# CPA LIABILITY FOR REVIEW ENGAGEMENTS IN WISCONSIN


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## INTRODUCTION.

In terms of CPA commitment, review engagements fall between compilations, which purport to commit the CPA to nothing at all in the client's financial statements, and audits, which can commit the CPA to the proposition that the client's financial statements contain no material errors or irregularities. Yet the language of the standard review report is quite confusing regarding the extent to which the CPA is taking responsibility for any representations in the accompanying financial statements, and it is therefore questionable how much anyone may justifiably rely on such a report in making financial decisions.

Few courts, and none in Wisconsin, have addressed the question of CPA liability for review engagements per se. CPAs have been sued for malpractice in interim reviews for audit clients, but courts have rarely addressed CPA liability for the reviews apart from audit liability. Therefore it is not possible to provide a definitive answer to most questions about review liability. This outline focuses on applicable AICPA Professional Standards, primarily in SSARS, and on several court decisions that discuss review liability as a separate issue.

## I. WHAT IS A REVIEW ENGAGEMENT?

### A. Definitions of "Review of a Financial Statement."

1. *AICPA definition*: "*Review of financial statements*. Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting." AR § 100.04.

2. *Wisconsin Accounting Examining Board definition*: "'Review' means to perform an inquiry and analytical procedures that permit a certified public accountant or public accountant to determine whether there is a reasonable basis for expressing limited assurance that there are no material modifications that should be

made to financial statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting." Wis. Admin. Code, § Accy 1.302(1)(k).

B. **The Review Report.** The expected result of a review engagement is the CPA's review report. The standard AICPA review report for a nonpublic entity (AR § 100.35) is an expression of limited assurance balanced with a partial disclaimer of responsibility:

> I (we) have reviewed 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. All information included in these financial statements is the representation of the management (owners) of XYZ Company.
>
> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.
>
> Based on my (our) review, I am (we are) not aware of any material modification that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

For an example of a review report on a public entity, see AU § 722.28. Regarding review reports on pro forma financial information, see AT § 300.12. For an illustrative review report on other assertions, see AT § 100.58.

C. **Applicable AICPA Professional Standards.** Professional standards for reviews of historical financial statements are found, among other places, in SSARS at AR § 100.23-.42, .52 and .54. These standards apply only to financial statements of entities that are not publicly traded. For publicly traded entities, see AU § 722. Review of *pro forma* financial information is addressed in AT § 300, and review of other assertions in AT § 100.56-.58. AICPA Professional Standards do not provide for the review of prospective financial statements.

## II. ANATOMY OF A REVIEW REPORT.

The standard review report of AR § 100.35 states explicitly, incorporates by reference or implies the following.

A. **The Name of the CPA, and Identification of Him or Her as a CPA**. See the discussion of this point in the outline on compilation engagements.

B. **The Client's Assertion**: "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." "All information included in these financial statements is the representation of the management (owners) of XYZ Company."

C. **Client's Assumptions Underlying the Client's Assertion**: None.

D. **Standards Against Which CPA Tested Client's Assertion**: "generally accepted accounting principles."

E. **Procedures the CPA Used to Test the Client's Assertion**: Procedures required by "Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants." These provide for "inquiries of company personnel and analytical procedures applied to financial data," but these procedures are

"substantially less in scope than an audit in accordance with generally accepted auditing standards."

F. **The CPA's Express Statements Regarding the Reliability of the Client's Assertion:**

1. *The CPA's express statements regarding the form in which the client's assertion is presented*: The reference to GAAP implies the statements have the form required by GAAP.

2. *The CPA's statements regarding assurance*: "Based on my (our) review, I am (we are) not aware of any material modification that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles." Although applicable standards refer to this assurance as "limited" and "negative," these off-putting characterizations do not appear in the report itself.

3. *The CPA's disclosures regarding the assertion*: None in the standard report.

4. *The CPA's disclaimers, warnings, disavowals, cautionary statements, caveats and limitations on use and users.* A review "is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion."

