

Practice Advisory

Surprise! Compilation Engagement Claims Exist

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This article addresses the primary causes for compilation engagement claims, and offers helpful information on both the precautionary measures that can be taken by firms to avoid these claims, as well as details regarding accountants' liability in these cases.

Notice to Reader financial statements are compiled from information supplied by management, and the Notice to Reader attached to the financial statements explicitly states that the Chartered Accountant has not "performed an audit or a review engagement in respect of these financial statements and, accordingly, expresses no assurance thereon." Readers are cautioned that "this statement may not be appropriate for their purposes". Whether this disclaimer appears on each page, or pages are conspicuously marked "Unaudited – see Notice to Reader", the Notice clearly informs readers about the nature of the work and cautions them that the statements may not be appropriate for an intended use.

Accountants' liability for compilation engagements

One might think the accountant is protected with the Notice to Reader disclaimer, but this is not necessarily so. Most users read and understand the Notice to Reader as a disclaimer of the accountant's responsibility – likely the reason that very little case authority exists in the Courts on duty and potential liability in these disputes. The question is: "Can you safely assume that investors and lenders are sophisticated users who understand the accountant's limited involvement in the preparation of the statements?" Unfortunately, you cannot always make this assumption. Companies – in particular, small businesses – typically obtain and use financial statements for a variety of reasons, including to prepare their tax returns and to obtain financing. Statements can easily fall into the hands of a wide range of users beyond the accountant's client who may use, rely on, or claim to have relied on the statements. So why do these claims arise? Between 1999 and 2010, almost 10 per cent of all claims reported through the AICA-sponsored program arose from compilation engagements, with the majority of these claims arising from lenders who allegedly relied on the financial statements.

A typical situation is one where a banker calls the accountant to discuss the information on the statements and he/she engages in a discussion, with the banker enquiring about accounts receivable, inventory and fixed asset values on the financial statements. The accountant readily responds to the enquiries, not once suggesting to the banker that the statements were not prepared with the intention of being used for lending decisions, nor were they appropriate to be used for such decisions. When the claim later ensues, the bank takes the position that since the accountant knew that the banker should not be relying on the statements for a lending decision, he or she should not have been willing to discuss them in the first place. In a sense, the banker views the conversation as

a waiver on the Notice. In these situations, the accountant is alleged to have failed to warn the bank that it is using the statements for a purpose other than that for which they were prepared.

As with an audit engagement, the first question to ask when considering liability is whether there is a sufficient legal proximity (closeness of the relationship) between the accountant and the user of a statement to give rise to a duty of care. This involves an analysis of all of the factors of the engagement, including the accountant's knowledge of the ultimate users for whom the statement is intended. Note that accountants are cautioned about discussing financial statements with bankers – for a number of reasons – to avoid demonstrating more familiarity and involvement with the preparation of the financial statements than prudent and to avoid taking on advocacy roles for their client, which are also independence issues.

Assuming proximity exists in a given case, the issue now becomes whether the user in fact relied on the financial statements and whether that reliance was reasonable. If it is discovered that both legal proximity exists and the user's reliance on the statement was reasonable, there is a potential for liability – notwithstanding the limited nature of the engagement. In many cases, the reliance will be negated by clear words in the Notice to Reader, indicating that a user is expected to understand that the accountant is not providing any form of assurance. This may be clear to sophisticated users, but the Court does not assume that all users are sophisticated, nor may it expect anyone besides an accountant to be familiar with the differing procedures prescribed by the *CICA Handbook*.

Beware the extent of work in compilation engagements

Another trend that is giving rise to claims is that practitioners are doing extra work in compilation engagements, thinking this might afford additional protection. An accountant's working papers on a compilation engagement may include some steps normally associated with audit or review engagements. There may, for example, be a bank confirmation or an analysis of receivables. While there is a lack of judicial authority on this issue, it is likely that once an accountant undertakes to perform any of those steps, he/she undertakes a duty to perform them completely and accurately. To the extent that the accountant has performed any of those steps, the disclaimer contained in the Notice to Reader becomes simply untrue – the accountant has now reviewed or verified some of the information.

Be aware that the courts will consider *what you ought to have done as well as what you actually did*. The courts may hold an accountant to a standard based on the greater of the procedures that ought to have been performed rather than the procedures that were actually performed. Make sure to follow up on any "red flags" that may come up based on procedures that you performed that may have been beyond the scope of the engagement. It is not an acceptable defence to say that the red flag was not followed up on because the procedure that led to it was beyond the scope of the engagement. In any event, an accountant should not be associated with information that may be false or misleading.

Who gets sued? Not just the large firms!

Some sole practitioners and CAs in small firms believe that all or most of the large claims against CAs are limited to the medium and large CA firms. Nothing can be further from the truth. In the AICA-sponsored program, which insures approximately 85 per cent of all small and medium-sized CA firms across Canada, 20 per cent of the 50 largest claims since 1999 originated from sole practitioners and an additional 20 per cent originated from two to three partner firms.

How to protect yourself from potential liability

Litigation is an adversarial process. Even if the claim is eventually found in your favour, the time demands and stress of the claims process are enormous. With that in mind, accountants performing compilation engagements should take the following steps to protect themselves from potential liability:

1. Confirm with the client in writing that the client understands the limited nature of the engagement and the limited use to which the statements can be put.
2. Ensure that the work performed does not go beyond the scope of the compilation engagement and that if work is done beyond the scope of the engagement, that all queries that may arise from the extra work are cleared.
3. If a bank or other user contacts you, do not engage in a discussion about the financial statements. If that is unavoidable, clearly warn the caller that the statements were not prepared for that purpose and document in your files that you have done so. Communicate the limitations of the Notice to Reader.
4. Do not distribute financial statements prepared under a compilation engagement to third parties on behalf of your client, regardless of any request or pressure from your client.
5. Recommend that your client upgrade to an assurance (a review or audit) engagement if the intended purpose is to distribute the financial statements to third parties.

Most claims arising from compilation engagements are vigorously defended on the basis that there is a clear disclaimer in the Notice to Reader communication and that sophisticated users of financial statements, especially lenders, should demand an assurance engagement if they intend to rely on parts of the financial statements as a basis for their lending decision.

Following the above listed recommendations should, however, help to minimize the chances of successful litigation by third parties against accountants based on their reliance on financial statements prepared under a compilation engagement.

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For more information, and to download the Risk Management presentation that provides other tips to avoid claims, visit www.aica.ca.