

INFORMATION THAT MIGHT BE PROVIDED BY UNAUDITED (REVIEWED OR COMPILED) FINANCIAL STATEMENTS

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In many respects legal interpretation of accountant reporting duties is still in its infancy. There are relatively few appellate-level court decisions interpreting accounting pronouncements and accountant practice duties. The majority of cases relating to accountant reporting standards involve situations in which the accountant performed an audit of the financial records; and, thus, was held to the highest standard of care. Considering the large number of unaudited (i.e., lower standard of care, compiled or reviewed) financial statements that are submitted quarterly and annually, there is a need for greater understanding about the representations that unaudited financial statements may provide. The discussion below provides some understanding in that regard, and should be read in conjunction with the required quarterly and annual discussions between the audit committee and the outside auditor for public companies. To understand the type of information that a review will provide, you first need to understand the type of information that a compilation opinion might provide. This discussion begins with an overview of the information that a compiled report might provide, and then follows with a discussion about the additional information that a review report might provide.

COMPILED FINANCIAL STATEMENTS

The standard accountant's compilation report states in pertinent part:

... 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.

However, contrary to prevalent belief, a compiled financial statement may provide representations or assurances.

Both reviewed and compiled financial statements provide representations or assurances less than those provided by audited financial statements. Compiled financial statements generally provide the fewest representations; reviewed financial statements fall somewhere in the middle of the spectrum. In the most basic sense an accountant engaged to compile financial statements is not required to verify, corroborate or review the accounting records provided by the reporting entity, or to perform an analytic analysis of that entity's financial information. Thus, the standard compilation report states that the accountant does not express an opinion or other form of assurance of the financial statements. However, it is always the accountant's duty to use such skill, prudence and diligence as other members of the accounting profession commonly possess and exercise when performing similar professional services.

Accounting pronouncements require an accountant engaged to compile financial statements to obtain a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are presented, and the form and content of the financial statements. If the accountant becomes aware that information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory for the purpose of compiling the financial statements, the accountant must obtain additional or revised information, or withdraw from the engagement if the reporting entity's management refuses to provide additional or revised information. The accountant also is required to inform management of any material errors (i.e., unintentional or inadvertent misstatements), irregularities (i.e., intentional misstatements) or illegal acts that come to the accountant's attention, unless they are clearly inconsequential. Thus, a "clean" compilation report may impliedly state that the submitting accountant is not aware that the compiled financial information provided by the reporting entity is incorrect, incomplete or otherwise unsatisfactory.

Typically an accountant engaged to compile financial statements is fairly knowledgeable about the reporting entity. The accountant may have obtained information by making those inquiries that are required by accounting pronouncements, or through other professional services performed by the accountant on behalf of the reporting entity. It is not uncommon for an accountant to have a long-term relationship with the reporting entity and to perform many different types of professional services for that entity. Other services that the accountant may have performed might include tax advice and return preparation, bookkeeping, computer consultation, accounting system design, business and finance consulting, depreciation calculation assistance, account receivable management and valuation, or cash account management and reconciliation. Thus, regardless of actual procedures performed by an accountant during a compilation engagement, it is not uncommon for that accountant to possess substantial additional information about the reporting entity. The accountant may be required to consider that additional information when submitting the compilation report.

The following are some of the problem areas that an accountant engaged to compile financial statements may, or possibly should, become aware of while completing that compilation engagement or while performing other prior work on behalf of the reporting entity.

Disclosures. Generally Accepted Accounting Principles ("GAAP") require that disclosures be made with financial statements. An accountant may compile financial statements that omit disclosures required by GAAP if the compilation report contains an additional paragraph stating (1) that management has elected to omit the disclosures, and (2) that if the disclosures had been included they might influence the user's conclusions. However, disclosures may not be omitted if, based on the accountant's knowledge, the

omission is intended to mislead users of the financial statements. The accountant must skeptically question why management wants to omit disclosures with a view toward erring on the side of concluding that disclosures are necessary.

