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# Managing the malpractice maze

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MANAGING THE MALPRACTICE MAZE

BY MARK F. MURRAY, J.D.

AICPA

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## BY MARK F. MURRAY, J.D.

AICPA
American Institute of Certified Public Accountants

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# Managing the Malpractice Maze

By Mark F. Murray, J.D.

Issued by the Management of an Accounting Practice Committee
American Institute of Certified Public Accountants

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# FOREWORD

In the past, with a less litigious society, few practitioners felt the need to become educated in professional liability or adopt procedures that would protect them from malpractice claims asserted by their clients or third parties. However, with the acceleration in malpractice litigation and with settlements and judgments reaching multimillion dollar levels, practitioners now realize that becoming a party to malpractice litigation is not something that happens only to someone else. A heightened awareness of professional liability and the implementation of defensive measures not only decreases the chances of being sued and improves the chances of a successful defense, but also results in an improvement in the quality of services, the most substantial benefit of which will be passed on to clients.

Despite the seriousness of the malpractice liability situation, there is cause for hope. Judges are becoming increasingly aware of the objectives and design of accounting and auditing services; strong defenses by attorneys and stricter settlement philosophies assumed by insurance companies have resulted in victories for accountants. In January 1992, members of the AICPA voted to amend Rule 505 of the Code of Professional Conduct to permit CPA firms to practice in any organizational form permitted by state law or regulation, including a general corporation or limited liability company (LLC). This amendment enables firms to adapt to the changing economic, legal, and regulatory environment in which they operate, and it may help to protect individual partners from unwarranted legal liability. The AICPA continues to work to bring about reform of the tort laws across the country.

W. THOMAS COOPER, JR.
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# PREFACE

No firm can afford to overlook the risk of malpractice liability or the cost of defense. The increasing frequency with which malpractice lawsuits are being brought against accountants—not only by clients but also by third parties—makes professional liability a major management issue for any firm, large or small.

The purposes of this book are to alert CPAs to the full extent of the malpractice litigation initiated against accountants, to provide practical ways to reduce the likelihood of claims and improve your chances of a successful defense if a claim is brought. These goals are best accomplished by understanding the types of claims most frequently asserted and the legal theories underlying them, implementing and monitoring a defensive-practices program, choosing complete professional liability insurance coverage, selecting an attorney to provide the best possible defense, and properly responding to claims.

This book includes the following sections:

- Section I examines the increase in professional malpractice litigation and the legal theories upon which claims are based. It also explores the reasons for the acceleration in accountants' malpractice litigation and examines the personal and professional costs of litigation, which are often overshadowed by the more easily quantifiable costs of mounting a defense. The section concludes with a discussion of the cost and availability of professional liability insurance and an overview of the accountants' susceptibility to claims from nonclient third parties, as well as a chart employing a myth-versus-reality format addressing the arguments most frequently used to question the need for malpractice insurance coverage.
- Section II offers specific techniques for lowering or transferring the risk of malpractice liability. It discusses risk management policies and procedures that are necessary for an effective defensive-practices program. These techniques can be used to evaluate your own program or develop such a program if one is not currently in place. Among the techniques discussed are the use of engagement letters, client screening, quality control, and defensive billing practices.

- Section III begins with a discussion of your attorney's pivotal role when a claim is brought—specifically, counsel's contribution to your firm's defensive-practices program, and to the investigation and defense of a malpractice claim. The section continues with a discussion of how to select an attorney and what qualities to look for in counsel. Featured in this section is a ten-step plan that guides you through the stages of malpractice litigation, beginning with the first notice of a claim and concluding with settlement or judgment.
- Section IV opens with a discussion of how you can obtain the full value of malpractice insurance protection. By analyzing the predominant features of the typical professional liability policy, this section enables you to become more informed about issues prevailing in the industry, and to more actively participate in the policy selection process. It recognizes that because a firm's insurance needs are intertwined with those of the owner, coverage that meets the distinctive needs of the firm is best obtained with the accountant's involvement. Also included is an analysis of the accountant's responsibilities under a professional liability policy. The section concludes with a guide to purchasing malpractice insurance coverage and a discussion of the factors to consider when choosing a professional liability insurance program.
- Appendixes include sample engagement letters, a client screening form, engagement checklists, and an insurance policy log.

There are no quick solutions to the prevailing malpractice crisis, and reading this book cannot guarantee that you will never be involved in malpractice litigation. However, following its guidelines and devoting the necessary resources to a defensive-practices program can help you not only survive, but also prosper in an increasingly litigious society.

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# SECTION I

# THE CRISIS IN MALPRACTICE LITIGATION

# CHAPTER 1

# The Crisis in Malpractice Litigation

For decades, accountants have been perceived by the general public as professionals who practice with skill, honesty, and integrity, and as individuals whose first commitment is to public service. Accounting has frequently been cited as one of the most respected professions. Nevertheless, accountants—like doctors, lawyers, architects, engineers, corporate officers and directors, and other professionals—have been swept up in a tidal wave of professional malpractice litigation.

Since the mid-1960s, accountants have been exposed to increasing litigation; however, it was not until 1984 that a worldwide crisis began, with malpractice insurance premiums rising significantly and coverage becoming less available. This situation has created a financially and professionally troubling environment for today's CPAs, with virtually any engagement exposing the practitioner to liability. The professional environment has also changed. Clients are now less willing than they were ten years ago to informally resolve with the accountant any professional errors or oversights in accounting services. Clients are now more

likely to resort to litigation for relief. Moreover, third parties, who had formerly been more prone to disregard an accountant's error, are now bringing formal claims against the accountant if they relied upon the accountant's work product.

Increasing litigation, accompanied by escalating judgments and prohibitive legal costs, is a broad national trend. Accountants do not need to be reminded of their exposure to malpractice liability or of the mushrooming of claims. Professional journals, newspapers, business news, and reports by commentators on the accounting profession are replete with stories of increasing claims premised upon a spectrum of allegations ranging from oversight and negligence to fraud and disregard of proper accounting practices. Settlements and judgments now range from thousands to millions of dollars. Indeed, increasing costs and awards are reflected in accountants' malpractice insurance premiums, which directly confirm this trend.

Beginning in the 1960s, the basis for the liability of accountants and the amounts for which practitioners could be liable increased dramatically in scope. Throughout the 1970s and early 1980s, publicity was given to the malpractice claims pending against large CPA firms that, it was claimed, had negligently performed audits for major publicly held corporations. As a result, some practitioners in small and medium-sized firms assumed that malpractice litigation was a problem of large firms only and, for a time, the absence of claims against smaller firms seemed to support this assumption.

However, in the 1980s the profile of accountants involved in malpractice litigation began to change. In the litigious climate that characterized that decade, small and medium-sized firms received their share of malpractice litigation. Today, prevailing legal concepts

of civil litigation make no distinction between the sole practitioner performing compilations and reviews for small businesses and the large firm performing audits for multinational companies. Local and regional firms are sued for reasons ranging from allegedly improper tax preparation and negligent tax advice to failure to discover fraud and embezzlement. The list is endless. Rollins, Burdick, Hunter & Company—the administrator of the AICPA Professional Liability Insurance Plan, which is underwritten by Crum and Forster Managers Corporation (Illinois)—reports that in 1991, 31 percent of the new losses reported to the plan resulted from accounting services (compilation and review reports, bookkeeping services, and detection of defalcations).

These statistics indicate that malpractice claims are a very real threat for all practitioners. However, with more carriers entering the market for professional liability insurance, coverage is now becoming more widely available, and with increased competition among carriers, premiums are less expensive than they were during the period from 1984 to 1986.

# CHAPTER 2

# Defining Accountants' Malpractice

Burgeoning litigation against accountants has prompted many practitioners to ask themselves what exactly constitutes accounting malpractice. Does it occur only when practitioners file tax returns in an untimely fashion? Miscalculate tax liability? Recommend tax shelters subsequently disallowed by the Internal Revenue Service (IRS)? Prepare substandard financial reports with or without an audit? The answer is that malpractice occurs whenever an accountant's performance falls below the standard of care. An element of responsibility exists in the relationship between practitioners and their clients in most engagements other than audits, and accountants therefore must comply with the highest standards of conduct in all professional matters involving their clients.

The determinative factor in finding malpractice liability is whether there was a duty of care to the individual claiming a loss. That individual could be a client or third party. The fact that alleged errors are beyond the scope of the engagement letter or that the auditor complied with professional standards is no guarantee that malpractice claims will not be filed nor

is it an absolute defense when a claim is brought. An accountant's attorney has the opportunity, and indeed the duty, to explain to a judge or jury the accounting standards at issue in the claim; however, the trier of fact is free to use these pronouncements as guidelines. Claimant's attorney can argue that guidelines and publications in force are largely self-serving because they were established and produced by the same group they attempt to regulate. If the judge or jury finds that the accounting standards as they exist are inadequate in the circumstances, they may impose their own standard of due care.

## The Three Forms of Malpractice

Claims against accountants stem from all types of services, and by gaining a basic understanding of the legal theories upon which malpractice claims are based, practitioners may be spared the painful experience of civil litigation, or at least be able to participate knowledgeably in their defense in the event of litigation. Liability for accountants may be based upon (1) breach of contract, (2) fraud, and (3) negligence.

### Breach of Oral or Written Contract

The accountant–client relationship is a matter of contract, and an accountant's liability to a client is generally drawn from the obligations imposed by this contract. For this reason, judges and juries closely scrutinize the specific terms of the contract—that is, the engagement letter, if written, and client consultations, if verbal—to determine what the parties intended the contract terms to be. Accountants are liable for breach of contract and are not entitled to compensation if they fail to comply with the terms of the contract in the course of rendering professional services. Breach of contract, like a negligence claim, is founded on the

accountant's failure to carry out a duty. In the absence of a written or oral contract, the accountant's duty is often construed in sweeping terms to mean the performance of "all services pertaining to the client's financial affairs." In this instance, a finding by a court in the claimant's favor would broaden the intended range of the accountant's services and increase the likelihood of liability.

An engagement letter or client consultation that defines the professional services to be performed by an accountant will come under scrutiny while litigation is pending. The importance of having clear engagement letters that, unlike verbal contracts, memorialize the agreement between the parties for all engagements cannot be overemphasized. (The use of engagement letters as a defensive accounting practice is discussed in chapter 9.) However, practitioners should bear in mind that an engagement letter can rarely be used as an absolute defense because its effectiveness may be mitigated to some extent by a client's assertion that it was not read or understood, or by a practitioner's deviation from it as services to clients broadened.

◇ ***Example***

*An accountant is engaged to prepare a business client's income tax returns, but also bills the client for "accounting services" consisting of assisting the bookkeeper in reconciling the bank account and/or closing the books. The bookkeeper embezzles substantial sums from the employer, who sues the accountant, contending that he or she understood that the accountant was "supervising the work of the bookkeeper" and, as a result, should have discovered the defalcation.*

## Fraud

An accountant can be found liable for fraud if the claimant is successful in proving the following four elements:

1. The accountant made a representation regarding a material fact.
2. The representation was false and the accountant knew that it was false when it was made, or it was made recklessly and without reasonable grounds for believing its truth.
3. The representation was made by the accountant with the intent to induce the other party to do or refrain from doing some act.
4. The party relying upon the representation suffered damage or injury.

