CPA LIABILITY FOR COMPILATION ENGAGEMENTS IN WISCONSIN

Gary M. Young

From *Accounting Malpractice Law in Wisconsin* (November 1995)

 | (608) 233-6800 | FAX (608) 233-6806 | gary@younglaw.net | http://www.younglaw.net

I. WHAT IS A COMPILATION ENGAGEMENT?

A. **A First Approximation**: In a compilation engagement the CPA obtains financial information from the client, "compiles" financial statements from the information (i.e. puts the client's financial information into the *form* of a financial statement, such as a balance sheet), and attaches the compiled statements to a short report from the CPA which says in substance that the CPA provides no opinion or assurance regarding the *content* of the financial statements. This first approximation, though correct as far as it goes, is nonetheless seriously misleading, because it omits all the aspects of the engagement which might make the CPA liable to client or third party. These further aspects of the engagement are discussed in detail in Sections III through VII, below.

B. **Authoritative Definitions of "Compilation of a Financial Statement."**

1. *AICPA definition.* "*Compilation of financial statements*. Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements." AR § 100.04.

2. *Wisconsin Accounting Examining Board definition.* "'Compilation of a financial statement' means a presentation of information in the form of a financial statement that is the representation of any other person without the undertaking of the certified public accountant or public accountant to express any assurance on the statement." § Accy 1.302(1)(d).

C. **The standard AICPA compilation report** (AR § 100.17) consists primarily of a disclaimer of CPA responsibility for the assertions in the accompanying compiled financial statements:

> I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (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.

For standard compilation reports for prospective financial statements, see AT § 200.17-.19.

D. **Applicable AICPA Professional Standards.** AICPA Professional Standards provide for compilation of both historical financial information (for a past date and operating period now ended) and prospective financial information (for a future date and operating period not yet ended). In December 1978, effective July 1, 1979, the AICPA issued its first Statement on Standards for Accounting and Review Services (SSARS), which authoritatively defined and set forth professional standards for the compilation (accounting) and review of historical financial statements of nonpublic entities. Before SSARS, what we now call compilations were sometimes called "unaudited write-ups," as in several pre-SSARS court decisions discussed below. Professional standards for engagements to compile historical financial statements are found, among other places, in AR 100.09-.22, 100.39-.42, and .53. Compilation of prospective financial statements is addressed in AT 200.10-.26 and .62.

II. THE ANATOMY OF A COMPILATION REPORT.

It can seem puzzling how the CPA could possibly be liable to a client or a third party as a result of a compilation engagement. The puzzle arises from the compilation report, which seems to disclaim the CPA's responsibility for virtually everything. Therefore it is worth taking a more careful look at compilation reports.[1] The standard compilation report of AR § 100.17 and its common variants state explicitly, incorporate by reference or imply the following.

[1] See also Section VII, below, relating to CPA representations outside the compilation report.

A. **The CPA's Name and His or Her Identification as a Certified Public Accountant.**

1. The CPA's name and professional identity play a key role in the use of the compilation report -- it is the strongest affirmative CPA representation in the entire report. The client gets the CPA's name and professional identity without paying the CPA much (especially if the client omits all disclosures) and without much risk the CPA will discover errors or irregularities the client wants hidden.

2. The client can show the report, with the CPA's name, to lenders, trade creditors, and investors, who will infer (or who will at least testify they inferred): "If the CPA is willing to have her name professionally associated with the report and the client's financial statements, the statements must be worthy of *some* reliance. The CPA must have contributed something of value to the statements, after all, or else why did the CPA charge for the work? Of course the report contains a strong disclaimer, but the disclaimer cannot be so strong as to mean: 'Disregard these financial statements entirely.' If the CPA wanted the financial statements disregarded, why did the CPA associate her professional name with them at all?" These are good questions. It is not sufficient to answer -- at least courts generally hold it is not sufficient to answer -- that the CPA contributed only the form, not the content (information), or that the CPA is just the messenger, not the author of the message. But this leaves it an open question just *what* the CPA has contributed to the report and the financial statements that could make the CPA liable to anyone.

B. **The Client's Assertions**: The financial information in the accompanying historical financial statements, "information that is the representation of management (owners)," including "the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended."

C. **Client's Assumptions** underlying the client's assertion: None.

D. **Standards Against Which CPA Tests the Client's Assertion**: the closest the report gets to describing this is the phrase "form of financial statements." The

CPA must at least test the *form* of the client's assertion against the form required by GAAP or some other comprehensive basis of accounting, or some form prescribed by a contractual agreement or regulatory provision. But the process of putting client information in this form can raise questions about the adequacy or correctness of the information.

E. **Procedures the CPA Uses to Test the Client's Assertion:** Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants, found in AR § 100. As shown below, this reference to SSARS is the primary key in the report to the CPA's risk of liability both to client and to third parties. SSARS (and both pre-SSARS and post-SSARS court decisions) makes the CPA responsible for much more in a compilation engagement than the standard compilation report suggests.

F. **The CPA's Express Statements Regarding the Client's Assertions:**

1. *The CPA's express statements regarding the form in which the client's assertion is presented*: that the client's information is presented "in the form of financial statements." The standard report does not say what form this means, but SSARS makes it clear that, unless the report states otherwise, it means in the form required by GAAP. AR § 100.20.

2. *The CPA's statements regarding assurance*: "I (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."

3. *The CPA's disclosures regarding the assertion*: The standard report contains no disclosures. But SSARS requires the CPA to disclose the CPA's lack of independence, the use of a basis of accounting other than GAAP, the omission of disclosures required by GAAP, and (to the extent the CPA is aware of it) the failure of the financial statements to comply with specific applicable requirements of GAAP. These disclosures are discussed in detail in Sections V and VI, below.

4. *The CPA's qualifications, disclaimers, warnings, disavowals, cautionary statements, caveats and limitations on use and users.* Two disclaimers are in common use. First, the standard compilation report

states "I (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." Second, if management has elected to omit substantially all of the disclosures required by generally accepted accounting principles, the report should contain this disclaimer: "If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters."

G. **The CPA's "Implied Representations" Regarding the Reliability of the Client's Assertion.** These "implied representations" are the primary source of CPA liability to third parties. They are not really representations, but rather facts whose nonexistence the CPA is required to disclose in the report, so that the absence of such a disclosure implies the fact. The grounds for requiring such disclosure (or if disclosure is impossible, withdrawal from the engagement) are found in SSARS. They are discussed in detail in Sections V-VI, below.

III. LIABILITY TO THE CLIENT ARISING FROM COMPILATION ENGAGEMENTS: CPA LIABILITY FOR FRAUD, DEFALCATIONS, AND EMBEZZLEMENT BY CLIENT'S EMPLOYEES AND AGENTS.