Uncertainties. GAAP requires disclosure of uncertainties or contingencies such as litigation exposure, contracts that are in dispute, possible tax position liability exposure, or the potential cost of environmental cleanup. A reporting entity on the accrual method of accounting must accrue to the financial statements the estimated amount of a contingent liability that is probable to actually occur. The estimated amount of a contingent liability that is reasonably possible to occur is not accrued to the financial statements, but must be disclosed in the footnotes to the financial statements. Although a reporting entity on the cash method of accounting may not be required to accrue a contingent liability that is probable to occur, footnote disclosure of the estimated amount of that contingency or of the estimated amount of a contingency that is reasonably possible to occur may be necessary. If the accountant becomes aware of an uncertainty issue he or she must discuss that matter with management, consider disclosing the uncertainty in the compilation report if the accountant believes disclosure would be sufficient, or withdraw from the engagement. Alternatively, in appropriate but generally limited circumstances management may elect to omit disclosure of uncertainties, but as discussed above, the accountant must carefully evaluate any decision by management to omit disclosures. Inconsistencies in the application of acceptable accounting principles are treated in a like manner.

Going Concern. The ability of the reporting entity to continue as a going concern, that is, to continue in business for the following year, is a form of uncertainty. Similar to the above discussion relating to uncertainties, if the accountant becomes aware of conditions that indicate a going concern problem he or she must discuss the matter with the management, consider disclosing the going concern uncertainty in the compilation report, or withdraw from the engagement. Alternatively, in appropriate but generally limited circumstances, with the acquiescence of the compiling accountant, management may elect to omit the disclosure of a going concern issue.

An accountant engaged to perform an audit must evaluate conditions or events discovered during the engagement that raise substantial doubt regarding going concern issues. Going concern in accounting literature generally relates to the entity's ability to meet maturing obligations without selling operating assets, debt restructuring, or revising operations based on outside pressures or strategies. Thus, an accountant's obligation to evaluate going concern may be more broad than an obligation to evaluate the likelihood that an entity will file for or be forced into bankruptcy during the following year. At this time, an accountant is not required to employ specific procedures to identify conditions or events that might raise substantial doubt regarding going concern issues, but must be sensitive to all evidence gathered or obtained as that information may relate to going concern issues. Typically going concern issues are identified by operating losses, negative cash flows

from operations, working capital deficiencies, loan defaults, debt restructuring, the need to sell assets or seek new financing, labor difficulties, significant litigation liability exposure, prolonged difficulty obtaining approval for a new product, loss of a significant contract, or undue concentration of risk by product line, consumer, or material supply. Going concern issues often are identified by analytic procedures comparing changes in key account balances, cash flow and financial ratios.

GAAP Departures. An accountant who is engaged to compile financial statements may become aware of material departures from Generally Accepted Accounting Principles. That is, a failure to correctly account for a particular transaction or type of transaction. Possible GAAP departures are almost unlimited. Typically financial statements are improperly enhanced by overstating cash, recognizing revenue prior to the time it is actually earned, deferring expenses until a later period, failing to accrue or disclose contingencies, overstating accounts receivable, overvaluing assets, or understating cost of goods sold. It is not acceptable for management to elect not to disclose a material departure from GAAP. In that circumstance the accountant may convince the client to revise the financial statements, disclose the departure in the compilation report if the accountant believes disclosure would be sufficient considering the financial statements as a whole, or withdraw from the engagement.

Accounting estimates are inherent in the accounting process. Typical examples include estimates of uncollectible receivables, income taxes, inventory losses due to obsolescence, and other contingencies. If an accountant engaged to compile financial statements becomes aware that an appropriate estimate has not been made or the accountant believes management's estimate of an item is not reasonable, the accountant must treat that matter as a GAAP departure.