A claimant therefore must prove that an accountant made false statements of material fact that were known to be false with the intent to induce reliance by the other party. The claimant is not required to show that the accountant had a subjective intent to injure the claimant or that the accountant derived a profit from the wrongful act. Fraud claims can include alleged misrepresentations in financial statements, prospectuses, and income tax returns.

## Negligence

Accountants can be found liable for negligence when it is determined that they failed to render professional services with the degree of skill or knowledge exercised by other professionals performing like or similar services. Depending on the issues presented by the claim, expert testimony may be used to prove the accountant's departure from the professional practices prevailing in the community. The role of expert testimony is discussed in chapter 17.

A claimant's success in recovering for malpractice against an accountant is premised upon proving the existence of the following four elements: duty, breach of duty, proximate cause, and damages. A claimant's

failure to prove *any one of the four* elements of negligence could result in a finding of no liability.

**Duty.** An accountant agrees to use the judgment, skill, and diligence used by other practitioners in the community—that is, the minimal standards prevailing in the accounting community. *Due care* is not interpreted to mean that an accountant is required to exercise extraordinary skill or provide services equal to the best in the profession.

**Breach of Duty.** Through expert testimony—for example, that of another CPA—a claimant must prove that the level of an accountant's services fell below that of other practitioners in the community. The only time when expert testimony may not be necessary is when an accountant's performance is obviously substandard and falls well below prevailing practices. For example: An accountant fails to prepare or file tax returns in a timely fashion when there are no extenuating circumstances.

**Proximate Cause.** Claimants must establish a connection between an accountant's departure from professional standards and their own loss. For example: The failure of the accountant from the example in this chapter to "supervise" the bookkeeper was at least part of the reason that the embezzlement occurred or was allowed to continue.

**Damages.** A claimant must have suffered an actual loss. Damages in cases of accounting malpractice take the following forms:

1. *Compensatory damages* are the direct results of wrongful conduct. Damages in this category include monies lost due to an accountant's negligence, and fines and

penalties assessed against a claimant by the IRS due to negligent tax advice.

2. *Consequential damages* arise from unique circumstances that are not generally expected by the parties. Damages in this category include mental anguish and injury to reputation. Recovering consequential damages in accounting malpractice litigation is difficult because of their speculative nature.
3. *Punitive damages* serve as a form of punishment of the defendant for wrongful conduct and are usually denied in the absence of compensatory damages. To successfully recover punitive damages, a claimant must prove that an accountant engaged in malicious conduct. Punitive damages are generally excluded from coverage under most accountants' malpractice policies. Most courts believe and state statutes provide that it is against public policy and not in the public interest to permit an insured to insure against a penalty. The intent of punitive damages is to punish the wrongdoer, and this intent would be frustrated if the wrongdoer could protect him- or herself from them by malpractice insurance.

Claimants are required to mitigate damages caused by an accountant's conduct. This duty applies to both clients and third parties.

Factors influencing a determination of negligence may include a fiduciary relationship between the parties and the statements accompanying an accountant's financial reports. Inasmuch as the prevailing judicial system requires a practitioner to comply with prevailing standards, such as those from the Financial Accounting Standards Board (FASB) and the Auditing Standards Board, they serve only as a minimum measure of competency. It is the accountant's burden to prove that he or she complied with these requirements

in the performance of an engagement when a claimant alleges negligence with the aid of the expert testimony of another accountant. Failing to successfully meet this burden of proof exposes an accountant to malpractice liability.

## Statute of Limitations

Each state has its own time period during which a party can file a lawsuit for various types of claims. This period usually depends on the type of claim. Although the statute of the appropriate state should be consulted before making any decision on this issue, the general rule is that the statute of limitations begins to run on a negligence or fraud lawsuit when the negligence or fraud was or should have been discovered. The statute begins to run on a breach of contract claim on the date of the breach. The statutes of limitations are generally shorter for oral contracts than they are for written contracts because, in the case of a written contract, documentation exists that can be used to jog memories. In the case of an oral contract, nothing prevails except memories, which often change with the passage of time, and it becomes difficult to determine the parties' intent when they originally executed the contract. Usually, the statute of limitations for oral contracts is two years and the statute of limitations for written contracts is five to six years. The party's failure to file a lawsuit during the specified time period bars a claim.

# CHAPTER 3

# The Increasing Risk of Litigation

No one would dispute that persons injured by the wrongful conduct of another should be compensated for the injuries they have sustained. However, the financial loss of a business is rarely the result of negligence by an accountant. Why, then, has there been an acceleration in accountants' malpractice litigation? The reasons run the entire spectrum. Some of the major ones are discussed in this chapter.

## Societal Attitudes

The accountant's role is vague in the public's mind, since much of what CPAs do is not fully understood. As professionals who record and analyze the financial condition of persons and entities, and whose work is relied upon by owners, investors, and government agencies, accountants are held to a high standard. In some situations, the public has come to believe that accountants are responsible for protecting its financial interests, even though no such responsibility is placed

on the profession. The proliferation of malpractice claims and the manner in which they are resolved are testaments to a continuing misunderstanding of the CPA's role in society.

Accordingly, the impetus for many lawsuits does not relate to an actual engagement agreement between an accountant and a client. Rather, it arises from the expectation gap, which consists of the difference between an accountant's actual responsibility and what this responsibility is perceived to be. For example, to the CPA, an unqualified audit report communicates to management that their financial statements are presented fairly and that they adhere to standard accounting principles. However, not only the general public but also the country's judicial system often have the mistaken impression that an audit serves as the accountant's personal guarantee of the financial health of an audited company. When financial difficulty is experienced, the accountant is often sued for not having alerted owners or investors to difficulties, even when little or no fault can be attributed to him or her.

## The American Legal System

The structure of our judicial system and the procedures followed in our courts, as discussed in the following seven sections, do much to facilitate the filing of claims and recovery by claimants.

### A Low-Cost Procedure

Individuals have little, if anything, to lose in bringing a claim against an accountant, other than their own legal expenses, the burden of which can be lessened by a contingency fee arrangement.

## Contingency Fees

The attorney's contingency fee structure provides claimants with the option of not having to make a substantial initial cash payment—or, sometimes, of making no payment at all—to the attorney at the start of litigation. Legal fees and expenses are paid at the time of settlement or judgment, if any, and the contingency fee is based upon a percentage of recovery, usually 33⅓ percent; however, it can rise as high as 50 percent if the claim proceeds to trial.

## The Privity Defense

The failure of a number of states to adopt the privity defense established in *Ultramares v. Touche* and affirmed in *Credit Alliance v. Arthur Andersen & Co.* has expanded the class of persons to whom the accountant potentially owes a duty. In those states adhering to its principles, the privity defense provides that when a relationship between parties is remote, there is no basis for legal liability. Inroads to the privity defense have enabled members of the general public who have no direct contact with an accountant to sue for professional negligence. This issue is discussed in greater detail in chapter 5.

## Tort Law

Trends in tort law have eroded traditional defenses—for example, contributory negligence—and have lowered standards of fault.

## Joint and Several Liability

The doctrine of joint and several liability has done much to convince the public that accountants are valuable sources of recovery regardless of the extent to which they are at fault. The doctrine was developed to protect

the financial interests of claimants and to spread the risk among defendants by allowing claimants to recover all or part of their damage award from any of the defendants found to have any responsibility for their loss. Unfortunately, it has resulted in grossly unfair economic burdens for some defendants who can be held liable for the negligence of others even if they were only minimally involved in a transaction.

According to this doctrine, recovery is not proportionate among defendants. It is not based upon relative degrees of fault; rather, it is premised upon a finding that a defendant accountant was at least partially responsible for the claimant's loss. Application of this rule can result in one partially liable defendant's being financially responsible for the entire cost of a judgment. For example, an accountant who is judged 1 percent responsible for a $3,000,000 loss could be held liable for the entire $3,000,000 if the claimant chooses to recover solely from the accountant.

Since accountants play a key role in the establishment, maintenance, and expansion of businesses or enterprises, there is an automatic tendency to name them as defendants when a business or enterprise fails. Since accountants are usually the only defendants who survive the financial collapse of a business or enterprise with any insurance or personal resources intact, they have been particularly hard hit by the doctrine of joint and several liability.

Responding to the detrimental effects of the application of joint and several liability, several jurisdictions have modified or abolished this doctrine.

Accountants involved in malpractice litigation pending in jurisdictions adhering to the doctrine of several liability, in which accountants are responsible only for the actual harm they cause, do not find themselves in the same legal quandary.

## RICO

The Racketeer Influenced and Corrupt Organizations Act, commonly referred to as RICO, has made it increasingly difficult to defend accountants involved in malpractice litigation. Originally drafted as part of the 1970 Organized Crime Control Act, RICO was designed to curtail organized crime's involvement in legitimate businesses. Despite its purpose of combating organized crime, RICO has often been used by private parties in civil litigation against legitimate businesses. These are parties for whom the act was never designed. When applied, it permits private persons to sue for treble damages and attorney's fees. Frequently, the mere possibility of treble damages causes the insurance company to recommend settlement, even in those claims in which liability is slim.

Because litigation emanating from business failures, unsuccessful investments, and fraudulent securities trading can be initiated under RICO's broadly drafted civil provisions, accountants can also be held accountable under this act. An accountant's involvement is usually premised upon a close relationship with an entity that has been accused of engaging in criminal conduct. Allegations of mail fraud may be premised upon an accountant's having sent financial statements and reports through the mail, while claims of securities fraud arise when an accountant recommends an investment. Because punitive damages are rarely insurable, the accountant can be held personally responsible for such recovery.

### Class Action Lawsuits

The prevalence of class action complaints, which combine all parties or a majority of the parties allegedly wronged by an accountant's actions, has

resulted in prohibitively large settlements and judgments. Liberal court interpretations of claims have exacerbated this problem. Therefore defendants often agree to a settlement to avoid the formidable expense and possibly devastating judgment of a class action trial.

### Consequences of Expanded Liability

The seven preceding developments, which have become intrinsic parts of our legal system, reflect an increasingly litigious society whose members seek legal redress for virtually any harm they suffer. Society has become more confrontational; the prevailing litigation explosion affects not only accountants, but everyone. Using litigation to redress a presumed harm has become more acceptable, and this acceptance encourages more litigation.

## Litigious Public

Since the start of the twentieth century, tort litigation has evolved into a system of liability in which fault is often a nominal issue, persons expect to be compensated for all losses, and awards are far greater than could have been predicted. No one would dispute the fact that accountants should render high-quality services and be held accountable to parties for losses sustained as a direct result of the accountants' negligence. However, when practitioners' professional duty is extended to a broadening class of persons, when settlements and judgments are paid in disproportionate amounts exceeding actual damages and having no relationship to fault, and when the accountants are exposed to potentially limitless liability, their ability to practice and make a meaningful contribution to the economy becomes seriously constrained.

The American philosophy of "sue when dissatisfied" has resulted in this country's becoming the most litigious society in the world. According to the Council on Competitiveness, lawsuits filed in United States federal courts have nearly tripled in the past thirty years, and in 1990 there were 251,113 cases pending in U.S. federal district court. Moreover, according to the American Bar Association, there are almost 800,000 licensed lawyers in the United States—one attorney for every 300 Americans. This country's law schools have been successful in turning out attorneys who are ambitious, imaginative, and more than willing to apply their knowledge and experience to creating new theories of recovery. The following examples illustrate the radical nature of this dangerous trend:

- Students suing their schools for providing a substandard education
- Children suing their parents for an improper upbringing
- Consumers suing manufacturers for even the slightest defect in a product

Accidents are no longer seen as unfortunate occurrences but rather as opportunities to win the legal lottery. It seems that the expression "Let's sue" has become the standard by which the public lives.