G. **The CPA's Implied Representations Regarding the Reliability of the Client's Assertion.**

1. Most of the representations implied by a compilation report are stated expressly in the review report. By stating that the CPA is "not aware of any material modification that should be made to the accompanying financial statements in order for them to be in

conformity with generally accepted accounting principles," the review report says in substance that the CPA has no reason to believe that the information supplied by the client is (materially) incorrect, incomplete or otherwise unsatisfactory, that the financial statements are free from obvious material errors, and that the CPA is not aware of any departures from GAAP (or at least not aware of any departures not disclosed in the report). See AR § 100.30 (procedure if information is incomplete, incorrect or otherwise unsatisfactory), and .39-.40 (departures from GAAP other than omission of disclosures).

2. But at least two implied representations survive in the review report.

   a. The CPA who signs the review report thereby implies that *he or she is independent with respect to the client.* In a review report, unlike a compilation report, the CPA may not disclaim this implied representation by disclosing lack of independence. AR § 100.38. For a somewhat different use of "independent" in review litigation, see *Joel v. Weber, infra*.

   b. The CPA who signs the review report thereby implies that *the accompanying financial statements include the disclosures GAAP requires.* In a review report, unlike a compilation report, the CPA may not disclaim this implied representation by indicating the omission of GAAP-required disclosures. AR § 100.19-.21 and 39.

## III. **LIMITED (OR NEGATIVE) ASSURANCE.**

To the extent the review report, unlike the compilation report, expressly provides *some* assurance, it raises the question of what that assurance means and what reliance it justifies. The highest assurance a review report may provide regarding a client's assertion is "limited" (AR § 100.04, .24, .36; Wis. Admin. Code, § Accy 1.302(1)(k))

or "negative" (AT § 100.52, .56-.58, AT § 300.09). It is difficult for a third party to know the extent to which it is reasonable to rely upon such assurance, because the meaning of such assurance is usually obscure. This section of the outline describes the problem and suggests a possible cure. Note, however, that this problem has not been the focus of any reported court decision, apparently because the reasonableness or justifiability of reliance is almost always a question for the jury, and so far all reported decisions regarding review liability address pretrial motions to dismiss or for summary judgment.

A. **The general form of negative or limited assurance** is: "Based on my review, I am *not aware* of any respect in which the client's assertion materially fails to conform with the applicable criteria or standards." Here are some examples of negative assurance:

1. "Based on my (our) review, I am (we are) not aware of any material modification that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles." AR § 100.35; AU § 722.28-.29 contains nearly identical language.

2. "Based on our review, nothing came to our attention that caused us to believe that the accompanying [*identify the presentation of assertions -- for example, Statement of Investment Performance Statistics*] is not presented in conformity with [*identify the established or stated criteria -- for example, the measurement and disclosure criteria set forth in Note I*]." AT § 100.58. AT § 300.12(e)(2) contains similar language.

B. **Why is negative assurance worth anything?** For instance, what assurance does it provide beyond the minimal assurance of a standard compilation report? The CPA who signs a standard compilation report necessarily implies that he or she is not aware of any respect in which the client's financial statements materially fail to conform with GAAP. So why should a third party, seeking assurance, think a review report provides it any more than a standard compilation report? Is the only

difference between a compilation report and a review report that the CPA states expressly in the latter what she merely implies in the former?

C. **What negative assurance means.** The answer is that negative assurance means more than merely "I am not aware of any respect in which the client's assertion materially fails to conform with the applicable criteria or standards." Negative assurance begins with the phrase: "*Based on our review*." Negative assurance means: "*I have performed these procedures [namely, inquiries of company personnel and analytical procedures applied to financial data] to determine whether the client's assertion conforms with the applicable standards*, and I am not aware of -- those procedures have not disclosed -- any respect in which the client's assertion materially fails to conform with those standards."

