LIMITED ASSURANCE ENGAGEMENTS:
BANKERS, AUDITORS AND REALITY
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Abstract

Bankers are becoming increasingly reliant on limited assurance reports (LARs) issued by accountants. A clear understanding the level of assurance intended by these reports aids in optimal management of the credit function and leads to efficient allocation of scarce resources. The difficulty lies in that accountants cannot quantify, and thus users may not understand, how much assurance the accountant intends to convey in a LAR. This raises the concern that bankers may be making suboptimal decisions based upon a misconception of the assurance intended by the accountant. This paper presents the results of an empirical test designed to access whether bankers and accountants have a congruent understanding of the assurance intended by several common LARs. The findings indicate a significant difference exists between bankers’ and accountants’ perceptions of the intended assurance levels. Particularly, bankers believe interim reviews provide more assurance than they really do and they believe reviews of financial forecasts provide less assurance than they really do.

INTRODUCTION

The traditional relationship between bankers and accountants was well established: auditors issued a standard opinion (or variation thereof) and bankers relied on that report in making various financial decisions. Bankers knew how much assurance they were receiving from the auditor and their reliance on the report was commensurate with that understanding. However, in recent years, bankers have become increasingly reliant on a myriad of new limited assurance reports (LARs) issued by accountants. These LARs are issued in connection with engagements in which the services provided by the accountant are more limited in scope than those associated with the standard opinion audit. Unfortunately, these limited assurance reports (LARs) are not well defined in terms of the assurance intended by the accountant or the degree of reliance a user should place on the report.

Bankers’ clear understanding of the assurance intended by accountants’ reports aids in optimal management of the credit function and leads to efficient allocation of scarce resources. In contrast, misperception of the assurance intended by accountants’ reports may lead to suboptimal decisions and costly subsequent difficulty in loan repayment. Prior research has shown that the message intended by the standard audit opinion is effectively communicated to bankers (Libby and Short, 1980). However, a question remains as to the effectiveness of communication when one or more of the 21 limited assurance reports are employed. This question arises because, as will be discussed later, even the accounting profession is not yet prepared to define or quantify the assurance provided by LARs-- and
if the accountants have not certainly the bankers cannot. (Ascertaining the level of assurance retroactively by experience could be disastrously expensive!) What is needed, then, is a two-part process:

1) Empirical research to determine whether there is in fact confusion, uncertainty, or miscommunication between bankers and accountants regarding limited assurance reports.

2) If such confusion exists, begin identifying specific misconceptions or areas of ambiguity, as a necessary first step in improving banker-accountant communication.

The purpose of this paper is to present the results of an empirical study designed to explore the communications, and sometimes miscommunications, between bankers and accountants when LARs are issued. The banking profession-lending officers and risk managers in particular—will benefit from the results of this initial research effort into this troublesome area, and thus be able to make more informed lending decisions.

LIMITED ASSURANCE ENGAGEMENTS

Limited assurance engagements have arisen because of a marketplace demand for attestation services. For years, attest services were generally limited to expressing a positive opinion on historical financial statements. However, in recent years accountants have been increasingly been requested to provide, and have been, providing, assurance on representations other than historical financial statements and in forms other than the positive opinion. Appendix A lists the 21 LAEs currently recognized by accountants' professional standards. Appendix B lists a variety of attestation services which are commonly performed but have not yet been sanctioned by professional standards.

Meeting user needs has been the prominent thrust of limited assurance engagements. For example, bankers are primarily concerned with the solvency of their customers; that is, their ability to repay loans when due. Profitability is of concern to lenders only in that a firm's profitability may provide insight into its long-run solvency (Heath, 1981). Since today's financial statements are profit, not solvency-oriented, they are less useful for lending decisions than they could be. In response to creditors' request, accountants have recently started issuing reports which provide some assurance as to the solvency of the prospective borrower. Another situation in which a LAR is commonly given involves mergers and acquisitions. Many merger/acquisition situations involve the belief that the target company's assets are undervalued. In these cases, many investment bankers want additional assurance regarding the valuation of these assets and will therefore engage accountants to perform certain agreed upon procedures. Subsequent investment of capital or debt is contingent upon the results of the Agreed Upon Procedures Report.