Although an accountant may never be sued for malpractice, statistics show that many will be. 1990 statistics provided by Crum and Forster indicate that one out of every thirteen CPA firms insured under the AICPA Professional Liability Insurance Plan were the subject of a malpractice claim. Accountants have become targets of litigation largely because they often have professional liability insurance, and therefore are thought to have "deep pockets" and to represent a likely source of recovery. The accountant's vulnerability to malpractice

claims is exacerbated by the doctrine of joint and several liability.

Accountants' increasing vulnerability to litigation is demonstrated by statistics furnished by the AICPA Professional Liability Insurance Plan and summarized in the following table. Although the raw data indicate a decline in the number of claims, a closer analysis shows a steep rise in the *proportion* of claims (expressed as the number of claims per thousand policies), from a low of forty in 1984 to a high of seventy-three in 1987. And while the actual number of claims filed in 1990, 618, represents a nominal increase when compared to the 600 filed in 1984, the proportion—sixty-two—remains stubbornly high.

| YEAR | NUMBER OF POLICIES | NUMBER OF CLAIMS | NUMBER OF CLAIMS PER THOUSAND POLICIES |
|---|---|---|---|
| 1984 | 15,000 | 600 | 40 |
| 1985 | 13–14,000 | 900 | 64–69 |
| 1986 | 10,000 | 600 | 60 |
| 1987 | 9,000 | 658 | 73 |
| 1988 | 8,700 | 573 | 66 |
| 1989 | 10,000 | 713 | 71 |
| 1990 | 10,000 | 618 | 62 |

Lawsuits against accountants insured by the AICPA plan are averaging more than one per day, and as attorneys become even more knowledgeable about professional liability claims, this trend is likely to continue. The increase in litigation is exacerbated by media coverage of these claims, which further encourages members of the general public to sue. This situation could create the same crisis in the field of accounting that now exists in the medical and business

communities. Physicians are turning increasingly to health maintenance organizations (HMOs) and principals of corporations are declining once-prized positions as directors because they fear that claimants using the judicial system could tap their personal assets.

However, there is some cause for hope. Beginning in the late 1980s, some courts became more sensitive to the abuses in the legal system and began invoking sanctions against those initiating frivolous litigation. Although the instances of sanctions have been rare, it is a favorable development.

## Business Failures

The fragile state of the economy since the late 1980s, which has been characterized by the savings and loan failures, a depressed real estate market, and insolvencies in the brokerage industry, has fueled the rise in litigation against accountants and has created a volatile work environment. As inflation continues, unemployment rises, and business failures mount, accountants will become more vulnerable to claims brought by owners, investors, and creditors of large and small businesses acting upon the mere appearance of professional negligence.

People who suffer damages are constantly searching for ways to recoup their financial loss, obtain much-needed cash, or appease their own sense of failure for errors in business judgment. Because accountants play a prominent role in the structuring, maintenance, and expansion of businesses, parties suffering a loss look to the accountant to make them financially whole. Moreover, judges and juries are more likely to hold accountants liable for losses associated with business failures because they believe that the accountant can best prevent business losses.

A related issue concerns the increased competition among practitioners for clients. Although competition is a given in any economic climate, it is most pronounced during periods of poor economic performance. Responses to heightened competition include lowering fees and expanding services, sometimes to areas beyond the accountant's expertise. Maintaining quality control while remaining competitive is a constant challenge for firms.

## Practice Growth

Accountants are entering new fields, such as personal financial planning (PFP), litigation support, business valuation, disaster recovery, and computer hardware and software support. As accountants expand their scope of professional services, they also expand the range of possible claims. Moreover, the increased complexity of transactions, statutes, and standards further makes malpractice an all-too-real possibility.

# CHAPTER 4

# The Costs of Litigation

Malpractice litigation can be an emotionally painful, financially draining, and protracted experience that imposes a tremendous hardship on practitioners even when they prevail. The three types of costs that a practitioner incurs when involved in malpractice litigation are set forth in the following sections.

## Indemnity—Settlements and Judgments

As the frequency of claims and the exposure to liability increase, so does the severity of claims. This may be attributed to the growing value and sophistication of firm engagements and the effect of inflation on the valuing of settlements and judgments. Whatever the cause, multimillion dollar losses are occurring with greater frequency, and they are not restricted to large firms.

Moreover, statutes (such as RICO and the Consumer Protection Acts) and court decisions have made the possibility of incurring treble damages a very real concern for accountants.

## Legal Expenses

Defense costs for accountants' malpractice litigation can be enormous. They tend to be higher than those incurred by others involved in civil litigation because of the extensive use of expert witnesses, the need for extended hours of research, and lengthy trial preparation and actual trial time when cases are complex. A skilled plaintiff's attorney can cause the accountant to incur exorbitant legal fees by prolonging discovery (the process by which relevant information is obtained before trial), which may occur even if a claim is meritless. Too frequently, this situation forces an accountant to settle a case to cap defense costs, which may have the undesirable effect of encouraging others to initiate litigation against accountants even when there is no legitimacy to a claim. Defense costs can range from a few thousand dollars for a straightforward tax claim to millions of dollars for a claim dealing with an audit of a failed financial institution.

## Personal Cost

Professional liability insurance pays for all covered damages and defense costs up to the limit of liability. However, the accountant will first be required to pay the policy's deductible as well as indemnity dollars for all allegations that are not covered. Defending oneself against real or threatened litigation results in an enormous amount of lost billable time, especially when senior management is involved. This has a detrimental effect on profits, regardless of the size of the firm; however, the effect is felt most severely by small and medium-sized firms. Most large accounting firms have attorneys on staff who are specially trained in malpractice defense. They are experts in accountants' malpractice and their specialty encompasses insurance

considerations and procedures. The time spent in the defense of a malpractice claim will draw significantly from the billable hours of a small firm, which usually does not possess the resources or expertise needed for effective risk management and claims supervision.

Other consequences of malpractice claims may include—

- The impairment of concentration.
- A sense of failure—an erosion in one's personal and professional confidence.
- Damage to reputation.
- Loss of clients.

# CHAPTER 5
## Liability to Third Parties

Traditionally, the accountant owed a duty of care only to clients. However, accountants are now becoming more susceptible to an additional risk: the possibility that claims will be brought not only by clients but also by nonclient third parties, particularly by creditors, banks, investors, customers, and suppliers who claim reliance on financial statements that were provided to them by an accountant's client. Despite the fact that 1991 statistics from the AICPA Professional Liability Insurance Plan indicate that 10 percent of malpractice claims against accountants are brought by third parties, these claims are increasing at an alarming rate and have more than doubled since 1988.

This increase in claims may be partially attributed to the technically sophisticated transactions in which practitioners become involved when rendering professional services. It is now quite common for small and medium-sized firms to perform audits and provide professional advice in connection with securities offerings involving millions of dollars, and for clients to distribute their accountant's work product—such as audited financial statements, registration statements for a publicly registered offering, and private placement memoranda—to banks for loans, to prospective

investors for investment financing, and to suppliers for lines of credit.

When a client subsequently goes bankrupt, liquidates, or experiences other financial problems that prevent it from honoring its financial obligations to a nonclient third party, the client's accountant becomes a target. The accountant expressed his or her opinion on whether the financial statements present fairly, in all material respects, the financial position of the company and its operations and cash flow for the year then ending in conformity with generally accepted accounting principles. The auditor, in the audit report, also states that the audit was conducted in accordance with generally accepted auditing standards. The nonclient third party may then claim that it relied on the financial statements when evaluating the financial stability of the enterprise and its ability to repay financing.

An accountant's liability to third parties is seen within the context of what is usually referred to as privity. Under privity, an accountant's duty of care to clients is based upon a contractual relationship. It is universally accepted by practitioners and recognized by the courts that accountants have a duty to render services to their clients in good faith, without fraud, and in a fashion consistent with the degree of skill and judgment exercised by other accountants in a particular locality and in accordance with accepted professional standards. Practitioners are liable to a client when this duty is breached, and clients have traditionally been successful when suing accountants on such grounds.

When third-party claims are based on negligence, however, the majority of courts impose liability only after finding a relationship between an accountant and a nonclient third party. But how far does this legal duty extend to nonclients with whom an accountant has no contractual relationship? Can these third parties recover for losses sustained when they relied to their detriment on an accountant's work product?

In those states that have addressed the issue of the accountant's liability to nonclient third parties, the law is clear. However, the laws governing this issue are not uniform among the states, and in those states where third-party liability has not been addressed, the law is unclear. Three different standards have been developed and applied by the courts. The uncertainty created by differing standards and the lack of an established standard in those states that have not addressed the issue has created a sense of urgency among practitioners. With a basic understanding of developments in the law of accountants' liability for negligence to third parties, practitioners can establish appropriate relationships with both clients and nonclients. This chapter will examine these developments, discuss their impact on practitioners, and analyze the trends they have set for the future.

## The Three Measures of Liability

Standards pertaining to an accountant's liability to nonclient third parties can be categorized in the three following groups: Privity, Restatement Rule, and the Reasonably Foreseeable Standard. Each state chooses from among the three standards.

### Privity

This standard holds that an accountant owes a duty of care and is liable for professional negligence only to those who are a part of the accountant-client relationship, and to those who the accountant knows will be using his or her work product. Therefore, nonclient third parties who rely to their detriment on an accountant's negligently prepared work product cannot recover under the privity standard because they are not part of the direct contractual relationship between the accountant and client. Recovery is premised upon a

finding of privity between the parties or a relationship so close as to approach privity. Accountants' liability for negligence is not defined by users of their work product but by the boundaries of the contract.

◇ ***Example 1***

*An accountant was retained by a client to perform an audit of the client's business operations. A bank relying upon the audit reports provided the client with financing. The accountant did not know that the claimant bank would be using the reports in making financing decisions. The client filed bankruptcy and was unable to honor the terms of the loan, resulting in a loss to the bank. Even if successful in proving that the accountant was negligent in performing the audit and in preparing the audit report, the bank would be barred from recovery against the accountant under the privity standard because of the absence of privity or its equivalent with the accountant.*

An accountant is liable to nonclient third parties despite the lack of privity or its equivalent if he or she intentionally commits fraud in the course of providing professional services. Moreover, an inference of fraud *may* be made from grossly negligent conduct. Thus, in example 1, the bank could recover from the accountant if the audit was tainted by fraud.

The landmark case upon which the privity standard is based, and the first approach by the courts to accountants' liability to third parties for negligence, is the 1931 New York Court of Appeals case *Ultramares v. Touche.* This case articulated the privity position by holding that an auditor was not liable for negligence to third parties who are not in privity of contract with the auditor. However, liability can be found for fraud. In *Ultramares,* the court made a finding of no liability for an accountant who overvalued a company's assets by negligently preparing an audited balance sheet upon which a lender relied when loaning money to the clients. Shortly after receiving the loans, the client filed for bankruptcy and the lender sued the accountant

to recover the unpaid loan. As the error was made without fraud, the court limited liability to the parties to the contract.