D. This means that to know how much reliance one can reasonably place on a CPA's expression of negative assurance, one must first understand what procedures the CPA has performed, and how likely or unlikely it is that those procedures will uncover departures from GAAP. But the review report says hardly anything at all about what the CPA has done. Who can tell, just from the report, what "inquiries to personnel" the CPA made and what "analytical procedures" the CPA performed? For instance, who but a CPA or a very sophisticated user will know that these inquiries and procedures generally need not include any significant scrutiny of the client's internal financial controls?[1] In short, how can anyone who is not a CPA have any idea of what reliance may reasonably

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[1] This is true only of engagements under SSARS. AU § 722.10 and .13a, relating to reviews of a public entity, require some knowledge of and inquiry into the entity's internal control structure. Moreover even SSARS requires inquiries into procedures for recording, classifying, and summarizing transactions, AR § 100.27b and .52. These inquiries can alert the CPA to potential internal control problems, which the CPA must then probe. AR § 100.30. Note that failure to probe potential internal control problems is not, in and of itself, a basis for a third-party claim against the CPA, though it may be the basis for a client claim. *Compare Monroe v. Hughes*, 31 F.3d 772 (9th Cir. 1994) (auditor has no duty to disclose findings regarding internal control to third-party investors). To be relevant to a third-party claim, such a failure must lead to a misrepresentation by the CPA, and then it is the misrepresentation, not the failure to probe internal control, that gives rise to the claim. The point in the text is not that the CPA owes the third-party a duty to undertake such inquiry, but that the third-party who understands that a review engagement under SSARS does not usually include (much) inquiry into internal control is less likely to rely on the review report. On internal control structure generally, see AU § 319.

be placed on a review report expressing negative assurance? The CPA expressing negative assurance is like the lifeguard who reports not that *there are no sharks* in the swimming area, but merely that *he has not seen any sharks*, without telling us how hard he looked for them. (Maybe the sharks are resting on the bottom. Who wants to get wet and find out?)

E. This reasoning might seem to suggest there can be no reasonable reliance on a review report expressing limited assurance (and therefore there can be no reasonable reliance on any review report). Ironically, this conclusion would support the CPA's defense that any reliance by the plaintiff was unjustified or unreasonable (negligent).[2] But this conclusion also makes review reports completely useless. Worse: It makes them look like a trap set by the CPA or client for the unwary lender or investor: The CPA's language in the review report, and name and identification as a professional, clearly invite *some* degree of reliance, even if that reliance is "limited" (a word that, like "negative," does not appear in the report).

F. Because the expression of limited assurance leaves the degree of reliability unclear, courts are likely (and juries more so) to conclude that an unsophisticated user could reasonably place considerable reliance on the report. In other words, the language of the review report plays right into the expectation gap between what CPAs in fact do and what the public thinks they do. Plaintiffs' lawyers will be happy to tell the jury at length about all the procedures the CPA performed (see AR § 100.27 and 100.52), and to minimize the importance of the tests and verifications only an audit normally requires.

G. What can CPAs do to protect themselves, short of refusing all review engagements? Consider including, within or attached to the review

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[2] In intentional and strict responsibility misrepresentation cases, comparative negligence is not a defense. In such cases, the plaintiff must establish that his reliance on the CPA's report was justifiable, but this will be relatively easy for any unsophisticated plaintiff to do, given the vague language of the review report. *See Imark Industries v. Arthur Young & Co.*, 141 Wis. 2d 114, 127-130 (Ct. App. 1987), reversed in part on other grounds, 148 Wis. 2d 605 (1989) ("while justifiable reliance is an element of intentional misrepresentation and strict responsibility, it is not a separate element of negligent misrepresentation").

report, a more detailed statement, in plain English, of what procedures the review did and *did not* include, and what the utilized procedures might reasonably be expected to discover and *not* discover. The sample engagement letter set forth in AR § 100.54 contains some useful though still obscure cautionary language for this purpose.

> A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. ...Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist.

