James L. Ulvog, CPA

Audit, Review, or Compilation?

The differences between an audit, a review, and a compilation

Extract from Step Up to the Next Level –
A Guide for Pregnancy Centers to Improve
Their Internal Operations and Prepare for an Audit

There are three different levels of services you could obtain from a certified public accountant. These are referred to as *compilation*, *review*, and *audit*.

There is a common base for presenting financial statements, regardless of which level of service is used. This is a large body of rules that describe what information should be included in financial statements and the format for the information. This body of knowledge is called *generally accepted accounting principles*, or *GAAP*. Imperfect in implementation though it may be, the concept is that similar transactions will be recorded by all organizations in the same way. In addition, financial statements of similar organizations will actually look similar.

Compilation

The goal of a compilation is to take information that is on the general ledger and accumulate it into financial statements in the same format that would come out of a review or audit. The format may look the same, but the accountant performs much less work in a compilation than in a review or audit.

The accountant will perform an extremely limited analysis on any of the numbers presented. The accountant would only follow up on information that is obviously incorrect, such as obvious departures from GAAP. For example, if there are no depreciation expenses recorded when there should be, or if the amount of fixed assets is minimal even though there are substantial amounts of equipment in use, then the accountant would have to address the issue and make appropriate corrections.

There is an extreme limitation on how much reliance can be placed on a compilation because the accountant has not gained an understanding of internal controls, has not even discussed with the organization how it is managing its fraud risks, and has not performed testing of any numbers.

The key sentence of a compilation report from the accountant reads, “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.” As a result, an external reader of the financial statements can place minimal reliance on a compilation report.

A compilation is used when an outside party, such as a lender, needs to see the financial information in a typical format (following GAAP presentation rules) instead of in whatever format the internal accounting system would produce. It is relatively rare for a small- or medium-sized nonprofit organization to obtain a compilation.

A compilation involves the lowest amount of work. As a result, the cost will be far lower than for a review or audit.

Review

The goal of a review is to provide limited assurance that financial statements do not have any known errors or departures from the accounting rules found in GAAP.

The procedures performed by the external accountant during a review will be limited to inquiries and analytical review. This means the accountant will ask many questions of management and the finance staff. If the answers to the questions indicate the accounting is appropriate, then no additional follow-up would be needed. Analytical review means the accountant will look at the relationships between numbers to make sure they make sense. For example, if attendance at a local church is up about 10% from a year ago, then the amount of contributions from the congregation should have increased by something in the range of 10%. If contributions increased by much more or less than 10%, the accountant would ask management why. Another example is that if the full-time staff of a ministry increased from three people to four people, then wages, payroll taxes, and other benefits should have increased by something in the range of one-third. The accountant will follow up with management on relationships in a financial statement that do not immediately make sense.

Normally, there will not be any testing of information in the financial statements beyond inquiry and analytical review. The accountant will not obtain an understanding of the internal control system and will not discuss how the organization is addressing the risk of fraud in the financial statements. As a result, there is a significant limit on how much reliance an external reader of the financial statements can place on the review report issued by the accountant.

The key sentence in a review report reads, “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.”

A review is most often obtained when an outside party, such as a lender, needs to see the financial information in a typical format and is looking for some assurance that the information can be relied upon.

The cost of a review is obviously more than a compilation and might be somewhere in the range of 40% to 70% of the cost of an audit.

Audit

The goal of an audit is to provide reasonable, but not absolute, assurance that financial statements are fairly presented in accordance with GAAP.

In an audit, the accountant will gain an understanding of internal controls, evaluate the risk of major fraud, test those places where there is a significant risk of major fraud, and perform testing as considered necessary for the significant components of the financial statements. A few examples of the type of testing involved would be confirming the amounts on deposit in banks, testing the cost of equipment, confirming with donors the amount of recorded contributions, and reviewing the supporting documentation for a number of disbursements. There is a body of knowledge, called *generally accepted auditing standards*, that outlines the necessary work in an audit. The exact tests necessary are determined by the accountant based on his or her professional judgment.

An audit report provides more assurance to a reader of the financial statements than a review or compilation. The report provides reasonable assurance that, overall, the financial statements are fairly presented in all material respects. This does not mean they are exactly correct, but they do provide some assurance that there are no major errors. Since an audit could never test 100% of the transactions in an organization, there is a risk that untested transactions could be missing, mistaken, erroneous, or even fraudulent.

The key sentence in an audit report reads, "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [organization name] as of June 30, [year], and the changes in its net assets and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles." As a result, the external reader of the financial statements can use the audit report to place reliance that the financial statements are fairly presented.

An audit is most often obtained because a lender requires it as a condition of making a loan. But in the nonprofit community, there are many reasons to get an audit beyond the requirement of a lender. Going through the audit process communicates a higher level of accountability. Many organizations voluntarily go through an audit because it subjects them to scrutiny by an outsider. Also, some voluntary membership organizations, such as the Evangelical Council for Financial Accountability, require an audit as a condition of membership. The ECFA allows members with income under $500,000 per year to alternate between audited and reviewed financial statements.

Organizations that give money to nonprofits often require an audit as a condition of making a grant. Federal funding over a certain threshold creates a requirement to go through the audit process.

The cost of an audit will be substantially higher than a review or compilation.

Update to 2010: The ECFA now allows an organization with income under $3,000,000 to obtain a review to be a member in the organization. ECFA allows organizations with annual income under $1,500,000 to obtain a compilation. This can represent a substantial cost savings for a ministry.