A. **How Could the CPA Become Liable to the Client in a Compilation Engagement?** All the financial information in the compiled statements comes from the client; the CPA "merely" compiles it. The CPA "is not required to examine or review any evidence supporting the information furnished by the client." AT § 100.02(d). The compilation report contains only one representation regarding the client's financial statements: that they are in the form of financial statements. And in the compilation report the CPA disclaims any assurance or opinion regarding the financial statements. Assuming that the CPA in fact does put the client's information into the appropriate form of financial statements, it is unlikely that the CPA will be liable to the client for anything in the report or statements.[2] How else could the CPA possibly become liable to the client?

B. **Liability to the Client for Nondisclosure of Errors, Irregularities and Illegal Acts.** The CPA runs little risk of liability to the client as a result of the final product of the engagement, the report-with-compiled-statements. But in the *process* of preparing this product in accordance with SSARS the CPA might acquire information which, though it does not appear in the final product, should be disclosed to the client nonetheless. If the client suffers losses which such disclosure would have avoided, then the CPA may be liable for those losses. SSARS requires that the CPA reach an understanding with the client that "(a) the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts and (b) that *the accountant will inform* the appropriate level of management of any material errors *that come to his or her attention*, unless they are clearly inconsequential." AR § 100.08 (emphasis added). (Note that, for whatever reason, the standards for compilation of prospective financial statements in AT § 200 do not expressly include this requirement.) The AICPA's illustrative compilation engagement letter similarly provides that "[o]ur engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However *we will inform* the appropriate level of management of any material errors that come to our attention and any irregularities or illegal acts that come to our attention, unless they are clearly inconsequential." AR § 100.53 (emphasis added). (The same language appears in the illustrative review engagement letter, AR § 100.54.)

C. **Liability to the Client for Negligent Failure to Discover Errors, Irregularities and Illegal Acts.** The CPA may be liable for nondisclosure not only when errors, irregularities, or illegal acts "come to the CPA's attention," but also when the CPA *negligently fails to discover* errors, irregularities, or illegal acts. At first glance it might seem that in a compilation engagement the CPA has little opportunity to discover such things. But SSARS makes it clear that there is much more to a compilation than the client giving the CPA some

---

[2] A theoretical possibility not considered further here is that a client sue a CPA who includes certain unwanted disclosures in the report, or refuses to issue a report at all. No reported compilation malpractice case has addressed such a claim, but compare *Hydroculture, Inc. v. Coopers & Lybrand*, 174 Ariz. 277, 848 P.2d 856 (Ariz.Ct.App. 1992), an audit case in which Hydroculture sued Coopers for refusing to issue an unqualified opinion unless Hydroculture reversed the recognition of certain income that Hydroculture had already recorded.

words and numbers on pieces of paper, and the CPA then arranging those words and numbers to look like financial statements. To compile financial statements, the accountant must first acquire a sufficient understanding of the client's industry, business and accounting records. AR § 100.10-.11. In particular, the accountant must have "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 to be presented, and the form and content of the financial statements. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel." AR § 100.11. If the CPA negligently fails to acquire this knowledge, and as a result fails to notice defects in the client's internal financial controls that would permit employee embezzlement, or fails to notice evidence of actual defalcations, then the client might have a claim against the CPA for negligent compilation. No reported cases have adopted this theory of liability for compilations, however, and the arguably outdated 1940 decision in *O'Neill*, below, might be read to reject it.

D. **Liability for Failure to Detect And/or Report Embezzlement by the Client's Employee or Other Agent.** In *Max Rothenberg*, below, the CPA had reason to suspect embezzlement, but told the client nothing; in a 1971 decision that shocked the profession, and helped lead to the drafting of SSARS, the court held the CPA liable for failure to warn the client. In *McCaslin v. Wood*, below, the CPA apparently had no reason to suspect embezzlement and so was not liable.

1. *1136 Tenants' Corporation v. Max Rothenberg & Company*, 36 A.D.2d 804, 319 N.Y.S.2d 1007 (N.Y. App. Div. 1971). The plaintiff corporation owned a cooperative apartment house. The plaintiff engaged defendant CPA to provides accounting services. One of the CPA's workpapers, entitled "Missing Invoices 1/1/63-12/31/63," showed invoices totalling over $44,000 missing from the records of the agent which managed the apartment, who, it turned out, had embezzled over $200,000 from the plaintiff. The CPA did not disclose the missing invoices to the plaintiff. The CPA defended on the ground it had been retained merely to provide a "write-up." The court rejected this defense: "[E]ven if defendant were hired to perform only 'write-up' services, it is clear, beyond dispute, that it did become aware that

material invoices purportedly paid by [the agent] were missing, and, accordingly, had a duty to at least inform plaintiff of this. But even this it failed to do. Defendant was not free to consider these and other suspicious circumstances as being of no significance and prepare its financial reports as if same did not exist." The dissenting judge wrote that "to require one in the relationship of defendants to take action would expand the obligation from bookkeeping to criminal detection."

2. *McCaslin v. Wood*, 1993 WL 8015 (Tenn.App. 1993). McCaslin's business Southern Lighting retained the defendant CPAs to provide accounting services.

> In the accounting profession, the services provided by defendants are generally described as monthly "write-up" work. This includes reconciling the monthly bank statement balance for Southern Lighting's operating account with company records to show the accurate balance, preparing and filing tax returns and keeping the financial records necessary to determine the profitability of the business.[3]

The defendants never compared, and were never asked to compare, the cancelled checks with the bank statement. Southern Lighting employee McFarland was responsible for accounts receivable and payable. Between 1982 and 1988 she embezzled $250,000 from the company.

> [F]rom time to time she would forge plaintiff's signature on Southern Lighting checks, which were made payable either to herself or to her husband. She would in turn complete the corresponding check stub, showing the name of a legitimate creditor. Each month when the bank statement with the cancelled checks was received at Southern Lighting, Ms. McFarland would remove the cancelled checks that bore the forged signature and destroy them.

---

[3] It is not entirely clear that these services amounted to a "compilation" within the meaning of SSARS. The decision never refers to any AICPA Professional Standards.

Southern Lighting sued the CPAs for negligence and breach of contract for failure to discover the embezzlement. The jury returned a verdict for the CPAs. The appellate court decision, affirming judgment for the CPAs, does not address the question of why the CPAs were not responsible for discovering the embezzlement and warning the plaintiff.

E. **Liability for Failure to Detect And/or Report the Risk of Embezzlement from Defects in the Client's Internal Financial Controls.** Arguably SSARS requires the CPA to disclose internal control defects, if known, to the client: "...[T]he accountant should consider whether it will be necessary to perform other accounting services, such as assistance in adjusting the books of account or consultation on accounting matters, when he compiles financial statements." AR § 100.11. Failure to provide such other services, or at least to offer them, can give rise to liability if such services would have prevented client losses. (On the other hand, agreeing to provide such services creates other risks. See Section IX, below, on agreed-upon procedures.) Of the two Pennsylvania decisions discussed below, *O'Neill*, pre-SSARS, seems to reject this approach, but *Wooler,* post-SSARS (though not citing it), is consistent with this approach.