If this language is good enough to give the client, why not incorporate it in the report itself? Better yet, why not put it in plain English, so that any would-be plaintiff could understand it? Say what internal control structure is, in simple terms. Say what errors and irregularities are, in simple terms. What is "corroborating evidential matter"? If the CPA does not explain these things clearly to the client and potential third parties as part of the engagement, he will be more likely to have to explain them in court, after he has been misunderstood.

## IV. LIABILITY TO THE CLIENT.

### A. Fraud and Conspiracy to Defraud the Client.

1. 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 (italics added). The illustrative review engagement letter in AR § 100.54 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." (The same language appears in the illustrative compilation engagement letter, AR § 100.53.) When Billy Joel sued his CPAs, he could have relied upon this language in AR § 100.

*2.* *Joel v. Weber*, 166 A.D.2d 130, 569 N.Y.S.2d 955 (N.Y.App.Div. 1991). Joel's agent Weber hired accounting firm BSS to conduct quarterly unaudited reviews of Joel's financial statements. Eight years later Joel fired both Weber and BSS and sued both for fraud. Weber and BSS moved to dismiss the twenty-seventh and twenty-eighth causes of action in Joel's third amended complaint. The trial court granted the motion, but the appellate court reversed. In these two causes of action Joel alleged that BSS and its partners defrauded him

> by submitting financial statements, in which those defendants [1] knowingly or recklessly overvalued certain assets of Mr. Joel, although some of them were worthless, [2] failed to identify certain related-party transactions, such as interest-free loans to defendant Mr. Weber and to Weber related enterprises, [3] failed to include contingent liabilities, which were material to Mr. Joel's financial condition, and [4] failed to disclose that Mr. Joel's copyrights were subject to a mortgage held by CBS. Further, those defendants [5] knowingly or recklessly misrepresented to plaintiffs that they were independent accountants, acting solely in Mr. Joel's interests, although they were also the accountants for various Weber partnerships, and a BSS partner, defendant Mr. Howard Schain, had invested in one or more thoroughbred horse breeding partnerships, in which Mr. Weber was a general partner.

(Bracketed numerals added.) The thrust of the allegations is that BSS fraudulently and for its own gain hid from Joel the fact that BSS's client Weber was defrauding Joel by diverting Joel's assets into various Weber enterprises. The court quoted the discussion of review engagements from *Iselin*, discussed below.[3]

3. SSARS and the *Joel* case address circumstances in which the CPA discovers fraud or defalcations, but does not inform the client. The CPA may also be liable when the CPA *negligently fails to discover* errors, irregularities, or illegal acts. AR § 100.26 requires that the CPA performing a review engagement must have

> a general understanding of the entity's organization, its operating characteristics, and the nature of its assets, liabilities, revenues, and expenses. This would ordinarily involve a general understanding of the entity's production, distribution, and compensation methods, types of products and services, operating locations, and material transactions with related parties. An accountant's understanding of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of the entity's personnel.

(Compare the lesser degree of knowledge required for a compilation engagement, AR § 100.11.) If the CPA 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

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[3] Note Joel's misleading use of "lack of independence" in [5] to mean conflict of interest. Lack of independence means a CPA's relation with the client that suggests possible CPA bias favoring the client, which might trouble third parties relying on the CPA's report regarding the client's financial statements. Conflict of interest means a CPA's relation with someone other than the client that suggests possible CPA bias disfavoring the client, which might trouble the client, such as Joel.

malpractice in the review. No reported cases have adopted this theory of liability for reviews, however.

B. **CPA's Failure to Provide (or Offer to Provide) Further Necessary Services to the Client.** "The accountant might consider it necessary to compile the financial statements or perform other accounting services to enable him to perform a review." AR § 100.04. Failure to perform such other agreed-upon services, or at least to offer to provide them, might give rise to liability. Again, no reported cases have adopted this theory of liability for reviews.