That bankers correctly interpret the message (and assurance) intended by such reports is obviously important. The lack of a clear understanding regarding the intended level of assurance could result in inappropriate decisions and serious consequences. Consider, for example, the case of a review report. Reviews have become a popular limited assurance alternative to an audit for nonpublic companies. Suppose a banker receives a review report with an application for a loan to be collateralized by accounts receivable and inventory. Unlike an audit, the review does not involve confirmation of accounts receivables or observation of inventory. Rather, a review requires only inquiry of the client and performance of analytical review procedures (ratio and trend analysis). Suppose the
banker is forced to the last resort of liquidating receivables and inventory. During the ensuing legal problems, the banker's reliance on the review report may be viewed as unwarranted.

The difficulty with limited assurance engagements, however, is that auditors cannot quantify, and thus users may not understand, the different levels of assurance. Implicit in the term "limited assurance engagement" is the concept that distinct levels of assurance exist. Each level of assurance lends an incremental degree of reliability to the financial information involved. Nonetheless, a simple ordinal ranking can be made. Audits provide more assurance than reviews, and, in turn, reviews more than compilations. But the difficult question remains: Where do the other limited assurance engagements rank? It is helpful to think of levels of assurance in terms of a continuum (see Figure 1).

Intuitively, the intended level of assurance should be some function of the scope of auditor involvement, nature of the subject matter, materiality level, risk, etc. However, analysis of auditing standards does not reveal guidelines as to the level of assurance being rendered by the various LARs nor does it reveal guidelines as to the reliance users should place on LARs. In fact, analysis of the auditing standards finds them fraught with inconsistencies and ambiguities. The AICPA has recently taken action to overcome these deficiencies by issuing "Attestation Standards". This attestation standards sanction auditor involvement with a variety of financial and nonfinancial assertions and provide overall guidance with regard to performing attest services. However, the attestation standards are not much of an improvement upon pre-existing standards since they simply identify a "highest" level of assurance and a "moderate" level of assurance and they do not provide guidance about how much users should rely on limited assurance engagements. In a profession traditionally characterized by methodology, quantification and analysis, and a high regard for precision, this quasi-sanctioned uncertainty is most surprising. The concern that users, especially bankers, may not understand what can reasonably be accomplished by a process less extensive than an audit has been raised by C.T. McGarrah (1979), Senior VicePresident of a major U.S. bank and former chairman of the Robert Morris Accounting Policy Committee.

Important questions must be answered by the banker when receiving limited assurance reports: Given the cost/benefit considerations, is a limited assurance report appropriate in the circumstances? If so, what level of reliance should be placed on the report? How can the amount of work performed be determined? What level of responsibility is the CPA assuming? And most importantly, will CPAs be successful in appealing to their (at present) unclear professional standards if the report misleads the banker and an inappropriate decision results?

THE EXPERIMENT

The next part of this paper reports the results of an experiment conducted to assess how bankers and auditors perceive the assurance intended by accountants when issuing different limited assurance reports. Twenty-five commercial loan officers from five of the largest commercial lending institutions in Chicago and twenty-five partners from the Chicago offices of five "Big Eight" accounting firms participated in the study. The experiment asked these subjects to make comparisons of the assurance provided by all possible combinations of eight selected reports. A standard opinion was included so that subjects would have a benchmark to use in measuring assurance levels (2). Figure 2 presents the abbreviated titles used to identify the reports.
The experiment was conducted by the author in the subjects' offices. Each subject received a folder which contained the eight reports and similarity rating sheets. The similarity rating sheets presented the 28 possible pairings of the eight reports in random order. The subjects were asked to familiarize themselves with the reports and to be able to identify them by the abbreviated titles. The subjects were then asked to rate, on a nine-point scale, the similarity of the assurance implied by each of the twenty-eight pairings of the reports.

After the subjects completed the experimental task, an interview was conducted to ascertain the subject's experience level, formal training, and familiarity with the reports. The subjects were also encouraged to discuss how and why they made their similarity ratings. Finally, each subject was asked to rank the eight reports (from first to last) according to how much assurance they felt the report was intended to convey.