Internal Control. Generally, internal control is the set of procedures implemented by the reporting entity to ensure that assets are safeguarded and transactions are accurately and timely valued, documented, recorded and reported in the accounting records. An accountant performing an audit must evaluate internal control to determine the extent to which the entity's accounting records can be relied upon during the audit. Adequate internal control typically requires separation of accounting duties among various persons, proper employee/managerial training, managerial and employee integrity, adequate transactional valuation and documentation, timely and accurate transactional recording and reporting, limited or controlled asset access, and appropriate independent reconciliation or verification. Internal control and other analytic procedures are also helpful to prevent or detect fraud and embezzlement.

An accountant who is engaged to compile financial statements must obtain knowledge about the nature of the reporting entity's business transactions, the form of its accounting records, and the stated qualifications of its accounting personnel and the accounting functions those personnel perform. A compilation engagement does not specifically

include an evaluation of internal accounting controls. However, an accountant may not compile financial statements from accounting records that are likely to be incomplete, incorrect, or unreliable because of the fact that the reporting entity's personnel cannot maintain appropriate records, or if it is known, or should be known, by the accountant that the reporting entity has inadequate internal accounting controls to establish that the accounting records are sufficiently reliable. In those circumstances the accountant must consider arranging to have additional services performed on the reporting entity's accounting records, or withdraw from the engagement. Thus, in cases of fraud or embezzlement arising from improper internal accounting controls an accountant engaged to compile financial statements may face greater responsibilities.

Related Party Transactions. Similar to the above discussion relating to internal control, if the accountant becomes aware of material related party transactions, and that the accounting treatment for those transactions is not reliable or in conformity with GAAP, the accountant must consider arranging to have additional services performed on the reporting entity's accounting records, or withdraw from the engagement.

Thus, by omission or failure to disclose otherwise, depending on the information that was obtained, or that should have been obtained by the accountant about the reporting entity, compiled financial statements provide negative representation or assurance that the accountant was not aware of material errors, irregularities, omissions, improprieties, or going concern or internal control uncertainties in the accounting records of the reporting entity, and that those material items in fact did not exist. Unlike the typical audit situation where it is clear the accountant's report attests that the financial statements taken as a whole are materially correct, in the case of compiled financial statements a determination of whether it was appropriate for the accountant to submit the compiled financial statements may depend upon an analysis of what information the accountant obtained, or should have obtained, about the client while performing the compilation engagement or other prior professional services.

REVIEWED FINANCIAL STATEMENTS

In a technical sense an accountant engaged to review financial statements must obtain a reasonable basis for expressing limited assurance that the financial statements are in conformity with Generally Accepted Accounting Principles without any material modifications. Thus, as stated above, reviewed financial statements provide a higher level of assurance than do compiled financial statements. More realistically, it can be difficult to determine at what level a reviewing accountant's duties stop—although a review is not performed in accordance with Generally Accepted Auditing Standards, in appropriate circumstances a reviewing accountant's duties may reach a level comparable to those associated with an accountant performing an audit. Thus, an accountant who performs review services may perform services under an erroneous belief that his or her duties are less than they actually are.

Although an accountant engaged to perform review services is not specifically required to perform tests of transactions, observe inventories, confirm accounts receivable, or evaluate internal control, a review is performed through a combination of inquiries, similar to the inquiries made during a compilation but in greater detail, and analytic procedures. Additionally, if an accountant performing a review becomes aware that information supplied by the reporting entity is incorrect, incomplete or otherwise unsatisfactory for the purpose of reviewing the financial statements the accountant must obtain additional or revised information, or withdraw from the engagement if the reporting entity's management refuses to provide additional or revised information.

The standard inquiries required in a review include those required in a compilation, e.g., inquiries relating to a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are presented, and the form and content of the financial statements. Thus, the above discussion pertaining to compilation services also applies to review services. However, specific inquiries required in review engagements are much more extensive than those required in a compilation. Inquiries at least should address the following areas:

1. Related party transactions.
2. Possible accounting problem areas or areas of greater risk.
3. Uncertainties and contingent liabilities.
4. Significant accounting policies.
5. Going concern.
6. Qualifications of accounting personnel and division of accounting duties.
7. Inventory.
8. Possible departures from GAAP.
9. Cash accounts.
10. Accounts receivable.
11. Inventory.
12. Investments.

