THE Transition Companies NEWSLETTER
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Levels of Assurance of Financial Statements… What Do They Mean to You?

Most business people have at least some idea of what a set of financial statements are. Many are familiar with "P&L's" (profit and loss, or income statements); some have familiarity with balance sheets. Few of us, however, understand the difference between various "levels of assurance" given by the CPA with respect to the financial statements. This can lead to unforeseen consequences.

There are essentially three different levels of assurance that can be provided by certified public accountants with respect to financial statements. They are, in increasing order of rigor, compilations, reviews, and audits.

When a CPA "compiles" financial statements, he or she is merely presenting the company's data in the form of "compiled" financial statements. The CPA is not required to perform any confirmations or examination of underlying records. In some cases, the CPA may not be doing much more than grouping some expense accounts together in order to make the income statement more intuitive or understandable. In other cases, the CPA may be recording depreciation, or reclassifying some expenses that have been put into the wrong accounts by company personnel.

If there are any amounts or other representations on the client statements that clearly appear to be incorrect, the CPA will identify those potential issues and follow up with the client. Perhaps an expense reclassification or some other adjustment is in order. However, it is important to remember that there will often be no significant inquiries or other similar steps taken. As a result, we find the following key language in a compilation report:

"A compilation is limited to presenting in the form of financial statements information that is the representation of management. 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***."

When a "review" is performed, the CPA is called upon to complete a proscribed set of procedures to express what has been called "limited" assurance on a set of financial statements. These steps include the completion of questionnaires based on interviews with management, trend analysis, and various other analytical procedures. It generally does not include any type of third party confirmation of data. As one can see, much of these steps are "big picture" or "macro" in nature. There is generally not a lot of verification of specific amounts or "detail" work.

Here is some key language from an accountant's review report that reflects what has been stated in the preceding paragraph:

"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 which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, ***we do not express such an opinion***."

In the case of a review, the CPA is required to perform certain steps to give the end user of the statements a certain amount of assurance but stops short of expressing a formal opinion on the statements.

This assurance comes in the form of an audit. As is implied by the language above, when a CPA audits a set of financial statements, there is normally significantly more work to be done. Not only are inquiries made of management, but there is generally a substantial amount of detail testing of the books and records, which is not done in a compilation or review.

Additionally, more inquiries are made of third parties. For example, the CPA will normally confirm the outstanding accounts receivable balances with the company's customers, at least on a test basis, and will also formally confirm cash balances with the applicable financial institutions. Additionally, the CPA will get a letter from the company's attorney(s) that

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Levels of Assurance, continued

requires them to disclose any litigation, whether pending or current.

As a result of this increased scope of work, the independent auditor's report will usually contain the following language:

"We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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…***In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of…and the results of its operations and cash flows…***"

So as you can see by the words in italics, only in an audit is the CPA ***rendering an opinion in the affirmative***. What does this mean to the end user of financial statements who hires a CPA to generate a report for the purpose of marketing it to potential buyers? What might it mean to the potential buyer?

Remember that in the case of a compilation, that the accountant has put the numbers on the client's books in the form of financial statements and specifically makes no assurances of any kind. The reader, whether they be potential buyer, potential seller, business consultant, or any other third party, is being put on notice that these statements are the representation of the company's management, and the CPA is not taking responsibility for the veracity of the numbers. The reader needs to ask himself/herself whether any significant decisions should be made based on this level of assurance.

In the case of a review, the CPA is taking the responsibility to perform a limited number of procedures on the company books, which results in language that while specifically stating that a certified audit has not been performed, also affirms that "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."

In the case of an audit, the CPA formally renders an opinion on the financial statements. Clearly, this is a higher level of assurance than a compilation or a review.

In choosing which to have performed, one must assess the proposed use of the statements, and especially the risk to the parties. In the case of a potential acquisition, the use of audited statements clearly reduces the risk, and in my opinion, is advisable in most cases. However, keep in mind some strategic issues – for instance, potential buyers and other key parties (e. g. third party financers, M&A professionals, etc.) generally prefer to work with at least reviewed statements.

In summary, it is important to realize that a CPA cover letter does not by definition imply that the CPA is expressing assurances on the financial statements. It is important to have an understanding of the different levels of assurance typically provided by compiled, reviewed, and audited statements. It is important to consult with a CPA or other qualified professional before using a set of financial statements in all business situations including M&A scenarios.

Mitch Sharpe is the founder of Sharpe, Kawam, Carmosino & Company, a New Jersey accounting firm that focuses on entrepreneurial, closely held companies. Prior to starting the firm, Mitch attended the Rutgers Graduate School of Business Administration, where he received an MBA in accounting, and then began his career with Price Waterhouse Coopers. He has been instrumental in growing the firm to 25 people and in creating its unique service model. He takes great pride in his passion for client service

Sharpe, Kawam, Carmosino & Company is a CPA firm located in Morris County that was founded by managing partner Mitchell Sharpe in 1982. The firm focuses on providing extremely high levels of services to, and maintaining uncommonly close relationships with, all of its clients. Infused with customary accounting services, they offer management consulting, computer/software training, tax planning, retirement planning, banking relationships, strategic planning, budgeting, and guidance in many other areas, making their service model absolutely unique.

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Innovus Investment Holdings LLC Purchases Windo-Shade Distributors, Inc.

The Transition Companies LLC ("TTC") is pleased to announce the sale of Windo-Shade Distributors Inc. ("Windo-Shade"") of Galveston, Texas to Innovus Investment Holdings LLC ("Innovus"). TTC acted as Windo-Shade's exclusive M&A advisor for this transaction.

The key to the transaction rested in TTC's analysis of the Company and the subsequent "packaging" and positioning of Windo-Shade in the marketplace.

TTC opened the market using our proprietary buyer list consisting of 318 prospective buyers. These resources resulted in numerous interested parties finishing with three "finalists". The shareholders of Windo-Shade were able to choose the transaction with the buyer that best met their personal objectives.

INNOVUS INVESTMENT HOLDINGS, LLC

has acquired the assets of

WINDO-SHADE DISTRIBUTORS INC.

THE UNDERSIGNED ACTED AS EXCLUSIVE M&A ADVISOR AND CONSULTANT TO THE SELLER

THE Transition Companies

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