THE METHODOLOGY

Multidimensional scaling (MDS) was used to compare bankers' and accountants' perceptions of the reports. MDS is a technique by which ratings of the similarities or dissimilarities between objects can be used to generate multidimensional spatial models (Schiffman, Reynolds and Young, 1981). These models depict the relationships between any two objects. MDS is predicated upon the assumption that the distance between any two objects in space is a function of the degree of similarity of the objects: as the degree of similarity between objects increases, the distance between the objects decreases. Conversely, as the degree of similarity between objects decreases, the distance between the objects increases. The virtue of MDS lies not in its ability to explain perception but rather in its ability to represent, or model, perception.

An example will assist in gaining an understanding of MDS. Prior to the 1968 Presidential election, a researcher (Johnson, 1969) asked subjects to compare the similarity of the political candidates. The subjects rated each possible pair of candidates in terms of how similar the candidates were, and the similarity ratings constituted the input for the MDS computer algorithm.

The MDS algorithm plotted the candidates on two dimensions based on the subjects' similarity ratings. The multidimensional representation obtained is called a perceptual model. The perceptual model represents the subjects' perceptions of candidate similarity and is shown in Figure 3.

An analysis of the perceptual model indicated that the subjects appeared to have based their judgments on two aspects of the candidates. The horizontal axis was interpreted as a liberal vs. conservative dimension. The vertical axis was interpreted as reflecting perceived favorability of the candidate's attitude toward government involvement in domestic and international matters.

RESULTS

The bankers' and auditors' similarity ratings of the 28 possible combinations of reports constituted the input to an MDS computer algorithm (3). The results of the algorithm included two perceptual models, one for the bankers (Figure 4) and one for the auditors (Figure 5). Each model represents that groups' perception of the relationship between the reports.

When analyzing the perceptual models, each axis (dimension) represents a factor which the subjects perceived to be important in differentiating among the reports (4). Those reports perceived to be similar in terms of that factor will be closely positioned on that dimension. In contrast, those reports perceived to be dissimilar in terms of
that factor will be positioned farther apart.

The horizontal dimension can be interpreted by comparing how the reports are ranked by the model (on this dimension) with the subjects’ mean rankings of the reports’ assurance levels. The model ranking represents the order (from left to right) in which the reports were positioned on the horizontal dimension of the model. The mean ranking was obtained when the subjects were asked to rank the eight reports (from first to last) in order of how much assurance they felt the report was intended to convey. Figure 6 presents a comparison of the two rankings.

An analysis of the mean and the model rankings indicates that the subjects’ rankings of the reports’ assurance levels seem very closely aligned with the positioning of the reports on the horizontal dimension. A Spearman rank correlation coefficient was calculated to measure the relationship between the two rankings. The rank correlation can range from +1 (complete concordance) to -1 (complete disconcordance). The bankers’ rank correlation coefficient was 1, indicating the exact agreement of the mean and model ranking. The rank correlation coefficient for the accountants’ sample was .952 and was significant at the .01 level. Because of the perfect correlation of the rankings, the horizontal dimension can be clearly interpreted as reflecting the level of assurance implied by the various reports.

The identity of the vertical dimension is less clear. Two reasons for this are apparent. First, the dimension is not necessarily the same for both accountants and bankers. Second, unlike the horizontal dimension, considerable disagreement existed among the subjects regarding the importance of the vertical dimension (5). When no definite interpretation of the vertical dimension was obvious, discussions were held with subjects whose results indicated that they weighed the dimension heavily when making their similarity ratings. These discussions did not lead to a definitive interpretation of the vertical dimensions.

A rather involved statistical test can be made to measure for any differences in the perceptual models of the two groups (6). The statistical test was significant at the .01 level (p < .01) indicating that there is a definite difference in the accountants’ and bankers’ perception of the assurance intended by the LAEs.

DISCUSSION OF FINDINGS

Analysis of the perceptual models revealed two major sources of difference in the groups’ perceptions of LAEs. First, bankers ascribed a significantly lower level of assurance to a review of a financial forecast than did accountants. Interviews with bankers suggest that this may be because bankers attach a negative connotation to forecasts. Bankers’ clients frequently provide management-prepared, unreviewed financial forecasts, and many bankers expressed the sentiment that these forecasts are not reliable. During the interview conducted after the experimental task was completed, almost all of the bankers indicated they had also received forecasts which were reviewed by a CPA. However, the bankers were not familiar with the guidelines established by the AICPA for a review of a financial forecast. These stringent guidelines, of which most accountants were aware, require rather extensive CPA involvement (7). Since a reference to such guidelines is the bankers’ only clue as to the scope and nature of the work performed, it is not too surprising that the bankers perceived forecasts to provide a much lower level of assurance than that intended by the accountants. This result suggests that the accounting profession needs to make a more concerted effort to inform bankers of the
advantages afforded by a review of a financial forecast.