1. *O'Neill v. Atlas Automobile Finance Corporation*, 11 A.2d 782 (Pa. Super. Ct. 1940). Atlas' bookkeeper embezzled funds from payments to Atlas by automobile lessees. The bookkeeper kept a card for each lessee showing payments; the bookkeeper transferred from the cards to the general ledger the total of all such payments (excluding the amount embezzled) and the total accounts receivable (including the amount embezzled). Each month the bookkeeper included the amount she had embezzled on a tape summing accounts receivable from all lessee cards. Each month the CPA compared the bookkeeper's tape with the accounts receivable the bookkeeper entered in the general ledger, and found they matched. When the CPA sued Atlas to recover unpaid fees, Atlas counterclaimed with a claim for negligence in failing to discover the embezzlement. The court held that the CPA had engaged to perform only "a limited examination, and a financial review of defendant's books, without verification," rather than "a complete and detailed audit and the furnishing of certified reports." The CPA testified: "Monthly we would visit the office of Atlas, make a revision

of the transactions, not verifying the data considered, we would instruct the bookkeeper in the handling of technical transactions, we would prepare from the trial balance submitted by the bookkeeper a statement of the condition and a profit and loss statement." The court affirmed the verdict for the CPA, reasoning that discovery of the embezzlement was beyond the scope of the engagement.

2. *Robert Wooler Company v. Fidelity Bank*, 479 A.2d 1027 (Pa. Super. Ct. 1984). Touche agreed to perform "unaudited accounting services" to Wooler. "In an unaudited engagement, the accountant does not warrant and is not responsible for the ultimate accuracy of the report if the figures supplied by the client are erroneous." Wooler's bookkeeper was single-handedly "responsible to post accounts receivable in a sales journal, to handle incoming receivables, and to record daily receipts of moneys received in settlement of accounts receivable," which the court called "suspicious circumstances which would have raised a 'red flag' for a reasonably skilled and knowledgeable account." In the course of the engagement, a Touche employee observed the bookkeeper perform all these functions. The bookkeeper later diverted 94 accounts receivable checks into her own bank account. The court held that "Touche Ross' agreement to perform unaudited services was not a shield from liability if it failed to warn its client of known deficiencies in the client's internal operating procedures which enhanced opportunities for employee defalcations." Query: Is the result in this case consistent with that in *O'Neill*, *supra*?

IV. LIABILITY TO THIRD PARTIES ARISING FROM COMPILATION ENGAGEMENTS: INTRODUCTION TO SECTIONS V-VIII.

A. **How Could the CPA Become Liable to a Third Party in a Compilation Engagement?** "To prepare a compilation report, the accountant takes the information provided by the client, presents it under general accounting principles, *but assumes no responsibility for its accuracy or completeness*." *Advance Concrete Form v. Accuform*, 158 Wis. 2d 334, 340 n. 2, 462 N.W.2d 271 (Ct. App. 1990) (emphasis added).[4] This statement, from a Wisconsin court, suggests this question: How could a CPA possibly be responsible for the detrimental reliance of a third party on the accompanying financial statements, when those financial statements contain only the representations of the client, not those of the CPA, and when the CPA expressly disclaims any opinion or assurance regarding those statements? (In other words, the compilation report is not an attestation.[5]) To be sure, the compilation report does contain one (and only one) explicit CPA representation regarding the accompanying financial statements: that they have the form of financial statements. So if the accompanying statements *do not* have the form of financial statements, then the CPA's report contains a false representation, and that might just conceivably be the basis for a third-party claim (though no reported decision anywhere addresses such a claim). Apart from that one

---

[4] This is the only reported appellate decision in Wisconsin that says anything about compilation engagements. This case did not raise the question of the CPA's liability to third parties for a compilation report. As shown below, courts in other states have found CPA compilation liability under certain circumstances. It is likely that when the question arises in Wisconsin, Wisconsin courts will do the same.

[5] The AICPA takes the position that compilation engagements under SSARS are not attest engagements: "Examples of professional services typically provided by practitioners that would not be considered attest engagements include... engagements in which the practitioner compiles financial statements, because he is not required to examine or review any evidence supporting the information furnished by the client and does not express any conclusion on its reliability." AT § 100.02(d). But the AICPA treats the compilation of *prospective* financial statements as an attest engagement, which entails that the CPA's report provides assurance on *something*. AT § 200.10-.26. This is puzzling: The form of the compilation report on prospective financial statements negates all assurance, like the report for ordinary compilations (compare AT § 200.17 with AR § 100.17), although AT § 200.68 appears to set forth more extensive procedures for the former report. The Wisconsin Accounting Examining Board usefully defines "attest engagement" to include compilation engagements in which the CPA "expects, or reasonably might expect, that a third party will use the compilation and the [CPA] does not disclose a lack of independence." § Accy 1.302(1)(a).

Is a compilation report an attestation? This is primarily an issue of semantics. One can argue that a compilation report is not an attestation, because it contains no explicit assurance regarding another's assertion. One can argue that a compilation report *is* (in some important sense) an attestation, because by issuing it the CPA implies some minimal assurance regarding another's assertion. Say what you want; just be sure you don't think that, because a compilation report is not an attestation, it carries no risk of CPA liability for misrepresentation or nondisclosure.

unlikely exception, however, how could the CPA possibly be liable to any third party?

B. In a compilation engagement, a CPA can become liable to a third party in four ways, covered in Sections V-VIII below.

1. In certain circumstances, to comply with SSARS, the CPA must add certain specific disclosures to the standard compilation report. Failure to add these specific disclosures can expose the CPA to liability to third parties who rely on the report and accompanying financial statements to their detriment, but who would not have relied if the CPA had included the required disclosures. This is discussed in Section V, below.

2. In certain other circumstances, to comply with SSARS, the CPA must withdraw entirely from the engagement without issuing any report. Failure to withdraw can expose the CPA to liability to third parties who rely on the report and accompanying financial statements to their detriment. This is discussed in Section VI, below.

3. If the CPA makes specific representations to a third party, beyond those contained in the standard compilation report (see Section II, above) or otherwise required by SSARS (see Section V), those representations can make the CPA vulnerable to third-party claims of fraud and misrepresentation. This is discussed in Section VII, below.

4. If the CPA fails to use the standard language in the compilation report (see Section II, above), the report will not provide adequate protection against third-party claims. But in cases that do not fall under the three preceding categories, the standard language is an effective defense to third-party claims. See Section VIII, below.

C. **Implied Representations, Disclaimers and Disclosures in Compilation Guidelines.** CPAs should consider incorporating in their compilation guidelines provisions that are sufficient to ensure that, for each of the implied representations discussed below in Sections V and VI, the CPA has determined that either (a) the representation is true, or (b) the representation is false, but is disclaimable, and has been disclaimed by use of the appropriate disclosure in the report. If any implied representation fails both (a) and (b), the CPA should take appropriate steps to terminate the engagement without issuing, or having his name associated with, any compiled statements or compilation report.

