of the public accountant.	6.5	6.4	6.4	6.6	6.5	5.8	6.0	3.0
The report indicates that the financial statements are free from material errors or omissions.	6.0	6.4	6.4	6.5	4.2	4.6	1.8	2.1
The report indicates that the financial statements are in conformity with GAAP.	4.9	6.3	5.3	6.3	2.8	4.3	1.1	1.3
The report indicates that the financial statements present fairly the financial condition of the company.	6.4	6.4	6.4	6.5	4.9	5.1	1.1	1.3

A = mean response of CPAs

B = mean response of Bankers

Where: 1 represents agreement and 7 represents disagreement with the statement.

report was based primarily upon inquiry and analytical procedures. This is not surprising since there is an explicit statement to that effect in a review report. Additionally, both groups recognized that the unqualified report was the only one which was based on verification tests of the accounting records and in which a review of internal control was made.

### The Level of Assurance

The participants were asked to respond to a series of five state-

ments which dealt with the level of assurance and the extent of the accountant's responsibility with respect to each report. The results are presented in Table 4. Both the CPAs and bankers perceived that only in an unqualified report did the accountant express confidence that the financial statements reflected the financial condition of the company, were free from material misstatements and fairly presented the financial condition of the company. However, there was less conformity in the CPAs and bankers

views in two other areas.

First, the bankers felt that, in general, as the level of assurance increases, the financial statements become the representation of the accountant. As shown in Table 4, there was a clear dichotomy of views with respect to this question for the unqualified opinion. The CPAs felt that in all four reports, the financial statements were *not* the accountant's representation. The bankers felt the financial statements were the representation of the accountant in the case of an unqualified opinion.

The current exposure draft of suggested changes in the short form opinion by the Auditing Standards Board attempts to correct this type of misinterpretation by including an explicit statement saying that the financial statements are management's representation.

A second area of difference concerned the extent of the financial statement's conformity with GAAP. The CPAs felt that the report indicated the statements were in conformity with GAAP for both the review and the unqualified report, although they agreed more strongly with this statement in the case of an unqualified opinion than for a review. This might indicate that the CPAs interpret the limited assurance of a review as being an indication (although somewhat weak) that the statements are in conformity with GAAP. The bankers do not appear to gain that degree of confidence. Rather, the banker's responses indicated that, in general, only the unqualified report gave positive assurance as to conformity with GAAP.

### **Usefulness of the Reports**

A series of questions were asked to discern the extent to which the various reports aided in evaluating the quality of the accompanying financial statements.

#### ***How reliable are the financial statements?***

Bankers generally felt that the financial statements were less reliable than CPAs. In the case of those statements accompanied by a compilation or disclaimer report, the bankers were undecided as to their reliability. CPAs in all cases felt that the statements had some degree of reliability and felt that reliability increased as the level of assurance (i.e., the type of report) increased.

#### ***Do the statements contain management bias?***

The bankers, across all four reports, felt the statements were more biased than did the CPAs. Both groups felt this bias was alleviated only in the case of an unqualified report.

The answers to both of the questions discussed above appear to indicate that the bankers place less faith in the financial statements than do the CPAs, regardless of the form of the accountant's association with those statements. This skeptical

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orientation of the bankers is understandable given that they utilize the statements in making credit decisions and they generally have more sources of input into that decision than just the financial statements. Hence the statements alone possess less credibility to the bankers.

#### ***Does the report affect the quality of the company as a loan prospect?***

The bankers consistently viewed the accountant's report as having a stronger impact on their evaluation of the quality of the company than did the CPAs. The bankers felt that a disclaimer, a compilation and an unqualified report would have more of an impact in this area than a review. This appears to be consistent with the fact that the disclaimer and compilation give no assurance and an unqualified opinion gives positive assurance. For these three forms of reports, there is a clear-cut line of demarcation and this information would be helpful in evaluating the quality of the company as a loan prospect. The review, being only a limited assurance, would be of less use than the other two forms of

assurance. The accountants were undecided as to impact of a disclaimer and a compilation, felt the review would have some impact and the unqualified report the greatest impact in this evaluation.

#### ***Is the riskiness of the company affected by the report?***

The bankers, indicated that the accountant's report would affect their evaluation of the riskiness of the company in all four cases. The CPAs indicated that, in every case, the riskiness of the company would be unaffected by the report.

