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Accountants: Risks presented in the preparation of compilation reports for private investment companies

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I. Overview

This article addresses the risks that are presented to accounting professionals that prepare compilation reports on financial statements for certain private investment companies. The objective of a compilation engagement is to present in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the financial statements. *See*, AICPA Professional Standards AR §100.06 – Compilation and Review of Financial Statements. Private investment companies can include hedge funds, venture capital funds, private equity funds and leveraged buyout funds that are typically structured in the form of limited partnerships or limited liability companies. *See, Goldstein v. SEC*, 451 F.3d 873, 371 U.S.App.D.C. 358 (2006) (holding that certain hedge funds managers were not required to register under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq.).

Compilation engagements are often incorrectly viewed by attorneys and other professionals, including accountants themselves, as a low-risk service because the accountant provides "no assurance" related to the financial statements. *See, Ris v. Finkle*, 148 Misc.2d 773, 561 N.Y.S.2d 499 (1989) (for authority that a compilation engagement provide no assurance and therefore cannot be relied upon). However, compilation engagements can pose significant exposure to accountants under certain circumstances. The article discusses the general obligations accountants have in connection with preparing compilation reports, common risks presented to accountants who issue these reports and concludes with defenses available to accountants against whom claims are brought. These defenses include loss causation and the fault of others.

II. Compilation Engagement

There are number of different types of engagements that accountants perform related to private investment companies. These include not only compilation engagements but also a) review engagements (which provide a reasonable basis for expressing limited assurance that the financial statements are not materially misstated) afford a higher level of assurance than a compilation engagement); b) audits (which provide reasonable assurance that the financial statements are not materially misstated); and c) agreed upon procedures, which are engagements where the accountant issues a report of findings based on specific procedures performed on subject matter (for example – calculate the rate of return on a specified investment (according to an agreed-upon formula) and verify that the resultant percentage

agrees to the percentage in an identified schedule). *See*, AICPA Professional Standards AU §201 – Agreed-Upon Procedures Engagements.

In addition to reporting services, accountants can perform "other accounting services," in connection with any of the above engagements, which include, but are not limited to, the preparation of journal entries to adjust the books of account and consulting on accounting matters. *See*, AICPA Professional Standards AR §100 – Compilation and Review of Financial Statements. All of these other engagement types present their own level of risk and are beyond the scope of this article.

A. Summary of the Compilation Engagement

The authoritative guidance for the compilation of financial statements by CPA firms is governed by AICPA Professional Standards AR §100 – the Statements on Standards for Accounting and Review Services ("SSARS") and certain aspects of these standards are highlighted below.

Engagement Planning. Although compilation engagements typically present information that is the representation of management, SSARS makes it clear that the accountant has much more responsibility than to just receive a client's financial information, rearrange the numbers and prepare an accountants' report on it. In particular, the accountant must "possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates…" This knowledge may be acquired by the accountant even if does not possess prior experience in the entity's industry.

The accountant must also 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. *On the basis of that understanding*, the accountant should consider whether it will be necessary to perform other accounting services, such as assist in adjusting the books of account or consult on accounting matters, when he or she compiles financial statements" AR § 100.09 (emphasis added).

Based on this planning, the accountant must assess the amount of work that must be completed in connection with the compilation engagement. Major risks to accounting firms are that adequate consideration has not been given to the form of the accounting records and stated qualifications of the accounting personnel. In cases where accounting firms know that the accounting records are in disarray or that the client's "accountant" has no formal accounting training, more work may be necessary in connection with the engagement, instead of merely relying on "management's representations" with respect to the amounts contained in the financial statements. These circumstances can also indicate more pervasive internal control weaknesses that may be necessarily analyzed.

Performance. SSARS indicates that in the performance of the accountant's compilation engagement, "The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. However, the accountant may have made inquiries or performed other procedures. The results of such inquiries or procedures, knowledge gained from prior engagements, or the financial statements on their face may cause the accountant to become aware that *information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory*." In circumstances where the accountant believes that the financial statements are materially misstated, the accountant should obtain additional or revised information" AR § 100.10 (emphasis added).

When the accountant determines that the information received is not complete or is otherwise unsatisfactory, SSARS requires the accountant to follow up on the information and investigate until satisfied. For example, if the accountant receives client prepared financial statements that contained numerous errors, it may be necessary for the accountant to gather sufficient documents to reconcile the accounts. If it does not, the engagement risks increase.

Communication. SSARS requires that the accountant reach an understanding with the client that "(a) the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (b) that *the accountant will inform* the appropriate level of management of any *material errors* and of any evidence or information *that comes to the accountant's attention* during the performance of compilation procedures that fraud or an illegal act may have occurred." AR § 100.05 (emphasis added).

When matters regarding fraud or an illegal act involve senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the manager (owner) or the board of directors. AR § 100.84. Failure to do so is a breach of the accountant's responsibilities and may cause significant liability for the accountant.

Compilation Summary. The standard compilation report does not give the appearance that the accountant has much responsibility for what lies beneath. The accountant, however, does make an important assertion in its compilation report—the engagement was performed "*in accordance with SSARS*." The duty to follow through with this promise is incumbent upon the accountant.

All aspects of SSARS are relevant in performing a compilation engagement. Improperly relying on management representations and failing to communicate are direct violations of the standards that can create significant liability.

III. Risks Presented

The primary fraud risks presented in connection with compilation services provided to private investment companies are the risk of a) fraudulent

financial reporting (overvaluation of investment assets, overstatement of returns, lack of adequate disclosure, etc.); and b) misappropriation of assets (diversions). Either the investment manager, or under certain circumstances such as where the investment manager either fails or refuses to take action, the individual investors, could bring claims against the accountants related to losses. While these claims may be primarily directed to the person directly benefiting from the misconduct, typically the fund manager, they are also brought against accounting firms and other professionals who can provide an avenue of recovery.

IV. Defenses

The primary defense in any investment case is related to loss causation. The argument is typically articulated as follows: any losses suffered by the investment company were the result of other causes (like market forces or bad business decisions), not by the failure of the accountant to meet the applicable standard of care and, therefore, are not recoverable. This defense is typically avoided by the investor alleging that if the accountant had acted in accordance with the standard of care, the investor would have taken steps to minimize and/or reduce the losses.

Another defense that is typically asserted is the fault of a third party, usually the fund manager, who was actively engaged in the fraudulent reporting and/or misappropriation. While it is usually the fund manager, or another intermediary, that directly benefits from the improper conduct, the argument in response to this defense is that the accountant had a responsibility to report the misconduct of third parties to appropriate levels of management or owners.

Finally, the defense of plaintiff fault is typically asserted by arguing the investor knew of the potential risks, accepted a financial statement report that was something less than a full scope audit and/or failed to adequately monitor the activities of the investment manager. The response to this defense is that the accountant had a duty to comply with all relevant professional standards, including communication by the accountant which would have given the investor the necessary information to minimize and/or reduce losses and at most, investor fault would reduce recovery, not preclude recovery.

V. Conclusion

Compiling financial statements presents litigation and liability risks to accounting professionals. Defense counsel need to be aware that claims can be successfully prosecuted under the applicable standards and that compilation engagements with private investment companies are not entirely "low-risk" engagements and at times present significant financial exposure.