A second source of difference in the bankers' and accountants' perceptions was that bankers perceived interim reviews as providing an appreciably higher level of assurance than did the accountants (8). One explanation for this difference may be that bankers tend to see interim review reports more frequently than some of the other reports included in this study. That is, familiarity breeds acceptance. A second explanation for the difference may be a misconception by bankers. During the interviews bankers generally indicated that they thought many of the same yearend audit procedures were performed during an interim review. That is, many bankers erroneously believed that a review was a "mini" audit.

However, a review differs substantially from an audit. Unlike an audit, a review consists mainly of inquiries of the client and application of analytical review procedures (ratio and trend analysis). The accountant is not required to make a review of internal control or obtain corroborating evidence of account balances. Hence, no confirmation of accounts receivables, no observation of inventories, no verification of cash or any other such testing is undertaken during a review engagement. When a banker has a loan collateralized by accounts receivable and inventory, this may be a crucial deficiency of a review.

**CONCLUSION**

As limited assurance engagements become more and more prevalent, a clearer understanding of the assurance accountants' intend to convey becomes increasingly important. This clear understanding aids in optimal management of the credit function and efficient allocation of scarce resources. This article focused attention on only two of the LAEs where misperception between bankers and accountants exists. A review of a financial forecast-where the banker is receiving more assurance than generally believed--and an interim review-where the banker is receiving less assurance than generally believed. As more research on this increasingly important aspect of accounting services is undertaken, and as bankers increasingly rely on LARs in making decisions, other areas of misperception and misunderstanding are likely to emerge.

But this article is also intended to accomplish a broader purpose. Bankers offer a myriad of services, from cash management to lending money. And in response to competitive pressures, the scope of services offered by banks will continue to expand. Likewise, accountants offer a variety of services, from tax planning to auditing. Limited assurance engagements offer an important new source of revenue for public accounting firms. As interaction between these two groups of professionals increases, they can better serve their clients and each other by having a greater knowledge of the services provided by each group.
REFERENCES


NOTES

1. An accountant may accept an engagement in which the scope is limited to applying procedures agreed upon by the users of the report. For example, in a merger/acquisition the investment banker might want many essential procedures of the audit. However, he might want the work performed without regard to a materiality limit.
2. The reports were selected randomly. The standard opinion was included at the suggestion of pilot study participants.
3. The MDS algorithm used, COSPA, is superior to other MDS algorithms in that it overcomes two difficulties associated with multidimensional scaling. First, a perceptual model can always be generated by a set of similarity rating. However, the model may not be a meaningful representation of the subjects' perceptions. COSPA provides a statistical test of whether the data fit the model. Second, previous algorithms have not provided a statistical method of testing for a difference in the models of two groups. COSPA provides such a test.
4. COSPA also determines the number of dimensions which provide maximal information content. In this case a two-dimensional solution was superior to a three-dimensional solution.
5. COSPA generates scattergrams indicating how strongly each dimension was considered in making the similarity ratings.
6. The interested reader can obtain details of the test from the author.
7. For example, the auditor does extensive work in evaluating the support for assumptions used in preparing the forecast. Also, extensive procedures are undertaken by the auditor in evaluating the preparation and presentation of the forecast.
8. An interim review of financial statements is performed for a publicly held corporation and should not be confused with the annual review for nonpublic companies described earlier.
APPENDIX A

TYPES OF LIMITED ASSURANCE ENGAGEMENTS CURRENTLY ESTABLISHED IN ACCOUNTANTS' PROFESSIONAL STANDARDS

1. Letters for underwriters (comfort letters) -- Statement on Auditing Standards #38

2. Application of agreed-upon procedures to specific accounts, elements, or items of a financial statement -- Statement on Auditing Standards #35