D. In general the greatest risk to CPAs from compilation engagements arises from *nondisclosure*, either nondisclosure to the client outside the report, or nondisclosure to third parties in the report. Courts and litigants sometimes refer to a nondisclosure claim as a sort of misrepresentation claim.[6] There is nothing wrong with this way of speaking unless it is taken to mean that in every nondisclosure claim, the plaintiff must allege and prove actual reliance on *the defendant CPA's failure to make the disclosure*. At least in the case of third-party compilation claims, that is not true. Such claims *do not require proof of reliance on any CPA representation or omission*. To be sure, the third party's reliance on *the accompanying financial statements* is part of the story, but that is not because those financial statements are representations of the CPA (they are not; they are the client's). It is because the CPA failed to take steps that foreseeably would have prevented the third party from relying on those representations. And though this outline refers to "implied representations" of the CPA's report, that is just a shorthand reference to the circumstances in which SSARS requires the CPA to make a particular disclosure or withdraw from the engagement. For example, to say that the standard report *implies* that GAAP is the basis of the financial statements means only that if GAAP is *not* the basis, SSARS requires the CPA to disclose the basis. There is nothing in the report on which the third party need rely, not even the perceived absence of some disclosure.[7]

---

[6] "For allegations of intentional misrepresentation through nondisclosure, the general rule is that 'silence, a failure to disclose a fact, is not an intentional misrepresentation unless the seller has a duty to disclose. If there is a duty to disclose a fact, failure to disclose that fact is treated in the law as equivalent to a representation of the nonexistence of the fact.' [Citation omitted.] This general rule also applies to negligent misrepresentation and strict responsibility." *Grube v. Daun*, 173 Wis. 2d 30, 56, 496 N.W.2d 106 (Ct. App. 1992).

[7] Of course a sophisticated user might know what the omission of CPA disclosures from the report means, and might actually rely on those omissions. The sophisticated user would then be in a position to bring a misrepresentation claim, alleging detrimental reliance on the absence of disclosures, an absence which implies that the reporting CPA was (say) not aware of any departures from GAAP, when in fact the reporting CPA knew perfectly well that land was stated at an inflated appraised value rather than at cost.

E. **Is the Privity Defense Available in Wisconsin Against Third-party Compilation Malpractice Claims?** In Wisconsin lack of privity does not bar third-party audit claims against CPAs. But one might argue that, unlike audits, compilations are obviously *not* designed for use, or in fact used, by third parties. Therefore lack of privity should bar third-party compilation claims. This argument is unlikely to succeed in Wisconsin. The argument's empirical premise is wrong: In fact third parties do ask for and even rely upon compilation reports and their accompanying financial statements, when, as with many small businesses, that is all they can get. Moreover, Wisconsin courts do not recognize a privity defense for any other third-party professional liability claim (with the exception of most claims against lawyers, which is a different story), and it is unlikely the court will carve out a narrow exception and permit the privity defense just for compilation engagements. But there is a functional equivalent to the privity argument which has a greater chance of success: That to impose third-party liability on a CPA for a mere compilation report is improper on public policy grounds. CPA's counsel should remember to raise this defense at every opportunity through motions after verdict. A full account of the privity defense and the use of public policy factors to limit liability in Wisconsin is beyond the scope of this outline.

V. LIABILITY FOR FAILURE TO DISCLAIM SPECIFIC REPRESENTATIONS OTHERWISE IMPLIED IN THE COMPILATION REPORT.

Under SSARS, the CPA who signs the standard compilation report of AR § 100.17 makes at least the following implied representations. The standard report will not effectively disclaim these implied representations, but the CPA may *specifically* disclaim them by making the disclosures indicated. A CPA who fails to make these disclosures may become liable to a third party who relies on the financial statements to his detriment, but would not have relied if the report had contained the disclosures.

A. That the Accompanying Financial Statements Are Compiled in Conformity with GAAP.

1. The standard compilation report of AR § 100.17 does not refer to GAAP. But the CPA who signs the standard compilation report thereby represents that the accompanying financial statements are compiled in conformity with GAAP, i.e. that GAAP is the basis of accounting. AR § 100.20. To be consistent with the purpose of a compilation engagement, this must be taken to refer only to the *form* of the compiled statements. It cannot mean that the accompanying financial statements comply with *all* applicable generally accepted accounting principles, or the compilation would become an audit.

2. If this representation is false, the CPA must disclaim it by disclosing in the compilation report the basis of accounting other than GAAP. AR § 100.20.

B. **That the Accompanying Financial Statements Do Not Omit Substantially All Disclosures Required by GAAP.**

1. The CPA who signs the standard compilation report of AR § 100.17 thereby represents that the accompanying financial statements do not omit substantially all disclosures required by GAAP. AR § 100.19.

2. If this representation is false, the CPA must disclaim this representation by disclosing the omission in the compilation report. To disclose the omission, the CPA adds this warning to the compilation report:

> Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

AR § 100.19-.21. But see below, Section VI C.

3. A balance sheet attached to a compilation report with this disclosure satisfied the requirement of former § 180.43(1), Stats. [now see § 180.1620(1), Stats.], that each corporation "shall cause a true statement of its assets and liabilities as of the close of each fiscal year and of the

results of its operations and of changes in surplus for each fiscal year, all in reasonable detail, to be made." *Advance Concrete Form v. Accuform*, 158 Wis. 2d 334, 338-342, 462 N.W.2d 271 (Ct. App. 1990).

C. **That the CPA Is Unaware of Any Respects in Which the Accompanying Financial Statements Depart from Generally Accepted Accounting Principles.**

1. The CPA who signs the standard compilation report of AR § 100.17 thereby implies that the CPA is unaware of any respects in which the accompanying financial statements depart from GAAP.

2. If this representation is false, the CPA must disclaim it by disclosing all known departures from GAAP in the compilation report. The standard disclosure of departures from GAAP consists of a separate paragraph describing each departure preceded by this sentence at the end of paragraph two of the basic report: "However, I (we) did become aware of a departure from generally accepted accounting principles that is (are) described in the following paragraph(s).") AR § 100.39-.41. Also see Section VI D, below.

3. The description of each departure from GAAP must disclose the effects of the departure or state that the effects have not been determined.

4. Examples of departures from GAAP (AR § 100.40): (a) stating land at appraised value not cost; (b) omission of statement of changes in financial position; (c) stating inventory cost at cost of material and labor instead of cost of material, labor and overhead; (d) changing accounting method without reasonable justification.

D. **That the CPA Is Independent with Respect to the Client.**

1. By signing the standard compilation report of AR § 100.17, the CPA represents that he or she is independent with respect to the client. AR § 100.22; see also AT § 200.21 (prospective financial statements).