The dichotomy in the survey responses to the preceding two questions indicates that the bankers, in evaluating financial statements, place more reliance or emphasis on the accountant's report than the CPAs perceive. If this is indeed true, then it seems to be imperative that the report clearly communicate the accountant's intended message. The survey results are a preliminary indication that there exists some danger of misinterpretation of the review report. This danger is highlighted by a recent study which

reported that 28 percent of those companies which previously submitted *unaudited* statements to bankers are now undergoing reviews and about 25 percent of those companies which previously submitted *audited* statements are now undergoing compilations or reviews.<sup>5</sup> Based upon these numbers, it appears likely that reviews will be utilized in many credit decisions.

To insure that problems are not encountered due to misinterpretation of the limits of a review, the efforts currently being made by the accounting profession to educate both the preparers and users of the report are imperative and should be continued. The participation of practitioners in this educational effort is needed since they have day to day contact with the users of the report. The practitioner can participate by contributing articles which explain the limitations of the review engagement to professional journals which are read by clients and the users of their financial statements. In addition, the practitioner should, as always, make every effort to aid the client in identifying what the needs are of the users of their financial statement in order to insure that the type of service provided by the CPA meets those needs. The study<sup>6</sup> recently completed under the sponsorship of Fox & Company, to be published as an Auditing Research Monograph by the AICPA, should aid the practitioner in this counseling effort. The study found, in part, that the following factors affect the accounting service decision:

Bankers:

1. "Loan size, and to a lesser degree the customer's capitalization and the bank's previous relationship with the customer, are the most significant factors used by bankers to determine whether a compilation, review or audit will be required in connection with loans.

2. *Compilation or review, in lieu of an audit, is more likely to be acceptable when the borrower is profitable, the loan is well secured and the customer and CPA firm are respected by the banker.*

CPAs:

1. *When advising a client on a potential change from an audit to a compilation or review, prior audit experience and adequacy of internal controls are the most important fac-*

*tors used in determining the advice to be given.*

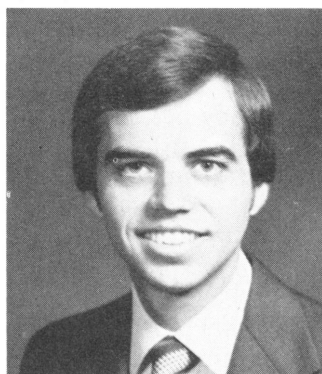
2. *When recommending the needed level of service for clients who received unaudited financial statements prior to SSARS 1, the most influential factors are the perceived needs of third party users, prior experience with the client, and adequacy of the system of internal control."*<sup>7</sup>

## Legal Liability

Neither the bankers nor the CPAs in our survey felt that lawsuits were likely to result from reliance on the accountant's reports. However, the accountants held this position less strongly for the review and unqualified reports than for the compilation and disclaimer. The perceptions of the accountants appear reasonable in view of the fact that in these two reports, they express assurance and, therefore, the relative probability of lawsuits should be higher than for those reports which give no assurance.

## CONCLUSION

The results of our survey indicate that both CPAs and bankers consistently order the four forms of



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accountant's reports which were presented to them and that they possess a good understanding of the meanings of the reports. However, the survey results provide a preliminary indication that the review report is not as well understood by the CPAs and bankers as the other three forms of reports. We encourage continued efforts to refine the report and to educate the preparers and users of the review report concerning the benefits and limitations of the new form of accounting service. In addition, continued monitoring of the perceptions of the preparers and users of the review report is needed until sufficient time has passed to permit complete familiarization with the report and to insure that it is well understood.Ω

## FOOTNOTES

<sup>1</sup>Statement on Standards for Accounting and Review Services no. 1, (SSARS no. 1), *Compilation and Review of Financial Statements* (New York: AICPA, 1979).

<sup>2</sup>Robert L. Israeloff, "Practitioners' Answers to Compilation and Review," *CPA Journal*, November, 1979, p. 29.

<sup>3</sup>Harry G. Brown, "Compilation and Review - A Step Forward?" *CPA Journal*, May, 1979, p. 23.

<sup>4</sup>Robert Libby, "Bankers' and Auditors' Perceptions of the Message Communicated by the Audit Report," *Journal of Accounting Research*, Spring, 1979, p. 100.

<sup>5</sup>Jerry L. Arnold and Michael A. Diamond, reported in "News Report," *Journal of Accountancy*, October, 1980, p. 8.

<sup>6</sup>Ibid. and referred to in "Attitudes and Perceptions: Compilation and Review One Year Later" (an Executive Summary), Fox & Company, Certified Public Accountants, 1980.

<sup>7</sup>Ibid.



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