The court directed much of its attention to the potential exposure that would result if a contrary decision was reached. The court's reasoning in *Ultramares* continues to be cited for support by those who advocate the privity standard. A finding for the lender and the application of a nonprivity standard would unreasonably burden the accounting profession because it is foreseeable that financial reports prepared by an accountant may be relied upon by others. The extent of an accountant's potential liability would greatly exceed the extent of fault, thereby imposing a tremendous hardship on the profession. These sentiments, and practitioners' worst fears, were succinctly captured by Justice Cardozo when he held that "if liability for third-party negligence exists, a thoughtless slip or blunder, the failure to detect theft or forgery beneath the cover of deceptive entries may expose accountants to liability in an indeterminate amount for an indeterminate time to an indeterminate class."

In a 1985 opinion, the New York Court of Appeals had an occasion to revisit the privity standard in *Credit Alliance v. Arthur Andersen & Co.* The court reaffirmed its privity or equivalent standard as enunciated in *Ultramares,* thereby providing the profession with further encouragement. *Credit Alliance* serves as a major victory and represents a favorable trend for practitioners everywhere. The accounting firm at issue had prepared for its client audited financial statements that were subsequently submitted to a lender to secure a loan. Relying on the statements, the lender issued a loan to the client. The same statements were used again to obtain additional financing. When the client subsequently filed for bankruptcy and was unable to comply with the repayment terms of the loan, the lender sued the accountant for negligence for overstating the client's

net worth. Moreover, the accounting firm made direct oral reports to the lender attesting to the client's finances at a meeting of the client's board of directors and indicated that the lender had relied solely on these reports in setting the amount of the loan that the lender made to the client.

The court's finding, which was similar to *Ultramares*, made clear the conditions under which the standards established by *Ultramares* would apply. Before noncontractual third parties can recover from accountants for negligence, they must prove that—

1. The accountant was aware that the financial reports were to be used for a specific purpose.
2. The accountant knew the claimant's identity and that the claimant intended to rely on the reports for that purpose.
3. The accountant indicated, by conduct or by verbal or written communication, that he or she understood this reliance through contact with the third party.

*Credit Alliance* therefore supports the privity standard, as stated in *Ultramares*, that bars nonclient third parties from recovery in negligence claims unless they are in privity or in a relationship so close as to approach that of privity. However, by satisfying the three criteria discussed above, a nonclient third party will fall within the second category.

Further encouragement for practitioners came as a result of the 1988 decision by the Appellate Division of the New York Court of Appeals in *Mann Judd Landau v. William Iselin & Co.* In *Mann Judd*, an accountant mailed a review report prepared by the accountant to a nonclient third party at the client's request for an unknown purpose. The court applied the three-pronged test established by *Credit Alliance* and found for the accountant. The court's reasoning was that because the accountant did not know the particular person to whom

the report would be provided or the specific purpose for which it would be used, the accountant was not liable to the nonclient third party. The significance of this case is its application of the *Credit Alliance* privity standard to review reports.

*Ultramares, Credit Alliance,* and *Mann Judd* clarify the law and conditions under which third parties can bring negligence claims against accountants.

Despite the long-standing rule of law that only persons in privity can recover against an accountant on a negligence theory and that others must prove fraud, during the period of social reform of the 1960s and continuing throughout the 1970s and 1980s, a movement was underway to expand the accountant's liability for professional negligence to include third parties whose reliance on his or her work product could reasonably have been foreseen by the accountant.

The first American deviation from the privity standard came in 1968 when a federal district court in *Rusch Factors, Inc. v. Levin* followed the *Restatement (Second) of Torts* (Philadelphia: American Law Institute) and extended an accountant's duty of care to an actually foreseen class of persons. The gradual erosion of the privity defense, as exemplified by the creation of the following two standards, and the confusion of the courts in differentiating between them have contributed to some extent to the current malpractice dilemma because they open up an entirely new class of potential claimants.

## Restatement Rule

The American Law Institute develops codifications of existing law and has included in section 552 of its *Restatement (Second) of Torts* a rule expanding accountants' liability to a class of persons beyond those in privity or near-privity relationships with an accountant but limits it to the "foreseeable class" of persons who receive an accountant's work product. The

foreseeable class consists of parties to whom the accountant knows the financial information will be given, or parties who are members of a limited class of persons to whom the accountant knows the financial information will be given. Nonclient recovery under this rule is not premised upon the accountant's specific knowledge of the specific purpose for which the specific third party would rely on the financial statements. Rather, recovery is limited to the group of persons whose reliance is actually foreseen by the accountant. The nonclients' burden consists only of proving that they are within the limited class of persons whom the accountant knew would be receiving his or her work product. This rule applies whether the accountant's work product is supplied to the third party by the client or the accountant; however, when the accountant's work product is provided by the client, the accountant must know of the client's intent to do so. Critics of this standard argue that there is no requirement that the accountant have acknowledged the third party relying on the financial statements.

◊ ***Example 2***

*An accountant may be liable to investors who receive and rely on negligently prepared financial information even though the investors are not identified to the accountant. It is enough that the accountant is informed of the intention to supply the financial information to investors to raise capital. The financial information needs only to be supplied in a transaction that the accountant intends the information to influence.*

## The Reasonably Foreseeable Standard

This liberal foreseeability standard, which has long been a part of common law, ignores the privity concept and holds an accountant liable to any person or group whose reliance on the financial statements could reasonably have been foreseen by the accountant. As the most expansive theory of recovery, it allows any

party who is a reasonably foreseeable beneficiary of an accountant's services to recover for professional negligence from the accountant. The effect of this standard is that the class of potential nonclient claimants is practically limitless. Nonclient third parties will prevail against an accountant for negligence so long as they were reasonably foreseeable users of financial statements prepared by the accountant for a legitimate business purpose. Claimants need not prove that an accountant either knew their identity or was aware that they would receive the financial statements. The difference between this standard and that set forth in the *Restatement* is that the *Restatement* requires actual knowledge of an intended party's reliance on statements, while the reasonably foreseeable standard merely calls for the ability to foresee that someone in a definable group is likely to rely on financial information.

Those who support the reasonably forseeable standard argue that professional liability insurance and more stringent accounting standards protect an accountant from possible abuses of the standard. They also claim that the accounting profession as a whole is better able to absorb a loss resulting from professional negligence than third parties who relied in good faith on the accountant's work product in making financial decisions.

Commentators critical of this standard argue that this reasoning imposes a duty on practitioners to purchase professional liability insurance—a duty that should not be mandated by the courts—and that a high price is exacted from the profession by contributing to the escalation in malpractice claims. This situation results in higher premiums, reductions in the amount and availability of malpractice coverage, an increase in the number of practitioners going bare, increased fees, and a reduction or termination in services.

## A Look Toward the Future

This chapter has shown that since the 1930s, there has been substantial litigation on the issue of accountant's liability to nonclient third parties for negligence, and that the accountant's professional responsibility has been expanded in some states beyond that articulated in *Ultramares*. Each of the three standards that have evolved has its own particular nuances and has a significant impact on an accountant's liability for negligence. *Ultramares* and *Credit Alliance*, the prevailing standards in the majority of states, limit claimants in lawsuits for negligence to those in privity or in an equivalent relationship, thereby creating a formidable obstacle to third parties' attempts to recover against the accountant. The *Restatement* standard expands the class to encompass third parties whose reliance was actually foreseen by the accountant. The final, most sweeping standard enables all reasonably foreseeable third parties to recover against an accountant for negligence.

It is crucial for practitioners, particularly those practicing near state borders, to understand the standard adopted not only by the state in which they practice but in all states encompassed and affected by their practices, because they could be sued in the state(s) in which they live, in which they practice, in which they contract for an engagement, and in which their clients are located. With today's sophisticated engagements and the unpredictable extent of third-party liability, practitioners can no longer be certain that their practices are restricted to one state. The standards followed by each state are subject to change as the courts refine them for consistency with subsequent decisions. However there are some states—for example, New York—that have ruled so consistently on the issue that change is not anticipated.

Despite the existence of differing measures for third-party liability, the accounting profession is winning the

battle with a gradual constriction in the ability of third parties to sue accountants for negligence. Although some states adhere to a standard of expanded liability for accountants, most states that have addressed this issue for the first time are following either the *Restatement* rule or *Credit Alliance.* (Still, practitioners should continue to establish and adhere to defensive accounting practices, which are an integral part of practice management.)

The courts and others upholding the privity standard or its equivalent have done so to avoid widespread liability for accountants. Those advocating expanded liability are under the mistaken impression that accountants can offset damages paid by raising fees, obtaining insurance coverage, or increasing coverage limits. However, consideration is not being given to the intense competition for clients that makes practitioners reluctant to raise their fees, or to the fact that as claims increase, and as insurance companies pay larger damage awards, insurance coverage will become less available and more expensive. Moreover, more practitioners will be hesitant to expand services and their client base. This may ultimately result in the exodus of many talented accountants from the profession.

Advocates of expanded liability claim that *Ultramares* is overly restrictive, arguing that the risk of loss arising from negligence is less easily borne by an unsuspecting creditor or investor, and that the threat of liability will encourage accountants to practice with a heightened degree of care. However, there is no guarantee that expanded liability will improve the quality of professional services. Ultimately, increased insurance costs will be passed along to clients, resulting in the possibility that those parties who advocate expanded liability may not obtain the anticipated benefits.

The American judicial system enables each state to choose its own position on this issue. Although the inconsistency among states may be frustrating, and

despite the fact that a minority of states are turning to an expanded scope of liability, the affirmation in 1985 of the traditional privity standard by the court in *Credit Alliance* and tort reforms by state legislatures can be interpreted as an ebbing in the tide of twenty years of litigation. Positive signs have thus emerged for today's and tomorrow's practitioners: The standard of *Ultramares* and *Credit Alliance* is alive, and there has been a return to more conservative concepts of limiting accountants' liability to third parties. Because accountants' liability to third parties is still in a state of flux, accountants should contact their attorney upon receipt of reliance letters or other communications from nonclient third parties.

# CHAPTER 6

# Insurance Coverage: Cost and Availability

Accompanying the escalation of claims and the expansion of liability has been a dramatic increase in the cost of malpractice insurance premiums, despite a resurgence in the availability of coverage. In the mid-1970s, practitioners were able to obtain malpractice coverage that was reasonably priced and readily available. However, like many other industries, insurance is cyclical and reactive. In 1984, as malpractice claims mounted against accountants—there was a 50 percent increase in claims from 1984 to 1985—and as losses ran 200 to 300 percent of premiums, professional liability insurers experienced the worst underwriting year in their history. Many carriers—including a significant number sponsored by state CPA societies—went out of business because of excessive claims or discontinued the line of coverage, thereby shrinking the pool of insurers.

In 1985 and 1986, those carriers remaining in the market increased their premiums, some by 400 to 1000 percent; raised deductibles; imposed stricter criteria in choosing their policyholders; and narrowed the scope of coverage. By the end of 1985, the number of carriers offering malpractice insurance coverage had dropped

to three. In 1991 the cost of premiums consumed up to 2 percent of a firm's total income from fees. The insurance crisis was not unique to American practitioners; it was a worldwide crisis that affected anyone who needed to purchase insurance.

Particularly hard-hit by high premiums and decreased coverage were the small and medium-sized firms. They believed that they were unable to afford malpractice insurance and became hesitant to expand their services and client base for fear of legal exposure. Those firms, regardless of their size, with a disproportionate share of clients or engagements considered to be high risk (see the discussion of high-risk engagements in chapter 11) or with a history of claims were denied coverage by some carriers. Some practitioners reacted to the situation by paying higher premiums and reducing or eliminating coverage. Others raised fees and rejected high-risk clients and engagements.