## V. LIABILITY TO THIRD PARTIES.

CPA liability to third parties for *compilation* reports arises from the third party's detrimental reliance upon the client's financial statements, when the CPA has failed to make a required disclosure or failed to withdraw from the compilation engagement before issuing the report. Such third-party claims ordinarily do not depend on any express representations by the CPA. By contrast, CPA liability to third parties for *review* reports ordinarily arises from detrimental reliance upon express CPA representations in the review report, namely the expression of limited (negative) assurance. Limited assurance is ambiguous, however (see Point IV, above). Therefore courts are likely to let juries decide claims of third-party reliance on a CPA's expression of limited assurance, as in *ML-Lee*, discussed below.

A. ***Iselin & Co. v. Mann Judd Landau***, 71 N.Y.2d 420, 527 N.Y.S.2d 176, 522 N.E.2d 21 (N.Y. 1988). Mann prepared review reports for client Suits Galore. After Iselin obtained a copy of one of the reports, Iselin made unsecured loans to Suits, which Suits was unable to repay. Iselin sued Mann for negligence and fraud in the preparation of the review reports, alleging that the accompanying financial statements "overstated inventory, understated liabilities and failed to disclose the diversion of corporate assets." The court granted Mann summary judgment, holding the negligence claim was barred by absence of a privity-like relation between Iselin and Mann (a defense that would fail in Wisconsin). But the court stated that "an accountant is not immune from liability to a

lender for negligence in reviewing a borrower's financial statements and rendering an uncertified report (Review Report)." The court quoted Mann's 1982 Review Report and discussed at length the difference between an audit and a review, stating that "[w]hile the essential character of a Review Report thus differs from that of the traditional audit, the accountant nevertheless has a duty to exercise due care in performance of its engagement." Because lack of privity barred the claim, however, the court did not elaborate further on the CPA's legal duties in a review engagement.

B. ***ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche***, 1995 WL 502511 (S.C.App.). From 1983 through 1990, Emb-Tex, a nonpublic corporation, was Deloitte's audit client. In 1988, at the request of Emb-Tex, Deloitte issued a comfort letter to ML-Lee in connection with ML-Lee's proposed purchase of subordinated notes in Emb-Tex. The comfort letter expressed limited assurance regarding the interim financial statements of Emb-Tex.[4] After receiving Deloitte's comfort letter, ML-Lee closed the transaction. In late 1990, Deloitte withdrew as Emb-Tex's auditor without explanation. In 1991, it was discovered that the president of Emb-Tex had overstated inventory for the years 1985-1989 by $7 million. Emb-Tex was placed in receivership, and ML-Lee sued Deloitte for professional negligence and negligent misrepresentation. The trial court granted Deloitte summary judgment. Reversing, the appellate court held that whether the comfort letter contained misrepresentations and, if so, whether reliance on the letter was reasonable, were questions for the jury. As to the first question, the court stated: "Considering the disclaimers and the limited assurances given in the letter, we question whether the comfort letter in fact

[4] The letter stated, in part: "The foregoing procedures do not constitute an examination made in accordance with generally accepted auditing standards, and they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations as to the sufficiency of the foregoing procedures for [ML-Lee's] purposes. Based upon [these procedures], nothing has come to our attention which causes us to believe that the unaudited financial statements ...have not been prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the [1987 audited financial statements]." 1995 WL 502511, *2.

contains any misrepresentations." 1995 WL 502511, *11. As to the second, the appellate court stated:

> The trial court also concluded that if ML-Lee relied on the comfort letter, any such reliance was unreasonable as a matter of law. The comfort letter contained fairly limited assurances about Emb-Tex's financial condition. In addition, the comfort letter included a disclaimer stating that Deloitte 'make[s] no representations as to the sufficiency of the foregoing procedures for [ML-Lee's] purposes.' The limited scope of the letter and the inclusion of a disclaimer, however, do not require a finding that any reliance on the letter was not justified as a matter of law.

*Id*. at *15. Note that in this case Deloitte provided limited assurance at an interim date after having audited Emb-Tex for five years, and that the real problem, if there was one, probably arose from the audit reports rather than the limited assurance.