13. Property, plant and equipment.
14. Current and long-term liabilities.
15. Other assets and liabilities.
16. Equity accounts.
17. Revenues.
18. Expenses.

A review also must specifically include analytic procedures designed to compare significant fluctuations in account balances between the accounting period for which the review is being prepared and prior periods. The accountant must inquire of management about significant fluctuations.

Because of the much greater initial inquiry required in a review, there is a greater likelihood that the accountant will or should become aware of any improprieties in the financial statements. The accountant must inquire about and/or investigate those possible improprieties until satisfied that the financial statements contain no material misstatements. It is arguable that a reviewing accountant's inquiry or investigation may in appropriate circumstance require procedures similar to those performed in an audit.

Historically, California and other courts have generally held that because a review report is not an audit, a claim for liability cannot be made against the accounting firm that issues the report—in essence holding that a review report provides no opinion at all. At least one recent California case is noteworthy for its holding to the contrary.

At the pleading stage, the court in *Murphy v. BDO Seidman* (2003) 113 Cal. App. 4th 687 held otherwise, stating that a legally viable claim can be alleged against an accounting firm that provides review services. The opinion of the court addresses a broad range of issues relating to auditor liability. Perhaps most important for accountants, the court rejected the auditors' argument that "a review is less searching than an audit, rendering [the plaintiffs'] reliance on any statement in a review unreasonable as a matter of law." The accountants cited language from the reports such as: "All information included in these financial statements is the representation of the management of World Interactive Network", and that the accountants expressed no "opinion regarding the financial statements taken as a whole." The court held that those arguments missed the mark, and that the accountants had stated that the financial statements complied with generally accepted accounting principles. "An accountant may not issue an intentionally false document of whatever type, whether styled as a review or audit. (Cal. Code Regs., Title

16, §16.58).” “Thus, even if reviews are less rigorous than audits, the relaxed standards were not a license to misrepresent, and [the accountant] was therefore still obliged to be truthful whatever the nature of its report. (*Billy*, supra, 3 Cal. 4th at p. 383; Cal. Code Regs., Title 16, §16.58.3 [accountant may not issue report on unaudited financial statements to client or others without complying with professional standards].) Therefore, the fact that some of [the accountant’s] reports were reviews, not audits, has no bearing on the reasonableness of [plaintiffs’] reliance on [the accountant’s] assertion that the reports complied with generally accepted accounting principles.”

The opinion also summarizes auditor duty arising from a claim of ordinary negligence (the duty being only to the auditor’s client); negligent misrepresentation (the duty expands to specifically intended beneficiaries of the report who are substantially likely to receive the misinformation); and intentional misrepresentation (the duty expands further to include anyone who the auditor should have reasonably foreseen would rely on the misrepresentation. In summary, without going into the extensive discussion provided by the court, for a claim of negligent misrepresentation, the representation must have been made with the intent to induce the plaintiff or a particular class of persons to which the plaintiff belongs, to act in reliance upon the representation in a specific transaction, or a specific type of transaction, that the auditor intended to influence. For a claim of intentional misrepresentation, the representation must have been made with the intent to defraud the plaintiff, or a particular class of persons to which the plaintiff belongs, whom the auditor intended or reasonably should have foreseen would rely upon the representation. The court’s opinion also discusses, clarifies, and perhaps expands the circumstances when a potential recipient/plaintiff of the report or information provided in the report becomes or is sufficiently known or should be sufficiently known to the auditor. For example, the court further holds that the auditor can be liable to plaintiffs who did not receive the auditor’s report, but to whom information about or in the report was communicated by other recipients of the report, through the “grapevine.”

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