Traditionally, accountants have always welcomed newly formed enterprises as clients. Now, practitioners must scrutinize the capitalization and management of an enterprise before adding it to their client base. Accountants recognize that this may at times be unfair to a prospective client, but it is dictated by the prevailing malpractice crisis. Even more established firms that have chosen to maintain their level of services may, because of higher premium expenses, be unable to hire additional staff to meet the demand for new services. This situation detracts from the profession's entrepreneurial and innovative spirit, which is vital to the growth of the economy and the profession itself. Had this condition existed in the 1970s, it is possible that this country would not have witnessed such phenomenal growth in the fields of high technology, medicine, and financial services.

The reason for the rise in malpractice premiums, and the attendant shrinkage in its availability, is the increasing value of claims. Reinsurers (insurance

companies that provide insurance to insurers) determined that the accountants' line of coverage was unprofitable and refused to renew contracts with carriers unless premiums and deductibles were increased and coverage was restricted through new exclusions. Moreover, insurance companies had to increase their loss reserves in proportion to the increase in claims. Reserves were funded by higher premiums. Insurance companies recognize practitioners' concerns about the cost and availability of coverage, but they too are in an unenviable position. The insurance companies' approach to underwriting and claim management is to identify where the risk lies and charge a premium that will allow payment of the loss. However, the major impediment that prevents an insurance company from establishing a stable premium rate is the unpredictable nature of future claims. Like other businesses, insurance companies base the price for their product—the premium for coverage—on the cost of the product. When there is no established method to measure the increasing value of claims and there is no uniform standard of measuring liability, it becomes more difficult for insurance companies to arrive at predictable premium costs.

By 1987, after three years of increasing malpractice insurance premiums, some degree of stability appeared to emerge. Insurers gradually began reentering the market. In 1991, there were approximately twenty carriers providing malpractice coverage, as compared to eleven in 1987, and the period of skyrocketing premiums appeared to be over, at least temporarily. The availability of accountants' malpractice insurance is best expressed by the following table that identifies the number of carriers offering such coverage since 1984.

| *AT YEAR END* | *NUMBER OF CARRIERS* |
|---|---|
| *1984* | *10* |
| *1985* | *3* |
| *1986* | *4* |
| *1987* | *11* |
| *1988* | *21* |
| *1989* | *23* |
| *1990* | *18* |
| *1991* | *20** |

**Approximation*

Some insurers are increasing their limits of coverage and providing what is termed quality coverage to eligible accountants. The AICPA Professional Liability Insurance Plan had a 7 percent decrease in premium rates for 1990 and a 20 percent decrease in 1991. Although coverage may be more available and less expensive, a return to the pre-1983 rate is not expected.

→ CHAPTER 7

# Practicing Without Protection

Accountants, with manufacturers, contractors, managers of municipalities, and other professionals, are caught in a whirlwind of civil litigation that appears to be spinning out of control. From impeding the production and sale to the public of needed goods and services to restricting the use of public parks and facilities, the prevailing litigation explosion has a significant influence on how we live. Small firms, often lacking the resources and staff to absorb malpractice losses, have been the hardest hit, and many may contemplate taking drastic measures, such as forgoing malpractice insurance, at a time when they can least afford to do so—during the country's most litigious period.

The prospect of forgoing malpractice insurance may have appeared to be less of a risk before the litigation explosion, when client relations were much different than they are now. Back then, if an accountant made an error, the error was acknowledged and a way of compensating the client for the error was worked out between the accountant and the client. Even today, firms that have a record of providing high-quality

service may still retain client loyalty when an error occurs. But in these litigious times, client loyalty cannot be counted on to the extent it once was.

Due to the still-high cost of coverage (although rates are lower than they were in the period from 1984 to 1986), high deductibles, and in some situations less favorable policy terms, a number of firms are indeed forgoing professional liability insurance coverage. This is the worst possible approach practitioners can take. During litigious times, accountants should not be reducing or limiting coverage; rather, they should be *evaluating* existing coverage, *increasing* it if necessary, and *obtaining* it if they are currently uninsured.

An accountant's decision to practice without the protection of malpractice insurance is inconsistent with his or her approach to safeguarding other assets. Few practitioners would forgo fire and theft insurance for their home, office, and jewelry, or first- and third-party liability insurance for their automobile. Yet, many practitioners jeopardize their professional reputation and financial security by failing to insure their most valuable asset, their accounting practice, against malpractice claims. The following table sets forth some reasons used by practitioners for not purchasing professional liability insurance.

| *MYTH* | *REALITY* |
|---|---|
| *Malpractice insurance is too expensive. Its cost outweighs its benefits. Defense costs and indemnification can be paid by the firm.* | *Under the AICPA Professional Liability Insurance Plan, premiums for 1991 are 26 percent lower than they were in 1989. It is not unusual for defense costs to equal a minimal deductible of $10,000 to $15,000 for a straightforward claim. If more complex issues are involved in the claim, defense costs can easily exceed $1,000,000, and settlements* |

*(Continued on next page.)*

| *MYTH* | *REALITY* |
|---|---|
| | *can exhaust the limit of available coverage and involve the accountant's personal assets. The cost of malpractice insurance is far less costly than defending and indemnifying an uninsured claim and risking irreparable damage to your reputation.* |
| *Malpractice insurance is unavailable.* | *There are now approximately twenty insurance carriers offering professional liability insurance, up from three in 1985.* |
| *Malpractice insurance is needed only by large firms involved in high-risk engagements.* | *Under the AICPA Professional Liability Insurance Plan, the vast majority of the claims reported in 1990 were brought against small and medium-sized firms and 65 percent of all claims emanated from tax and review and compilation engagements. Moreover, in 1990, more than $20 million was paid or reserved for settlements and judgments for these claims. Statistics provided by Crum and Forster indicate that the majority of uninsured services are in these areas (that is, tax and accounting services). The profile of the CPA who is at greatest risk is not one performing traditionally high-risk engagements, but any accountant practicing without the protection of professional liability insurance.* |
| *I restrict my practice to specialized engagements in which I have utmost competence and total control.* | *Regardless of the quality of work, there is no criteria that must be met by the claimant before a malpractice claim can be brought. Even if a practitioner could guarantee fault-free work, a claimant could still assert a claim, resulting in the practitioner's incurring legal expenses and possible payment of a settlement or judgment.* |

| *MYTH* | *REALITY* |
| --- | --- |
| *With malpractice insurance in force, I will be perceived as having deep pockets by potential claimants.* | *Dissatisfied clients and third parties do not give preferential treatment to anyone when they are intent on suing for damages. Uninsured accountants are equally at risk of malpractice litigation and are personally responsible for defense costs, settlements, and judgments.* |
| *Should the value of the settlement or judgment of an uninsured claim be beyond the firm's and my own assets, I can file for bankruptcy.* | *Filing for bankruptcy has dire personal and professional consequences that can remain with the practitioner for life. In addition to damaging the accountant's personal and professional reputation, filing for bankruptcy bars the accountant from resorting to this remedy for seven years, results in difficulty in raising capital, and adversely affects credit rating.* |
| *A malpractice claim is an unlikely possibility.* | *1990 statistics provided by Crum and Forster indicate that one out of every thirteen CPA firms insured under the AICPA Professional Liability Insurance Plan were the subject of a malpractice claim. Moreover, the discussion in chapter 3 indicates that the prevalence of malpractice claims is likely to increase in the future.* |

It is easy to understand why some practitioners hold to such myths. Usually, only large firms performing high-risk engagements become the subjects of commentary by the mass media. It is only logical that practitioners would use information regularly placed before them in formulating their personal and professional opinions. By analyzing factually supported statistics that are drawn from members of the profession and that are available from state CPA societies and professional liability insurance carriers, accountants can learn the truth behind the liability crisis.

The defense and payment of an uninsured claim, whether it is with or without merit, can be devastating to an accountant. It can literally obliterate a lifetime of hard work, dedication, and effort. Financing an uninsured claim can result in the loss of a practice, since few accountants have the assets to fund their own defense and indemnify a prevailing claimant. This situation may then result in an inability to pay creditors, the clients' loss of their accountant, and the unemployment of the staff. Sole practitioners and partners, whose liability is limitless, need malpractice liability insurance the most, and without it they are placing their assets in jeopardy.

The liability of accountants and their employees differs when they practice as partnerships than when they practice as professional corporations, and the treatment of some issues may vary among the states. Under the partnership form of practice, each partner is jointly and severally liable for the debts, obligations, and wrongful acts committed in the course of partnership business, and for the misappropriation of property owned by third persons. Under the Uniform Partnership Act (UPA), the liability of a new partner for pre-existing claims is limited to partnership property. If necessary, the assets of a partnership, partners, or both can be attached. This rule applies regardless of the extent of a given partner's interest in the partnership or involvement in the transaction from which the liability arose.

Professional corporation status typically provides that when accountants practice as professional corporations, the corporation is liable to the extent of its assets for all claims of creditors, including claims for the negligence of its employees. Shareholders are not personally liable for the acts, contracts, or obligations of a corporation, its employees, or agents. However, personal liability attaches to the shareholder for the professional work that the shareholder personally

performs or supervises and to the employee performing the work. Employees can always be sued for their work even though it is supervised by a shareholder.

The costs of malpractice litigation exact a tremendous toll on every practitioner; however, the cost of an insured claim pales by comparison to that of an uninsured claim. Practitioners involved in malpractice litigation who formerly believed they could not afford professional liability insurance now know that they cannot afford *not* to have professional liability insurance.

A profession's recognition of the malpractice crisis can be measured by the extent to which its members acquire professional liability insurance. According to a recent AICPA survey of 40,000 practice units, 44 percent of accountants have no professional liability insurance—that is, they are bare. However, some commentators believe that, excluding the Big Six, more than 50 percent of accountants are uninsured, and some state CPA societies (for example, those in California and Kentucky) report even higher percentages of uninsured practitioners. Survey data on this issue may also be overly optimistic because some accountants may be reluctant to admit that they are practicing without insurance. One hopes that, with continued awareness of the malpractice crisis, heightened sensitivity to trends within the insurance industry, increased availability of coverage, more favorable policy terms, and decreased premiums, the percentage of uninsured practitioners will fall. If it does, more widespread malpractice insurance coverage will not only do much to avoid the financial disaster for uninsured practitioners, but it will also expand the pool of insurance premiums, thereby decreasing insurance rates for all insured practitioners.

A positive trend has emerged. Practitioners are becoming more aware of the prevailing crisis and consider malpractice insurance to be a vital aspect of practice management. Accountants are joining the

ranks of other professionals who cannot conceive of practicing their chosen profession without malpractice insurance. Accountants should view professional liability insurance not as an additional expense for their firm, but as protection for their greatest asset and the product of their life's work.

# SECTION II

# DEFENSIVE ACCOUNTING PRACTICES

# CHAPTER 8

# Defensive Accounting Practices

In the past, with a less litigious society, few practitioners felt the need to adopt and implement procedures that would protect them from clients' malpractice claims. However, with malpractice lawsuits mounting against accountants, recoveries reaching multimillion-dollar levels (particularly after the savings and loan debacle), formidable insurance costs, and the likelihood of the awarding of some type of recovery when a claim is brought, practitioners are now aware that certain acts or omissions on their part can give rise to malpractice liability. They are becoming better educated in theories of recovery and more informed of defensive measures. And they are increasingly approaching engagements as if they were ultimately going to court.