3. Application of agreed-upon procedures to financial statements taken as a whole -- Statement on Auditing Standards #26/sec. 504.20

4. Review of interim financial information of a public entity presented alone -- Statement on Auditing Standards #36

5. Review of interim financial information that accompanies or is included in a note to audited financial statements of public or nonpublic companies -- Statement on Auditing Standards #36

6. Reviews of interim or annual financial statements of a public company that does not have its annual financial statements audited -- Statement on Auditing Standards #26/sec. 504.05 n4

7. Review of annual or interim financial statements of nonpublic entities -- Statement on Standards for Accounting and Review Services #1

8. Reports on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements -- Statement on Auditing Standards #14/sec. 621

9. Involvement with supplementary information required by the FASB -- Statement on Auditing Standards #27/sec. 553

10. Involvement with other information in documents containing audited financial statements -- Statement on Auditing Standards #8/sec. 550

11. Involvement with explanations of information disclosed in accordance with SFAS No. 33 -- Statement on Auditing Standards #28/sec. 554.04

12. Involvement with information accompanying basic financial statements in auditors-submitted-documents -- Statement on Auditing Standards #29/sec. 551


14. Compilation of financial statements of nonpublic entities -- Statement on Standards for Accounting and Review Services #1
15. Report on internal accounting control based solely on a study and evaluation made as part of an audit of the financial statements -- Statement on Auditing Standards #30/sec. 642.

16. Report on internal accounting control based on criteria established by regulatory agencies -- Statement on Auditing Standards #30/sec. 642

17. Reports on certain aspects of administrative control or on compliance with certain provisions in contracts or regulations -- Statement on Auditing Standards #30/sec. 642

18. Other special purpose reports on internal accounting control -- Statement on Auditing Standards #30/sec. 642

19. Reports on condensed financial statements and selected financial data -- Statement on Auditing Standards #42

20. Special-Purpose Reports on Internal Accounting Control at Service Organization -- Statement on Auditing Standards #44

21. Statement on Standards for Accountants' Services on Prospective Financial Information-Financial Forecasts and Projections

Note: Interestingly, 12 of the 49 Statements on Auditing Standards pertain, at least partially, to limited assurance engagements. In addition, five Statements on Standards for Accounting and Review Services (SSARS) have been issued.

APPENDIX B
OTHER LIMITED ASSURANCE
EXAMPLES OF ENGAGEMENTS

1. Reorganization and bankruptcy plans
2. Antitrust case data
3. Insurance claims data
4. Labor data for union contract negotiation
5. Characteristics of computer software
6. Audience and circulation data
7. Occupancy, enrollment, and attendance data
8. Integrity and security of a computer network
9. Cost-justification for a utility rate increase
10. Current values of real estate
11. Investment performance statistics
12. Whether tax shelter is likely to produce intended tax benefits
13. Financial feasibility of a rapid transit system
14. Productivity indicators
15. Cost reimbursement data
16. Elements of financial statements
NO ASSURANCE | MINIMUM ASSURANCE | MAXIMUM ASSURANCE | COMPLETE ASSURANCE

(i.e., compilation) | | (i.e., GAAS-based opinion audit)

RANGE OF POSSIBLE LEVELS OF ASSURANCE

Figure 1. Continuum of Levels of Assurance (not necessarily to scale)

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**Report 1:** Interim Review-Public Entity
**Report 2:** Compilation-Nonpublic Entity
**Report 3:** Contractual Compliance
**Report 4:** Supplementary Information
**Report 5:** Standard Opinion
**Report 6:** Condensed Financial Statements
**Report 7:** Agreed Upon Procedures
**Report 8:** Review of Financial Forecast

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Figure 2. Abbreviated Report Titles
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<td></td>
<td>Lemay</td>
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| Rockefeller | *       |
| Percy       | *       |
| Lindsay     | *       |
| Kennedy     | Humphrey|
| *           | *       |
| Johnson     | Eisenhower|

Figure 3. Multidimensional Scaling Solution for Candidate Similarity
Figure 4. Bankers' Perceptual Model

Figure 5. Accountants' Perceptual Model
FIGURE 6
BANKERS' AND ACCOUNTANTS' MODEL RANKING AND MEAN RANKING OF THE EIGHT REPORTS

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