Testimony Presented by

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Good morning, Chairman Rafferty, Chairman Sabatina, and members of the Senate Transportation Committee.

My name is Allison Henry. I am a CPA and currently the vice president of professional and technical standards for the Pennsylvania Institute of Certified Public Accountants (PICPA). In that capacity, I oversee the Institute's professional ethics and peer review programs, and serve as the liaison to 8 state-wide technical committees and several regulatory working groups. Prior to joining the PICPA I spent 11 years in public accounting concentrating on auditing, including 9 years with an international firm and 2 years with a regional firm.

Founded in 1897, the PICPA is a nonprofit, voluntary professional organization representing more than 22,000 members across Pennsylvania. The PICPA is the fourth-largest CPA organization in the country. One of our expressed goals is to speak on behalf of members when such action is in the best interest of the CPA profession in Pennsylvania and the public interest.

On behalf of the PICPA, thank you for the opportunity to appear before you this morning and to provide you with an overview of the differences between and audit, review, and compilation. Almost every organization—whether it's a privately held business, a publicly owned corporation, or a nonprofit organization—must prepare reports on financial performance. Such reports help owners and manager make operating decisions, enable creditors to evaluate loan applications, and provide individuals with information to make investment decisions.

As such, the CPA profession recognizes that different entities have different accounting needs, and therefore the profession has developed standards that enable CPAs to offer a range of financial statement services. All CPAs, regardless of the type of service provided, are required to comply with the AICPA Code of Professional Conduct and state CPA statutes that require the exercise of due professional care in the performance of an engagement.

There are three basic levels of attestation: compilations, reviews, and audits. Fundamental to all three levels is management's responsibilities for selecting the financial reporting framework, the fairness of the financial statement presentation, designing appropriate internal controls, preventing and detecting fraud, complying with laws and regulations, and ensuring the accuracy and completeness of the information provided to the CPA. The ultimate responsibility for financial statements resides with management; the CPA, however, adds value through the attest function as discussed below.

<u>Compilation</u>

The CPA in a compilation engagement applies accounting and financial reporting expertise to assist management in the presentation of financial statements and reports, without efforts to obtain or provide any assurance that there are no material modification that should be made. 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 to the mechanics of putting information in the form of the financial statements. Additionally, 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. However, 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. CPAs are required to read the financial statements and consider whether they are appropriate in form and free from obvious material misstatements, but are not required to corroborate information supplied by management. A CPA should obtain additional or revised information if the CPA becomes aware that any information supplied by management is inaccurate or incomplete.

<u>Review</u>

When performing a review of financial statements, the CPA obtains 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 is done primarily through inquiry and analytical procedures, which are not done for a compilation engagement. In addition, a CPA must be independent of the client for review engagements.

A review engagement requires the accumulation of review evidence that provides the CPA with a reasonable basis for obtaining limited assurance that no material modifications need to be made to the financial statements. Similar to a compilation engagement, a CPA is not obligated to obtain an understanding of the client's internal control structure. However, the CPA should have a general understanding of the client's industry and operating characteristics; the nature of its assets, liabilities, revenues, and expenses; as well as the accounting principles and practices, and the methods followed in applying them.

The CPA's inquiries should be directed to individuals having responsibility for financial and accounting matters, and should cover areas such as the following:

- Whether the financial statements are presented fairly, unadjusted errors, complex or unusual situations or transactions, related-party transactions, and subsequent events
- Known or suspected instances of fraud, illegal acts, or noncompliance with regulations, and litigation claims and assessments
- Procedures for recording, classifying, and summarizing transactions, as well as the accumulation of information for disclosure
- Actions taken at stockholder's, board of directors, and other meetings that may affect financial statements
- Material items stemming from the CPA's analytical procedures

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 comparisons 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.

At the conclusion of the review engagement, the accountant accumulates identified misstatements, including inadequate disclosure, to determine whether they are material, whether revisions should be made in order for the CPA to provide limited assurance, or whether the independent accountant's review report should be modified. In addition to the report, the CPA is required to communicate identified fraud or suspected noncompliance with laws and regulations.

Audit

The purpose of an audit is to provide financial statement users with an opinion on whether financial statements are presented fairly, in all material respects, 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 as a whole are free from material misstatement. A CPA must be independent of the client for audit engagements.

An audit opinion represents the highest level of assurance that financial statements fairly represent the entity's financial position and results of operations in accordance with the organization's financial reporting framework. Please note that an auditor can only obtain reasonable, not absolute, assurance that a client's financial statements are fairly presented in all material respects. The audit is inherently limited due to the auditor's use of sampling rather than 100 percent testing, documentary evidence being suggestive rather than conclusive, and the evasive nature of fraud, in that fraud typically involves active efforts by the perpetrator to conceal it through collusion, falsification of records, and misinformation. A properly performed audit is not designed to detect or prevent fraud, render an opinion on internal controls, or predict the solvency of an entity. An audit is not a forensic, or investigative, engagement.

Audit engagements necessitate that auditors obtain an understanding of the client's business and the industry in which it operates, the current year operations, and the client's internal controls, which are often documented in the form of questionnaires, flow-charts, or narratives, and assess the risk of fraud relating to the financial statements. Based on the CPA's understanding and information gathered and knowledge obtained, the CPA applies the concept of materiality and risk to design and execute audit procedures to obtain sufficient audit evidence to support the audit opinion. Such audit procedures could include audit sampling, reviewing supporting documentation, external confirmation of information, testing controls, observation and corroborative inquiry, analytical procedures, assessing the reasonableness of estimates, and evaluating the overall financial statement presentation and the footnote disclosures. Occasionally, auditors rely on specialists such as actuaries, data scientists, statisticians, or IT experts to assist in obtaining audit evidence.

An integral part of an audit is the CPA's dialogue with those charged with governance regarding the auditor's responsibilities, the planned scope and timing of the audit, and significant findings or issues from the audit. Other required communications to those charged with governance include material internal control weaknesses, noncompliance with laws and regulations, and suspected instances of fraud and illegal acts if uncovered. In certain situations, the auditor may be required to report material issues externally to regulatory bodies.

At the conclusion of the audit engagement, the accountant accumulates the identified misstatements, including inadequate disclosures, to determine whether they are material or whether revisions should be made in order for the CPA to provide reasonable assurance, or whether the independent auditor's report should be modified.

As you can see, each level of service is noticeably different. Selecting the right level of attestation for an organization depends on many variables, including the size and complexity of the organization, the level of oversight provided by those charged with governance, financial statement users' access to management, and the purpose of the financial statements (such as support for a bank's evaluation of debt covenant compliance, as a basis for management decisions, oversight of grant funds, etc.). While the audit provides the highest level of assurance, it is the most time consuming and costly; often a compilation or review engagement may be sufficient.

Once again, thank you for the opportunity to appear before you this morning. I would be happy to answer any questions.