The cost of mounting a defense, beginning with a preliminary investigation and the filing of a lawsuit and continuing through discovery and trial or settlement, averages $44,000, a figure that would be even higher if the unquantifiable losses were included. Practitioners know that although these costs may be covered by professional liability insurance (usually after a deductible

has been exhausted), claims are likely to lead ultimately to higher deductibles, higher premiums, and, perhaps, difficulty in obtaining coverage in the future. How can accountants avoid these problems? One way is to implement and adhere to an effective defensive-practices program. Doing so may not only decrease accountants' chances of being sued by clients and third parties while bolstering their defense, but it may also increase their firm's profits.

This section offers specific techniques for lowering or transferring the risk of malpractice liability. It also identifies general criteria for evaluating a firm's existing program of defensive management and provides guidance on developing such a program if one is not currently in place. Practitioners should bear in mind that the underlying factor in many malpractice claims is their failure to *implement* and *follow* defensive practices. Malpractice litigation is an expensive experience in terms of both money and time. In the prevailing litigious climate, measures taken to avoid lawsuits are worth the effort. An accountant's investment in defensive measures may easily be recouped by avoiding a malpractice claim.

Although some of the guidelines in the following chapters may appear to be a matter of common sense, experience has shown that they are frequently overlooked because of their seeming simplicity. These defensive measures have repeatedly proven to reduce malpractice risk, increase the chances of a successful defense, and enhance the quality of an accountant's work product. Therefore, it is recommended that the following measures be applied to *every engagement.* Accountants should remember that all defensive practices will be vitiated if they fail to provide a professional work product. Further, accountants should never assume that good faith and compliance with professional standards will eliminate or even significantly reduce liability exposure.

## Risk Management: Protection for Your Practice

Practitioners should institute a risk-management program because it shields them from malpractice exposure. It entails the use of a firm's staff and physical resources to—

- Identify instances of possible exposure.
- Devise and implement a system to prevent or curtail the likelihood of exposure.
- Monitor the firm's plan for defensive policies and procedures.
- Revise the plan as appropriate.

By recognizing the inevitability of claims, taking affirmative action toward a defensive program, and simultaneously keeping innovation alive, practitioners may save tremendous amounts of time and money in the resolution of claims. By incorporating the defensive measures set forth in the following chapters into the daily operation of their firms, accountants are making such practices a vital part of firm management.

# CHAPTER 9

# The Engagement Letter

Malpractice claims frequently arise when the client's expectations of what services will be rendered differ from those of the accountant. Typically, a client understands the accountant's responsibilities at the start of an engagement, but when problems arise—whether or not they are related to the engagement—the client's understanding frequently becomes less realistic. The resulting misunderstandings often give rise to lawsuits.

Many claims can be avoided, or more expeditiously resolved, if accountants and clients execute a written agreement that memorializes the terms, conditions, and limitations of their respective responsibilities. This contract is referred to as an engagement letter, and countless instances of malpractice litigation have repeatedly demonstrated its value. However, despite the extensive commentaries extolling the value of engagement letters, the number of accountants practicing without them or limiting their use to audits and review engagements is surprising. Under the AICPA Professional Liability Insurance Plan, for all claims reported during the 1990-91 period, no engagement letters were used in 36 percent of reviews, 50 percent of compilations, and 64 percent of other services (book-

keeping and personal financial statements). Engagement letters are no less important in nonaudit engagements. They can be used defensively by an accountant to prove that no audit responsibilities were assumed. An accountant's reliance on an oral agreement may yield short-lived benefits to client relations, but the long-term effects can be disastrous.

As the cornerstone of a firm's defensive accounting program, an engagement letter should clearly and explicitly define the nature and scope of each engagement (including its limits) and the responsibilities of the parties. Set forth in the following list are the objectives of using engagement letters.

- *Help avoid misunderstandings with the client.* The engagement letter establishes a professional understanding between the accountant and client concerning what each party is expected to contribute and receive from the relationship. As an instrument applied to client relations, the engagement letter attempts to reduce engagement-related misunderstandings between the client and accountant, thereby serving as a mutually beneficial instrument.
- *Help avoid misunderstandings with the staff.* A copy of the engagement letter in the working papers provides the firm's staff with an authoritative reference to supplement oral instructions and provides them with a more complete understanding of their professional responsibilities.
- *Reduce legal liability.* An accounting firm's legal duty to the client is its contractual obligation to perform the duties it was engaged to do. In today's litigious environment, it is important that there be no misunderstanding concerning the duties to be performed. There have been instances of litigation that could have been avoided, or resolved in the accountant's favor, if an engagement letter had been used.

- *Improve practice management.* The general practice of having an engagement partner review the letter before it is issued provides an opportunity to amend the terms of the engagement, approve the proposed fee and payment schedule, and set up guidelines to avoid possible collection problems.
- *Clarify the contractual obligation.* Engagement letters evidence that a contract is created when an accounting firm agrees to render services and a client agrees to pay for them. The engagement letter contractually binds both a firm and its client. Since the engagement letter is a contract, it should reflect the current nature of the engagement. If unexpected conditions are encountered that necessitate a change in the scope of the engagement, a revised letter should be issued. Also, if the engagement partner concludes that changed conditions prevent the firm from fulfilling its obligation and that it must withdraw from the engagement, the accounting firm's managing partner or legal counsel should first be consulted.
- *Explain the client's responsibility.* Particularly in engagements to compile, review, or audit financial statements, it is important that the client understand and accept its responsibility for the financial statements. The engagement letter offers the accounting firm an opportunity to explain that responsibility at the beginning of an engagement.

When drafting engagement letters, accountants should consider those aspects of an engagement that could be the subject of dispute. Identified in the following sections are those issues of greatest concern to the accountant and client when drafting their engagement letter. All clauses should be drafted as specifically and unambiguously as possible.

## Professional Services to Be Performed by the Accountant

This section identifies the engagement —for example, tax, audit, compilation and review, or management consulting services (MCS)—and specifies what is not to be performed—for example, providing investment advice or contributing to investment material. The scope of any limitations to be imposed or special procedures requested by the client should be described. When appropriate, the letter may mention special aspects of the engagement, such as the use of a specialist or another auditor. Language should be nontechnical, and it should distinguish between separate services if a mix of services is being provided. This clause is of particular importance because in its absence, judges and juries may have difficulty understanding the accountant's role. The client should be informed in writing of any altered circumstances that result in the qualification of an opinion. (Refer to appendix A, exhibit 1, for a sample letter, "Conditions Encountered That Do Not Permit Expression of Opinion as Anticipated in the Original Engagement Letter.")

## Responsibilities Assumed by the Client

This section itemizes the client's duties concerning the engagement, such as the duty to cooperate, provide documents and other necessary data, and submit requested information within specified deadlines. Client assistance can also include preparing schedules and analyses and typing confirmations.

## Extent of the Accountant's Responsibility

This section discusses all of the responsibilities that flow from the engagement. For instance, in a tax engagement, the client is responsible for the accuracy of the information submitted to the accountant and for having and maintaining the underlying support documentation. In the case of an audit, accountants stress the integrity of management and their reliance on internal controls.

## Timing

This section indicates the expected dates on which an engagement will begin and be completed and on which reports or tax returns will be delivered. The extent and timing of any interim work may be mentioned.

## Engagement Limitations

This section describes the inherent limitations of an audit—for example, that it is designed to detect material misstatements; that due to the inherent limitations of the audit process, it may not detect fraud, defalcations, and other irregularities; and that it should not be considered a guarantee of the accuracy of the financial statements. The engagement letter for a service other than one involving financial statements should indicate that it does not constitute an audit. The letter for an engagement involving prospective financial information should indicate the limitations resulting from the use of assumptions. Language should also be included that limits the use and distribution of the accountant's work product by identifying direct and indirect users—for example, by specifying

that it is for the client's internal use only. This may reinforce a privity defense and reduce third-party liability by providing substantial evidence for use in establishing the audience for and purpose of the accountant's work product.

## Type of Report

This section mentions the type of opinion or report expected to be issued, including an indication of whether the opinion is expected to be qualified for any reason. The expected wording of a compilation or review report may be included. The general content of the expected report on an MCS engagement should be described. The letter may indicate to whom the report will be addressed and the number of copies that will be delivered. Other reports that may be issued, such as reports on material control weaknesses or management letters addressing reportable conditions, may be mentioned.

## Billing Procedures

This section discusses a firm's fee for professional services, the method used to determine fees, or both. An accountant's failure to address this issue could result in a need for expert testimony on the value of services if a suit for fees results. The engagement letter identifies what will be done, and this provision sets forth what it will cost. It also addresses such issues as the frequency of billing, the treatment of collection costs and attorney's fees, interest on past-due balances, and the accountant's right to suspend work in progress until unpaid balances are cleared.

It is also good practice to indicate that the fee estimate is based on the assumption that the client will provide

assistance and that unforeseen developments may affect the fee. The letter for a new engagement may discuss the policy for start-up costs. Accountants should make every effort to clarify all billing arrangements in the engagement letter because clients frequently counterclaim against them for professional malpractice in response to a lawsuit for unpaid fees. Moreover, when clients receive an unexpectedly large fee, they are more likely to question the accountant's services, thereby giving rise to a possible lawsuit. (The issue of accountants' lawsuits against clients for uncollected fees is discussed in chapter 13.)

## Limitation of Accountant's Liability

In some situations, disclaimer clauses or hold-harmless agreements have been effectively used to transfer an accountant's exposure. The effect of such an agreement is that it requires a client to hold the accountant harmless from any claim pertaining to the engagement or limits the accountant's responsibility to the client for a loss to an agreed-upon amount. Some degree of client resistance should be expected if an accountant decides to include this provision in the engagement letter. An attorney experienced in these matters should be consulted to draft the necessary language. At the conclusion of an engagement, some practitioners obtain from the client an acknowledgment that services rendered were acceptable.

## Payment of Opposing Party's Attorney's Fees

This section stipulates that even in the event that an accountant prevails in an unmerited lawsuit instituted by a client, the client will be responsible for the account-

ant's legal fees. This clause serves a dual purpose: It discourages clients from filing a claim against an accountant unless it is warranted, and enables a CPA to recover the insurance deductible if he or she prevails. However, should a claimant prevail, the accountant will be responsible for the legal fees incurred by the claimant.

## Arbitration Clause

This section attempts to avoid the time and cost of defending a lawsuit in court. While arbitration can be a viable alternative, accountants should exercise caution in including an arbitration clause in the engagement letter because doing so may give rise to a coverage defense by their malpractice insurance carrier. As one of their conditions for coverage, most malpractice policies stipulate that the accountant agree not to compromise any claim and that any compromise may breach the policy terms, resulting in a denial of coverage. Since the attempted or actual resolution of a claim by arbitration may affect the insurance company's defense of a claim, the insurance company may deny the claim for breach of policy terms. Therefore, accountants should obtain the approval of their malpractice insurance carrier in writing before including or resorting to an arbitration clause in their engagement letter.

## Accountant Disassociation

This section stipulates the conditions under which an accountant can withdraw from an engagement or withhold his or her work product. Client conduct that results in such drastic measures includes nonpayment of fees, criminal conduct, or failure to provide needed information on a timely basis. Enforcement of this clause

by an accountant is a virtual landmine of liability; however, informing clients of this possible course of action and obtaining their consent makes the provision a part of the contract. It may also reduce the likelihood of the client's engaging in prohibited conduct and the accountant's being held liable in the event of its enforcement. This provision should be discussed with an attorney before it is carried out.