2. If this representation is false, the CPA must disclaim it by disclosing lack of independence. AR § 100.22.; see also AT § 200.21 (prospective financial statements). Compilation engagements are unusual in this regard; all (other) attest engagements require independence, AT § 100.22-.24.

3. Lack of independence, if associated with greater knowledge of and access to the client's financial documents and personnel, can significantly increase the risk of CPA liability in a compilation engagement, because it gives the CPA more to disclose, if disclosure is required. See *Blakely v. Lisac*, *infra*.

4. *CPA liability for strict responsibility nondisclosure.* Lack of independence, if it results from the CPA's financial interest in the client, might provide a basis for a third party claim of strict responsibility nondisclosure, a claim which is otherwise virtually never available against a CPA in an attest engagement.

    a. A strict responsibility misrepresentation or nondisclosure claim requires that the CPA stood to make a financial gain from the transaction in which the representation played a role, and (roughly speaking) that the CPA was in a position to have knowledge of the pertinent facts and his statements fairly implied that he had that knowledge. *Grube v. Daun*, 173 Wis. 2d 30, 55-56, 496 N.W.2d 106 (Ct. App. 1992).

    b. Ordinarily a CPA need not worry about such claims arising from an attest engagement. All attest engagements require independence (AT § 100.22-.24) and independence is inconsistent with the economic interest which is an element of strict responsibility misrepresentation (see, e.g., § Accy 1.101(1)(a)). Thus in *Grove Holding Corporation v. First Wisconsin National Bank of Sheboygan*, 803 F. Supp. 1486, 1504 (E.D. Wis. 1992), the court granted Grant Thornton's motion to dismiss a strict liability misrepresentation claim because the plaintiff failed to allege that Grant stood to make a financial gain from the transactions in which Grant's audit reports and forecasts were allegedly used.

c. But AR § 100.22 permits CPAs to compile financial statements even when the CPA stands to gain financially from a transaction which others will enter into only if the compiled financial statements give sufficient comfort. This sort of engagement therefore creates a risk of liability for strict responsibility misrepresentation. Beware such engagements if there is any chance of third-party reliance on the result.

VI. LIABILITY FOR FAILURE TO WITHDRAW FROM THE COMPILATION ENGAGEMENT: NONDISCLAIMABLE REPRESENTATIONS IN THE COMPILATION REPORT.

Under SSARS, the CPA who signs a compilation report makes at least the following implied representations, to which no language will provide a disclaimer sufficient to give the CPA an effective defense. A CPA who issues a compilation report when one or more of these representations is false may be liable to a third party who relies on the report and financial statements to his detriment, but who would not have been damaged if the report had not existed for him to rely upon. (Query: Must the third party's damages be caused by the facts that make the implied representation false?)

A. That the CPA Has No Reason to Believe That the Information Supplied by the Client Is Incorrect, Incomplete or Otherwise Unsatisfactory.

1. To compile financial statements, the accountant must have a sufficient understanding of the client's industry, business and accounting records. AR § 100.10-.11. In particular, the accountant must have "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 to be presented, and the form and content of the financial statements. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel." AR § 100.11.

2. As a result of this understanding of the client's business and records, or of prior engagements, or the financial statements themselves, the accountant might have reason to believe that information supplied by the client is incorrect, incomplete or otherwise unsatisfactory for the

purpose of compiling the financial statements. If so, the CPA must request additional or revised information. If the client does not provide additional or revised information, the CPA must withdraw from the engagement. AR § 100.12; see also AT § 200.14, relating to compilation of prospective financial statements, and ET § 102.02.

3. The CPA may not effectively disclaim this implied representation. *Ashland Oil, Inc. v. Arnett*, 875 F.2d 1271 (7th Cir. 1989). Arnett Oil's CPA Richards compiled a "special accrual" statement "which inflated Arnett Oil's accounts receivable by $400,000 and its inventory by $75,000." The statement was mailed to Marathon, which then extended credit to Arnett. Richards argued "that *the accountant's disclaimer* which accompanied the financial statement sent to Marathon makes any reliance on the accuracy of the statement unreasonable as a matter of law, or in any case that there was no evidence that reliance on such a statement was reasonable. Mr. Richards points out that the 'special accrual statement' was *merely an unverified compilation* of figures provided by Arnett Oil, not an audit, and did not carry an accountant's assurance of accuracy. ...[But] the jury reasonably found... that Mr. Richards knew that statement was fraudulent and that it would be relied on as accurate. *A disclaimer cannot relieve an accountant from the duty to refrain from knowingly being party to fraud.*"[8] (Emphasis added.) But, somewhat puzzlingly, the court declined to hold as a matter of law that Marathon's reliance on the compilation report was reasonable, and remanded the case for trial on that issue.

4. See also the pre-SSARS decision in *Blakely v. Lisac*, 357 F.Supp. 255 (S. Oregon 1972). This decision concerned an "unaudited write-up," perhaps analogous to a compilation under SSARS. Owens, the accountant for Cryo-Freeze since 1961, was also corporate secretary and member of the board. He prepared financial statements for

[8] It is perhaps an overstatement to say that the CPA has no effective means to disclaim this implied representation. We can imagine a compilation report making this disclosure: "The information supplied by Client in the accompanying financial statements is incorrect, incomplete and otherwise unsatisfactory for the purpose of this compilation. Indeed, the accompanying financial statements are fraudulent." But as a practical matter, such an outrageous disclaimer completely destroys the use of the report with third parties, which is of course the very reason to insert the disclaimer, to protect the CPA from third-party tort claims. The client will predictably insist the disclaimer be deleted or else discharge the CPA (without pay).

inclusion in an offering prospectus. Stockholders sued, alleging they purchased stock in reliance on the financial statements. The court stated:

> Owens contends that as an accountant performing an unaudited write-up, he is not liable for the errors in the Cryo-Freeze prospectus. This argument misses the point. Owens is not being charged with the information of which he was unaware or which would have been disclosed by a full audit. He is being charged with information which he knew or should have known. Owens was not an outside accountant called in to perform a single write-up. He had been the company's accountant since 1961 and was familiar with its equipment and with the action filed against Designs Unlimited. *Even when performing an unaudited write-up, an accountant is under a duty to undertake at least a minimal investigation into the figures supplied to him. He is not free to disregard suspicious circumstances.* ...Owens' testimony that he merely accepted Lisac's (the corporate president's) oral statement that the equipment was valuable does not satisfy the requirement of due diligence.

(Emphasis added.)

B. **That the Accompanying Financial Statements Are Free from Obvious Material Errors.**

1. "Before issuing his report, the accountant should read the compiled financial statements and consider whether such financial statements appear to be appropriate in form and free from obvious material errors. In this context, the term *error* refers to mistakes in the compilation of financial statements, including arithmetical and clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure." AR § 100.13. The obvious implication is that the accountant should correct any such mistakes.

