

The Practitioner's Corner - An Accounting Guide for Attorneys: Not all Financial Statements are Created Equal

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Financial statements, accounting, and auditing are all important aspects of a business that require careful attention and expertise. While most attorneys understand financial statements and deal with them on a regular basis, there are many who are not comfortable dealing with accounting issues and financial statement concepts.

Welcome to the first [in a series](#) in which we will explore basic accounting concepts. This will include terminology, principles, methods, reports, and statements. The goal is to increase your financial acumen, correct common misconceptions, and alert you to the items that matter most to you as attorneys. The goal is to also demonstrate that not all financial statements are the same. This knowledge will help you better interpret financial data in your practice and recognize when it is necessary to seek expert advice.

What are Financial Statements?

Financial statements are interrelated reports that illustrate the financial results and condition of an entity. Depending on the type of entity and the intent of the statements, accountants will apply different procedures when reporting on financial statements.

A *complete* set of financial statements will typically include the following:

- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Statement of Stockholders' Equity/Partners' Capital (typically for entities with more complex capital structures)
- Notes

Internally Generated Financial Statements

Internally generated financial statements refer to the basic financial statements that are prepared by management in the normal course of managing the business. These financial statements may be generated monthly, quarterly, and/or for the year-end. They have not yet been subjected to an audit or any other level of service by an outside accounting firm and typically do not contain notes. *Be aware that these financial statements may not contain all of the transactions or disclosures that should be included, especially if an external accounting firm will be issuing a report (e.g., audit, review or compilation) on the financial statements.*

Management vs. External Accountants

It is important to understand the differing roles of management and external accountants. Management is responsible for maintaining the company's books and records, which are used to prepare the financial statements. The external accountant's role is to perform an audit, a review, or a compilation of the financial statements that were **prepared by management**.

Keep in mind that an external accounting firm that performs an audit or a review

must be independent and is, therefore, prohibited from maintaining the books and records or making management decisions for the entity. *Be aware of facts that suggest an auditor is making management decisions, as this might indicate that their independence has been impaired, which can call the integrity of the audit or review into doubt.*

We often hear audited financial statements referred to as “the auditor’s financial statements,” which is incorrect and misleading. The **responsibility** for the **financial statements** remains with **management**. The auditor[1] is responsible for their report on the financial statements. The external accountant’s role is to employ the procedures required, based on the level of service provided, to support the report that they issue on the financial statements.

Important Information Found in the External Accountant’s Report

You may be looking at a set of financial statements that includes a report with the logo and signature of a certified public accounting firm. *However, be aware that not all accountants’ reports cover the same level of service, so you should read them carefully.* The work that is completed during an audit, review, or compilation varies significantly, thus providing different levels of assurance with each. This is relevant for all practitioners assessing the level of work that has been performed by the external accountants and how much reliance you place on those financial statements. It is important to understand the different levels of service provided by the external accountants and what they mean:

- **Audit** – An auditor issues an **opinion** as to whether the financial statements are fairly stated in all material respects in accordance with Generally Accepted Accounting Principles (“GAAP”). This opinion is supported by procedures performed during the audit but is **not a guarantee that the financials are correct or accurate**.
- **Review** – A review provides **negative assurance**. The accountant issues a report stating that they are not aware of any modifications that are required for the financial statements to be fairly presented in accordance with GAAP. The procedures performed in a review engagement are **substantially less**

in scope than an audit.

- **Compilation** – A compilation provides **no assurance**. The accountant issues a report stating that they do not express any assurance or opinion on the financial statements. The procedures performed typically involve collecting management's financial data and inserting it into the form of a financial statement.

While reviewing accounting reports, attorneys should think about the following:

- Has the entity recently changed external accounting firms and/or changed them frequently? While publicly-traded companies must disclose changes in auditors in a Form 8-K, counsel should investigate why a public or private company has changed its auditors. Was the company pursuing an aggressive accounting position and had disagreements with its auditors? *The reason(s) for recent or frequent changes in accounting firms should be explored.*
- Does it make sense that the accounting firm is performing an audit or review for the entity based on its size? *It would not make sense for a small, unknown firm to be the auditor for a large multi-billion-dollar investment firm. Yet, that is exactly what occurred in the Madoff fraud.*

Different Types of Audit Opinions

If an audit has been performed, it is important to read the audit opinion issued by the accounting firm because there is more than one type of audit opinion that can be issued.

- **Unqualified** – This is the **gold standard**. The auditor opines that the financial statements are fairly stated in all material respects in accordance with GAAP. Be sure to review the entire report because **explanatory language** can be added in an additional paragraph that can alert the reader to other relevant information, such as a comment on the entity's ability to continue as a going concern, any material changes in accounting principles, or a partial reliance on another auditor's work. *Be aware that this additional paragraph contains information that may be relevant. **Remember:** Auditors*

do not test every transaction. Audits are not a guarantee of accuracy!

- **Qualified** – This opinion **notes an exception**. The exception can involve a scope limitation in the audit or a disagreement regarding the accounting treatment of an item. *Be aware that this is an indication that further inquiry/investigation is needed to better understand the exception.*
- **Disclaimer** – The auditor issues **no opinion**. This would occur if the auditor lacked independence or found a significant scope limitation when they attempted to perform the required procedures (e.g., unable to perform a year-end inventory count). *Be aware that this indicates that further inquiry/investigation is needed to better understand the circumstances surrounding the disclaimer.*
- **Adverse** – An adverse opinion is issued when the auditor states that the **financial statements are not fairly stated in all material respects** in accordance with GAAP.

Key Points to Remember

- Internally generated financial statements may not contain all the transactions that should be included, especially if some level of service (e.g., audit) was not yet applied by an external accounting firm.
- Facts that suggest an auditor is making management decisions might be a clue that their independence has been impaired, which can call the integrity of the audit into doubt.
- An additional paragraph of explanatory language in an unqualified audit opinion contains information that may be relevant to the Company's financial condition.
- The qualified, disclaimer, and adverse audit opinions indicate that further inquiry/investigation may be needed.
- Be alert to changes in auditors. It is unusual for a business to change accounting firms frequently.
- Consider whether it makes sense for certain accounting firms to audit or review the financial statements of a particular entity.

For more information on understanding financial statements and how they impact your cases and practice, please reach out to [Anthony Bracco](#), Leader of the

Litigation, Forensic and Valuation Services Group, [David Beckman](#), Partner in the Litigation, Forensic and Valuation Services Group, [Margaret Kolb](#), Director in the Litigation, Forensic and Valuation Services Group, [Lisa Coughlin](#), Supervisor in the Litigation, Forensic and Valuation Services Group, or your Anchin Relationship Partner.

[1] External accountants are referred to as “auditors” when performing an audit or as “accountants” when performing a review or compilation.