## Client Reproduction of Reports

This section requires the CPA firm's approval to reproduce and disseminate reports to others.

## Other Clauses

Language emphasizing the following points may also serve to bolster the effectiveness of an engagement letter:

1. The accountant relies on information to be provided by the client.
2. Continuing engagements are separate and distinct from one year to the next. (Including such language avoids the continuous-representation rule, wherein an agreement to perform "annual reviews" never expires on an engagement.)
3. The client provides written acknowledgment of the terms of the engagement.
4. Internal control weaknesses are recognized and further responsibility is disclaimed.

## Other Considerations

Practitioners should strictly adhere to the following rules for all engagement letters:

1. No client, including a loyal and trusted one, should be

exempt from signing an engagement letter. The letter should be signed and dated by all parties and returned to the accountant prior to beginning the engagement. It serves as mutual assent and acknowledges the client's understanding of the work to be performed. The accounting firm may fear resistance by clients who have never received an engagement letter. The following steps will usually overcome anticipated resistance:

- Inform the client that engagement letters are required for all clients as a matter of firm policy, that most CPA firms require engagement letters, and that the client is not being singled out for any reason.
- Explain the reasons for the letter and how it benefits the client as well as the accounting firm. Consider giving the client a copy of the AICPA's brochure entitled "The Engagement Letter—An Agreement Between the Client and the CPA."
- Use nontechnical language in the letter whenever possible and make sure the client understands any technical terms used.
- Review the letter with the client before issuing it.

2. A signed engagement letter is a contract and should be filed in the permanent client file. A copy may also be filed with the current working papers for easier reference by the engagement staff for instructions, billing purposes, or preparing the following year's letter.
3. Review the engagement letter annually. Revise and update it to reflect changes in the engagement as they occur, particularly if the scope of the engagement has been narrowed. This is an important consideration because once the accountant deviates from the initial engagement letter without updating it, its defensive capabilities are diminished. Appendix A, exhibit 2, contains a sample letter memorializing a change in circumstances from those contemplated in the original engagement. The client should then sign and date the

document, acknowledging his or her understanding of and agreement to all changes. If any client refuses to sign an engagement letter, consider terminating the engagement or sending the client a letter setting forth the terms of the engagement. The client's failure to respond to any engagement-related questions in writing may provide the accountant with some degree of protection.

4. An engagement letter is not intended to be used as a marketing device; it should not be perceived as an opportunity to exaggerate an accountant's capabilities and services.

Although the engagement letter will not make a practitioner immune from malpractice claims, it is a significant step toward reducing liability exposure and improving the chances of having a successful defense. It also provides effective leverage during settlement negotiations should a claim occur. Firms that forgo the use of engagement letters may find themselves in a precarious position if a claim is made. Sample engagement letters are included in appendix B, in the following exhibits.

| *EXHIBIT* | *ENGAGEMENT LETTER* |
|---|---|
| *1* | *Individual Tax Services* |
| *2* | *Compilation of Financial Statements and Tax Services* |
| *3* | *Compilation of Personal Financial Statements* |
| *4* | *Review of Financial Statements and Tax Services* |
| *5* | *Review of Personal Financial Statements* |
| *6* | *Audit Services* |
| *7* | *Audit of Personal Financial Statements* |
| *8* | *MCS Engagement* |
| *9* | *SEC Engagement: Initial Registration, Form S-1* |

# CHAPTER 10

# Client Screening

Accountants should at all times be selective and avoid high-risk clients. Knowing when to walk away from a client can be as important to a firm's survival as acquiring new clients.

◊ ***Example***

*An accountant discusses an audit engagement with a prospective client, an officer of a manufacturing company, and the client indicates interest in retaining the accountant. The engagement could generate nearly $100,000 per year in fees. However, the firm's investigation of the client reveals that it has changed accountants twice over the last three years, that its signature product is becoming obsolete, and that no replacement has been developed. The accountant rejects the engagement solely because the malpractice risk presented by a client who is regularly dissatisfied with his or her accountant and who has impending financial problems far exceeds the potential benefit of any fees generated by it.*

There was once a time when accountants could accept almost every engagement without incurring the risk of malpractice. However, with the increasing prevalence of fraud by management, clients' unwillingness or inability to pay for professional services, financial troubles affecting enterprises of all sizes,

and dishonest professionals' cloaking themselves in an image of integrity, screening clients before acceptance is becoming a valuable part of a malpractice defense program: Forewarned is forearmed. By establishing and remaining faithful to client-acceptance criteria and by documenting their efforts, accountants can reduce their malpractice exposure. Clients who are untrustworthy and disreputable are too frequently involved in questionable financial transactions, and an accountant's connection in any way with such clients or activities may well result in the instigation of malpractice litigation by the wronged party.

Accountants should beware of the following characteristics when choosing clients:

- *Present or Impending Financial or Organizational Difficulty.* Insufficient working capital, an industry experiencing many business failures, high turnover in key positions, the vesting of management responsibilities in one person when conditions warrant that they be shared by several persons, poor credit, dependence on a few select customers for products or services, and companies that invest other people's money are all potential red flags. If a financially troubled client files for bankruptcy, there is a strong possibility that the accountant will be named as a defendant in any resulting litigation.
- *Involvement in Suspicious Transactions.* Accountants should be alert to any activity that is or appears to be illegal, such as bribery, kickbacks, unauthorized corporate transactions, illegal contributions, or artificially improved financial statements. Courts are increasingly expecting the accountant to detect fraud, embezzlement, and other irregularities existing in a client's organization.
- *Unreasonableness and Uncooperativeness.* Accountants should be wary of clients who balk at providing necessary documents and records in a timely fashion; fail to document underlying facts; have unrealistic expectations of

the time needed to complete an engagement; blame the accountant for their own company's financial problems; operate in an environment characterized by unfavorable tax laws and rulings and other circumstances beyond the accountant's control; chronically change accountants; provide vague, guarded responses to inquiries; threaten to take the company's business elsewhere; and request changes in the engagement. Practitioners should not count on being able to satisfy such clients; they too frequently injure one's spirit and one's wallet.

- *Fee Pressures.* Some clients are only willing to pay an unreasonably low fee for professional services and regularly dispute their bills. Bargain hunters often withhold payment while they question bills—sometimes for months. If such a client is accepted, the accountant may be forced to choose between losing money on the engagement or rendering services of lower quality. If malpractice litigation results, any deficiencies will be discovered and disclosed to a judge or jury. Moreover, the accountant may have future collection problems with such a client. Once the engagement is accepted, the fee structure should not be allowed to affect professionalism, and the engagement should be completed as it normally would in the absence of fee pressures.
- *Refusal to Sign Engagement and Representation Letters.* By accepting clients who will not sign these documents, accountants expand their liability to these clients and to third parties.
- *Demand for "Risky" Services.* A firm's partnership agreement should prohibit the performance of high-risk engagements that all partners do not agree to share. (See the discussion of high-risk engagements in chapter 12.)
- *Incompatible Personality.* Accountants should learn as much as possible about a prospect's corporate and individual personality to determine if it is compatible with the firm's culture.

- *Frequent Involvement in Litigation.* Being people, clients rarely change.

Other characteristics of prospects to be avoided include—

- A need for an auditor toward year-end.
- A weakness in or absence of internal controls.
- A lack of organization.
- Poorly maintained records and collection difficulties.
- A failure to file income tax returns for several years.

It is particularly important not to rely too heavily on one client or a group of clients for billings. For example, when one client represents 25 percent of a practice, or two clients represent 50 percent, or one publicly held client represents 10 percent, the accountant's objectivity may be detrimentally affected, since the client (or clients) may exert undue influence on the accountant's judgment. A diversified client base is the goal.

If, after considering all of the factors, an accountant decides to accept a risky prospective client and engagement, absolute compliance with the firm's defensive program will be mandatory. The increased risk factor should be considered when determining fees. Consideration should also be given to collecting the fee in advance. However, a practitioner may accept a client initially considered risky under the condition that he or she will be dropped if no positive change occurs within a specified period of time—for example, one year.

By strictly adhering to client-acceptance guidelines and documenting all conversations and decisions made pursuant to them, an accountant can increase the effectiveness of the screening process. A screening process that includes the following procedures is likely to result in a client base characterized by reputable, well-managed, financially secure clients who recognize

the practitioner's responsibilities in providing quality accounting services.

1. If the client approaches the practitioner first, determine why the client is interested in changing accountants.
2. Visit a potential client's business premises to determine the condition of its management, finances, and internal controls. Some practitioners require that all new clients have their internal controls analyzed.
3. Meet a prospect's accounting and tax personnel to determine its specific financial needs and the condition of its accounting records.
4. Conduct a background check for all potential clients and check references to determine their reputation for honesty, credit history and rating, financial stability, cooperativeness and litigation history, potential conflicts of interest, quality of management, competency of personnel, personality, and potential to be sources of new clients.
5. Determine if a prospect's industry or the services requested fall within the high-risk category.
6. After receiving any necessary authorization, contact a prospect's former accountant, as well as its attorney, bankers, credit bureaus, present and former business associates, and employees. Inquiries to the Better Business Bureau, Chamber of Commerce, or an applicable trade association can be especially productive. Document all communications.

It is far less complicated to refuse an engagement with a questionable client than it is to withdraw once services have already been provided. Should an accountant decline an engagement, the prospective client must be informed of the decision verbally and in writing and be advised that no action will be taken on the engagement. In some cases, it may be appropriate to inform

the potential client of any approaching deadlines or statutes of limitations and to advise him or her to retain another accountant.

The value of client screening extends beyond client acceptance. It is equally important for client retention. The same review procedures should be systematically applied to existing clients annually, or whenever there is a substantive change in client circumstances. Such changes include developments in a client's financial condition or management or changes in laws impacting a client—for example, Environmental Protection Agency (EPA) regulations or hazardous-waste laws. Since a client's circumstances can change remarkably over time, an accountant must immediately be made aware of any existing client that has become a high risk.

If the screening process does not produce sufficient information to warrant rejection of a prospective client or termination of an existing client, at the very least it identifies engagements that require extra precautions.