2. The CPA may not effectively disclaim this implied representation. *Coleco Indus. Inc. v. Berman*, 423 F.Supp. 275, 285- 310 esp. n. 60 (E.D. Pa. 1976), aff'd in part, 567 F.2d 569 (3rd Cir. 1977). Zelnick,

Royal's independent accountant, agreed to prepare an "unaudited" financial statement for the quarter ending April 1973. Coleco, which purchased Royal in partial reliance on the unaudited statements, sued Zelnick and others for $1.5 million in losses resulting from the purchase. The unaudited balance sheet overstated inventory by $50,000, because Zelnick made what the court regarded as "obvious and mechanical errors," including a failure to "multiply correctly" and a failure "to make overhead deductions from inventory that can be simply computed." The court rejected Zelnick's contention that "the unaudited status of the April 1973 statement" should relieve it from liability for its computational errors. The court held that "*even the most restricted undertaking would impose on Zelnick a duty" to avoid such errors*. The court limited damages to the amount of the errors.

C. **That the Omission of Substantially All Disclosures Is Not, to the CPA's Knowledge, Undertaken with the Intention of Misleading Those Who Might Reasonably Be Expected to Use the Financial Statements.**

1. As noted above, Section V B, the CPA may compile financial statements omitting substantially all disclosures, if (and only if) the CPA provides a warning in the compilation report that the client has chosen to omit disclosures. But by providing that warning and then signing the compilation report the CPA then implies that the omission of disclosures is not, to the CPA's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. AR § 100.19-.21.

2. Does this impose an affirmative duty on the CPA to inquire about the client's reason for omitting disclosures?

   a. What if the CPA has no reason to think the financial statements are misleading without disclosures: Does the CPA nonetheless have an obligation to ask the client why it wants to omit disclosures? No court has addressed this question, but the reasonable answer is that the CPA has no such obligation.

   b. What if the CPA suspects or even believes that the statements are misleading because of the omission of disclosures? In this case the CPA is probably at risk if she does not ask the client why it wants to omit disclosures.

c. If the CPA does ask the client why it wants to omit disclosures, what answers permit the CPA to sign the report? Is it always a sufficient answer that the client intends the statements solely for internal management use? If the client says this, should the CPA put this limitation in the report: distribution and use of this report and the accompanying financial statements are limited solely to management? If the client has no plausible answer, the CPA should probably advise the client to add the disclosures, and if the client refuses, the CPA should withdraw from the engagement. AR § 100.12.

3. It is difficult to see how the CPA could effectively disclaim the implied representation that the omission of disclosures is not, to the CPA's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. Under SSARS, it is not sufficient simply to warn that disclosures are omitted and to disclaim any opinion or assurance. The standards do not provide any other language for this purpose. No reported decisions address this question. What would be required is a specific disclosure of this form: "Management has omitted the required disclosures in order to mislead persons who use the accompanying financial statements."

D. **That the CPA Did Not Become Aware of Any Respects in Which the Accompanying Financial Statements Depart from GAAP, Other than the Respects Disclosed in the Compilation Report.**

1. As noted above, Section V C, the CPA may compile financial statements even if the CPA is aware that the statements do not comply with generally accepted accounting principles. But the CPA must disclose all such known departures from GAAP in the compilation report. The CPA who signs the compilation report thereby represents that the CPA did not become aware of any respects in which the accompanying financial statements depart from GAAP other than those respects disclosed in the compilation report. AR § 100.39-.41.

2. The CPA cannot effectively disclaim this implied representation. The standards do not provide any disclosure for this purpose. The disclosure would have to take this form: "We know that the accompanying financial statements contain other departures from GAAP, but we will not tell you what they are. These financial statements are not for the use of anyone who does not know what those departures are."

VII. CPA LIABILITY FOR REPRESENTATIONS OUTSIDE THE COMPILATION REPORT.

Sometimes CPAs make representations to third parties outside the compilation report -- in conversation, in separate letters or memos, or even (as the *Bonhiver* case, below, shows) in workpapers -- regarding a compilation client's financial position. If those representations are false, third parties who rely on them to their detriment may have misrepresentation claims against the CPA. CPAs should not make such representations (even if true, and even with client consent) without good reason.

A. **Oral Representations by CPA to Third Party.** *Ashland Oil, Inc. v. Arnett*, 875 F.2d 1271 (7th Cir. 1989). (See also Sections VI A 3, above, and VII H 2, below.) Arnett Oil's CPA Richards compiled a "special accrual" statement "which inflated Arnett Oil's accounts receivable by $400,000 and its inventory by $75,000." The statement was mailed to Ashland and Bell Fuels. Ashland and Bell Fuel employees testified "that they *contacted Mr. Richards directly* to confirm the accuracy of the figures in the statement" (emphasis added). Ashland and Bell then extended credit to Arnett. Richards argued "that the accountant's disclaimer which accompanied the financial statement sent to Marathon makes any reliance on the accuracy of the statement unreasonable as a matter of law, or in any case that there was no evidence that reliance on such a statement was reasonable." The jury found in favor of Ashland and Bell against Richards, and the trial court entered judgment in their favor. This judgment was not appealed. Rationale: The CPA made direct oral representations to the third parties, which were not subject to the compilation report and its disclaimers.

B. **Representations in CPA Workpapers and Oral Representations by CPA to Third Party.** *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976). This fascinating case arose from an accounting engagement even more rudimentary than a compilation. Bonhiver, receiver for the insolvent American Allied Insurance Company, sued CPA Graff for negligence. In 1964, at American Allied's request, Graff had gone to their offices to help "get their books up to date." (This was not the first time Graff's firm, Schwartz, Frumm, had provided services to the owners of American Allied, the Kitzers. In 1963, just the year before, Schwartz, Frumm had advised the Kitzers that American Allied Mutual Insurance, which the Kitzers wanted to buy, was impaired. The Kitzers nonetheless purchased it, in itself a red flag, and transferred its assets and liabilities to the new American Allied Insurance, which, one might suspect, was therefore also impaired.) When Graff arrived at the American Allied offices in 1964, he "made various entries in the books and records of American Allied and prepared workpapers in the course of his work." While Graff was there, agents of the insurance commissioner arrived to examine American Allied's books. Graff greeted them with open arms.

> Those examiners worked in the same room with Graff, examined his workpapers, and relied upon the entries he had made in the books, a standard practice. Graff at times personally furnished information to the examiners, and testified that he considered his work to be the "starting point" for the examiners. By his examiners' reliance upon Graff's entries, the commissioner was led to believe that American Allied was solvent, when in fact the company was insolvent.

The company was insolvent primarily because the Kitzers were in the process of embezzling over $2 million, by means of transactions between it and other companies the Kitzers controlled. Bonhiver alleged, and the trial court found, that had Graff examined the books of the other companies, he would have discovered the fraud, and that his failure to do so was negligence. Graff argued he could not be liable because he "did not produce a complete, certified set of financial statements, but only a set of unaudited workpapers which were themselves incomplete." The court disagreed:

> The fact that no previous accounting malpractice case deals with liability for erroneous workpapers or adjusting entries does not unduly concern us, for in the normal case no representations are made by use of such work product; rather, the accountants prepare complete financial statements from their workpapers and distribute the completed statements. The workpapers remain the property of the

accounting firm and not of the client. In this case, however, the defendants personally displayed their workpapers to the state examiners and knew that the examiners were relying upon them.

VIII. **WHEN THE STANDARD DISCLAIMER IS AN EFFECTIVE DEFENSE TO THIRD-PARTY CLAIMS.**

A. Section V, above, sets forth the circumstances in which the CPA should disclose facts of which the CPA is or should be aware, given the scope of a compilation engagement as described in SSARS. Section VI sets forth the circumstances in which the CPA should resign from the engagement without issuing an opinion. In these circumstances, a CPA who fails to make the required disclosures or withdraw may be liable to third parties who rely detrimentally on the accompanying financial statements. Section VII explains why CPAs should refrain from making representations to third parties beyond those contained in the standard report or required under the circumstances described in Section V. In these circumstances, covered by Sections V-VII, the standard disclaimer is not an effective defense. But in all other circumstances, the standard AICPA disclaimers are generally effective, as this Section explains.

B. The standard disclaimers are effective because they rebut the allegation that the CPA's report somehow made the plaintiff's reliance on the accompanying financial statements reasonable or justifiable. Courts addressing the issue have generally applied a per se rule that the presence of an appropriate disclaimer in the report makes reliance on the accompanying financial statements unjustified or unreasonable. (This overstates the point a bit, for surely *the CPA's* disclaimers would not bar a claim by the third party plaintiff against *the client* for damages resulting from reliance on the client's financial statements.) To protect the third-party plaintiff, however, courts generally will not apply this rule before the summary judgment stage of proceedings.

C. Thus in the *Seedkem* and *Cliff House* decisions discussed below, the courts denied motions to dismiss for failure to state a claim, so that the plaintiff would have a chance to produce evidence that the engagement included agreed-upon procedures beyond a mere compilation, or evidence that the CPA made representations beyond those in the compilation report. (On CPA representations outside the report, see Section VII, above. On agreed-upon procedures, see Section IX, below.) A court might also deny such a motion so that the plaintiff has an opportunity to produce evidence of CPA negligent or intentional nondisclosure or failure to withdraw, on one of the grounds set forth in Sections V and VI, above. Some courts are not so cautious or solicitous of plaintiffs: In the *Sparkmon* decision, discussed below, the court granted judgment on the pleadings because the disclaimers made reliance unreasonable as a matter of law.

D. At the summary judgment stage, the CPA gains the advantage. In the *Evans*, *Ris* and *High Tech* decisions, discussed below, courts granted summary judgment to defendant CPAs on the ground that disclaimers made reasonable reliance impossible. In *MacNerland*, the trial court granted summary judgment for the same reason. The appellate court reversed only as to the claim that the defendant CPA had an engagement to perform agreed-upon procedures on certain accounts; that claim alone was remanded for trial.

E. **Pre-SSARS Decisions.**

1. *Seedkem, Inc. v. Safranek*, 466 F. Supp. 340 (D. Neb. 1979). Safranek prepared financial statements for Agri-Products. He marked the statements "unaudited" and attached to them "an express disclaimer of opinion" (not quoted by the court). Seedkem alleged it extended credit to Agri-Products in reliance on Safranek's financial statements. Safranek moved to dismiss for failure to state a claim. The court denied the motion, stating:

> While it seems doubtful that the plaintiff will be able to recover under the extreme circumstances presented herein, the Court believes that it would be premature to dismiss the complaint at this early stage of the litigation. ...The fact that the financial statements were expressly marked "unaudited" and contained an express disclaimer of opinion is not necessarily dispositive at this time. ...Defendant accurately points out to the Court that there are no reported cases where an accountant's liability was founded on the circumstances presented at this point in this litigation.... However, the Court believes that it would be wiser to defer a determination of the issue presented herein until further discovery proceedings can be undertaken in order to ascertain whether any express representations were actually

> made between the parties or any understandings existed between those involved.

In a footnote, the court suggested that the defendant should move for summary judgment at the close of discovery. The court in effect ruled that the disclaimer was a sufficient defense to a claim based solely on the financial statements, but that the defendant might have agreed to provide further services (see Section IX, below, on Agreed Upon Procedures) or made representations outside the financial statements (see Section VII, above), either of which might give rise to liability. If discovery showed no further agreement or representation, summary judgment for defendant would be appropriate.

2. *MacNerland v. Barnes*, 129 Ga.App. 367, 199 S.E.2d 564 (Ga. Ct. App. 1973). Barnes prepared a financial statement with this disclaimer: "Disclaimer of opinion. We are not independent with respect to Airway's Rent-A-Car of Atlanta, and the accompanying balance sheet as of March 31, 1970 and the related statement of income and accumulated deficit for the three months then ended were not audited by us; accordingly, we do not express an opinion on them." The plaintiffs alleged they relied on the statement in buying stock in Airway's Rent-A-Car. The trial court granted Barnes' motion for summary judgment. The appellate court reversed, stating:
3. Where as here there is a written disclaimer, the accountant would not be liable to third parties for mere negligence in the preparation of a financial statement. ...[However] [t]here was evidence tending to show an agreement on the part of the defendant to verify certain major accounts to the plaintiffs. The accounts in question concerned the fleet of automobiles and accounts payable. This arrangement as described was between the plaintiffs and the defendant, that in supplying the figures in the statement he would check to insure the accuracy of the described accounts. The defendant would have had to show that there was no agreement to verify any accounts or that there was no basis for the plaintiffs to rely on figures furnished with regard to such accounts. Therefore, the case must be reversed for a jury's consideration as to this issue alone.

F. **Post-SSARS Decision on the Effectiveness of the Basic Disclaimer:** *Evans v. Israeloff, Trattner & Co.*, 208 A.D.2d 891, 617 N.Y.S. 899 (N.Y. App. Div.

1994). The defendant accounting firm prepared monthly compilations for Westfall Inc. Each compilation report contained the AICPA's standard basic disclaimer, AR 100.17:

> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (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.

After receiving the reports, plaintiff Evans lent Westfall money. The accounting firm moved for summary judgment. The trial court granted the motion, and the appellate court affirmed, holding that under the circumstances Evans had not shown justifiable reliance on alleged misrepresentations in the compilations. (The decision does not say what misrepresentations were alleged.)

G. **Post-SSARS Decisions on the Effectiveness of the Basic Disclaimer with the Standard Warning Regarding Omission of Disclosures.**

1. *Cliff House Condominium Council v. Capaldi,* 1991 WL 165302 (Del.Ch. 1991). Accounting firm DG&G prepared two compilation reports for Cliff House Condominium. Each report included both the basic disclaimer and the warning regarding omission of disclosures:

> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (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.
>
> Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Capaldi and Rizzo used the reports to market condominiums. The Council, alleging it relied on the reports to its detriment, sued DG&G for fraud and negligent misrepresentation. DG&G moved to dismiss for failure to state a claim. The court followed *Seedkem* and denied DG&G's motion, stating: "Other courts, faced with the question of whether one may reasonably rely on a compilation that includes a disclaimer, have declined to rule reliance unreasonable as a matter of law.... [I] appears unlikely that plaintiffs ultimately will prevail on their fraud claims. However, in keeping with the cautious approach expressed in other jurisdictions, I decline to rule as a matter of law that it is unreasonable for a party to rely upon a compilation that contains a disclaimer."

2. *Ris v. Finkle*, 148 Misc.2d 773, 561 N.Y.S.2d 499 (N.Y. Sup. Ct. 1989). Accountants F&R provided a compilation report to client Etna, including both the basic disclaimer and the warning regarding omission of disclosures. Etna gave the report to Penvest, which then invested in Etna. (Apparently Etna defaulted.) Penvest sued F&R for fraudulent representations concerning the value of certain leases owned by Etna. The court granted summary judgment to F&R, stating: "In view of the express language of the last paragraph [i.e. the language from AR 100.17 and .21], Penvest cannot have justifiably relied on any representations by F&R (and its members) on the financial condition of Etna. Moreover, in light of the express statement therein that the information contained in the financial statements 'is the representation of management,' and that F&R and its members 'do not express an opinion or any other form of assurance on them,' plaintiff cannot even demonstrate that the compilation was a representation of material existing fact made by F&R (and its members).'

3. *First National Bank of Newton County v. Sparkmon*, 212 Ga.App. 558, 442 S.E.2d 804 (Ga. Ct. App. 1994). Defendant CPAs prepared a review report, and then a series of compilation reports, for M&L. The compilation reports contained the standard disclaimer plus the warning regarding omission of disclosures. M&L furnished the reports to plaintiff bank, which sued the accountants when the bank defaulted. The CPAs moved for judgment on the pleadings. The trial court granted the motion, and the appellate court affirmed, stating: "We find these disclaimers effective to preclude any justifiable reliance by a

third party upon the ...compilation reports they prefaced. Accordingly, [the defendant CPAs] may not be found liable to FNB for mere negligence in the preparation of the financial reports, including any negligent failure to comply with the AICPA standards for reviews and compilations...."

4. The court cited this disclaimer in *Advance Concrete Form v. Accuform*, 158 Wis. 2d 334, 338-342, 462 N.W.2d 271 (Ct. App. 1990). But the court did not rule, and was not asked to rule, on the disclaimer's efficacy as a defense.

H. **Post-SSARS Decisions on Other Disclaimers.**

1. *FDIC v. High Tech Medical Systems, Inc*., 574 So.2d 1121 (Fla. Dist. Ct. App. 1991). High Tech hired Kaufman, an accounting firm, to provide to the bank "monthly reports regarding the amounts of High Tech's accounts receivable and inventory on hand." Kaufman's first report "contained an express disclaimer to the effect that something less than the certification and guarantee that the bank required was being provided." High Tech defaulted and the bank sued Kaufman. On Kaufman's motion for summary judgment, the trial court dismissed the misrepresentation claims against Kaufman. The appellate court affirmed, because "the express and unambiguous disclaimer" ruled out the possibility of justifiable reliance on the reports. The court noted that it had examined the record for evidence of an alleged "oral promise to certify the report," and had found no such evidence.

2. *Ashland Oil, Inc. v. Arnett*, 875 F.2d 1271 (7th Cir. 1989). (See Section VI A 3, above.) Accountant Richards issued a compilation report on Arnett's financial statements (the decision does not report what disclaimer he used). The trial court granted a directed verdict against Marathon, apparently applying a per se rule that the disclaimer prevented reasonable reliance. The court of appeals reversed, stating that a disclaimer in a compilation report "cannot relieve an accountant from the duty to refrain from knowingly being party to fraud." But the court declined to hold as a matter of law that Marathon's reliance on the accompanying financial statements compilation report was reasonable, and remanded the case for trial on that issue.

IX. CPA LIABILITY ARISING FROM ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES.

A. In the course of performing a compilation, a CPA might agree to give heightened scrutiny to a limited number of items. Breach or negligent performance of this agreement may make the CPA liable to the client or a third party, even if the performance of the underlying compilation engagement did not. See *Ryan v. Kanne*, below, and *MacNerland v. Barnes* and *Seedkem, Inc. v. Safranek* in Section VIII A, above.

B. Where a compilation engagement is supplemented by a side engagement to perform agreed-upon procedures, the agreement should always be put in writing. The engagement letter should state clearly what additional procedures the CPA is to perform and what types of report and assurance (if any) the CPA will provide, depending on the results of applying those additional procedures. When a compilation engagement is not supplemented by any agreed-upon procedures, consider stating that in the engagement letter.

C. Not surprisingly, engagements to perform agreed-upon procedures vary widely, and the applicable AICPA Professional Standards give only general and illustrative guidance. AICPA standards provide for application of agreed-upon procedures to historical financial statements (see AU § 622), prospective financial statements (see AT § 200.49-.57), assertions regarding compliance with specified requirements (see AT § 500.15-.28), and other assertions (see AT § 100.59-.62). AICPA standards do not provide for application of agreed-upon procedures to pro forma financial information (see AT § 300). Further discussion of such engagements is beyond the scope of this outline.

D. *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969). CPA Ryan sued client Kanne for fees. The purchaser of Kanne's business, Kanne Lumber and Supply (KLS), also a defendant, counterclaimed for negligent performance of agreed-upon-procedures regarding Accounts Payable -- Trade. KLS alleged it purchased Kanne's business in reliance on Ryan's report on payables. Ryan contended he could not be liable because his report stated he had not audited the financial statements and expressed no opinion on them. The court rejected this contention.

> Although in this profession a distinction is made between certified audits where greater time and effort are expended to verify book items,

> and uncertified audits where greater reliance is placed upon book items, it is clear to us that accountants, or any other professional persons, must perform those acts that they have agreed to do under the contract and which they claim have been done in order to make the determination set forth and presented in their report. Their liability must be dependent upon their undertaking, not their rejection of dependability. *They cannot escape liability for negligence by a general statement that they disclaim its reliability.* ...As to other items which he agreed to and states he did investigate, but did not, we hold the lack of certification will not absolve him from liability. *He must perform as agreed whether the work is certified or not.* This being so, we have here fact questions as to the substance of the agreement between the parties, as to the care exercised in its performance, and to the representations made, rather than whether the report was certified or uncertified.

(Emphases added.)