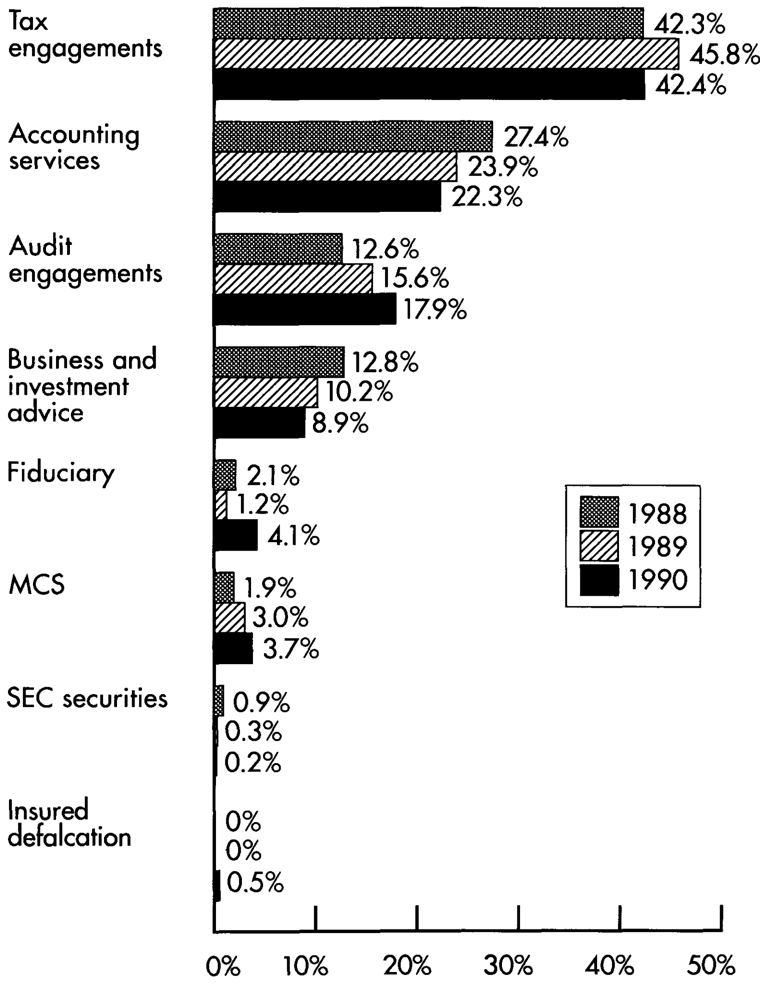
The establishment and adherence to strict client-acceptance and -retention guidelines yields a screening process that gets results. Maintaining client-acceptance and -retention programs is one method of reducing accountants' exposure to questionable clients, thereby avoiding one possible road to malpractice litigation. A successful program is one in which the accountant's representation of the client is in the best interests of the client and the firm. (Refer to appendix C for a sample new client acceptance form.)

# CHAPTER 11

# High-Risk Engagements and Industries

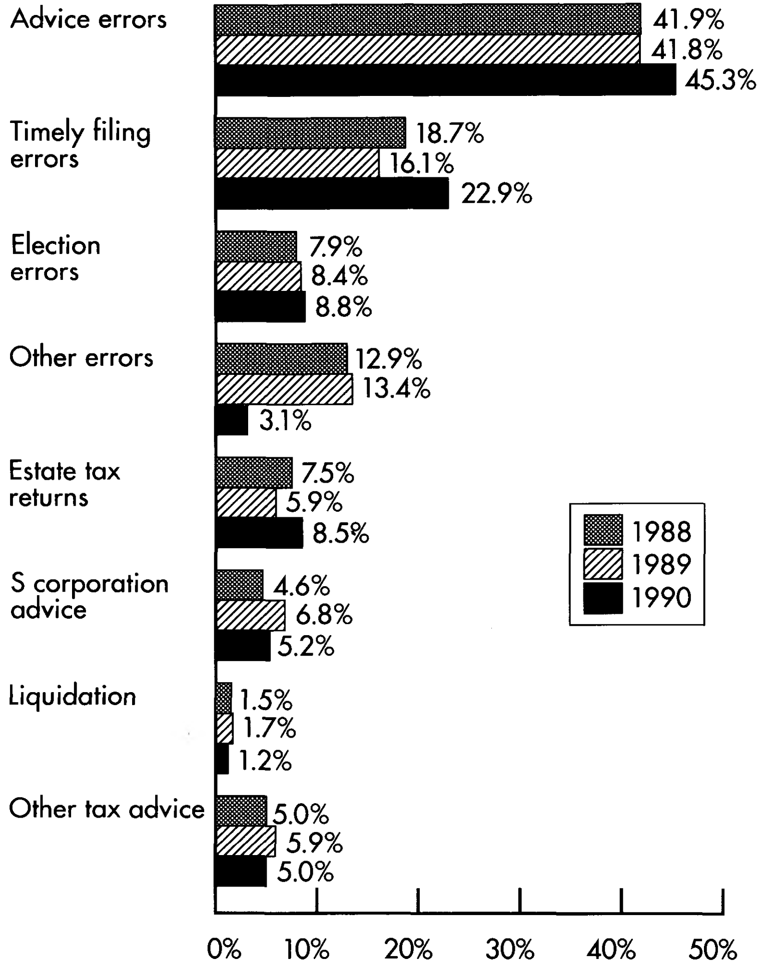
In addition to becoming alert to clients who are prone to litigation, accountants can further safeguard their practices by being able to identify those engagements and industries from which a high percentage of claims arise. The graph in figure 11.1 identifies and compares by year the proportion of claims, by category, brought against accountants. Figure 11.2 analyzes and compares by year the three engagements most prone to claims — tax, accounting, and audit. The graph in figure 11.3 depicts the frequency and severity of claims brought against accountants.

***Figure 11.1***



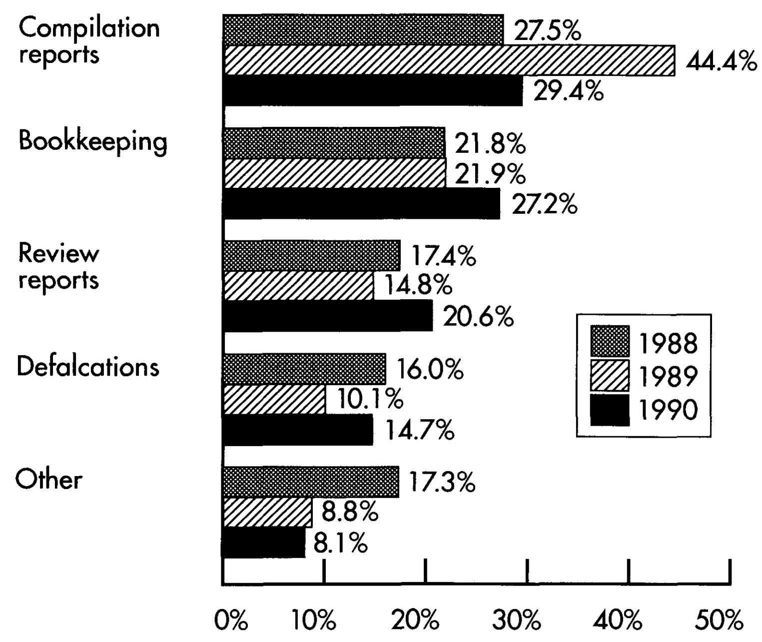

*Percentages are derived from the number of claims filed.

***Figure 11.2A***



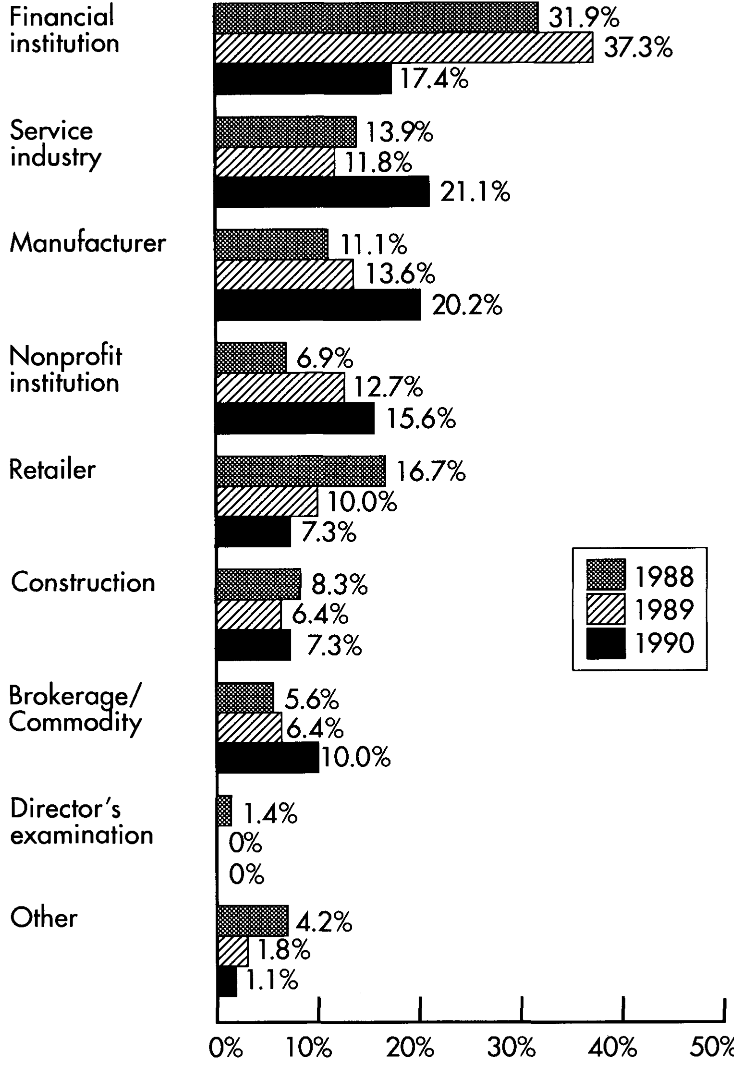

*Percentages are derived from the number of claims filed.

***Figure 11.2B***



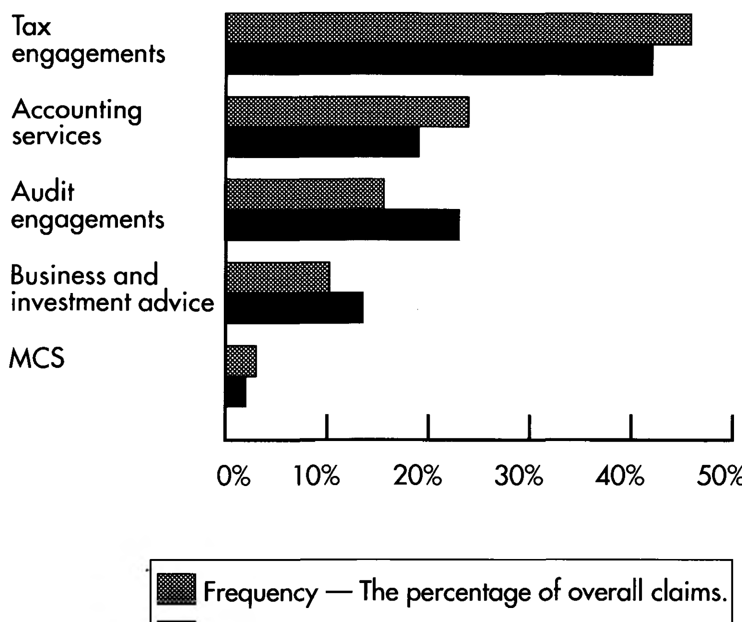

*Percentages are derived from the number of claims filed.

***Figure 11.2C***




*Percentages are derived from the number of claims filed.

***Figure 11.3***




**Tax Engagements.** This type of engagement leads all others in terms of frequency of claims, primarily because tax engagements are performed by the largest number of accountants for the largest number of clients. Claims usually result from untimely filing of tax returns, election errors, advice concerning liquidations and S corporations, disallowed tax deductions, inaccurate representation of tax results for a transaction, failure to completely report all taxable income, and underpayment of taxes. Damages usually consist of additional tax, penalties, reasonable legal fees, and interest levied against the taxpayer-client; the accountant's liability includes all or a portion of the penalties and interest. However, the accountant

is generally not liable for the tax when a claimant taxpayer would owe the tax regardless of the accountant's error.

Because many malpractice claims founded on the untimely filing of tax returns are not due to an accountant's negligence but, rather, to a client's failure to provide the documentation necessary to complete the return on time, accountants should clearly inform their clients of the need for this information and the consequences of a failure to do so. Such communications should then be documented. If returns are mailed to clients, certified mail (return receipt requested) should be used (clients mailing their returns should be advised to do the same). The accountant should always obtain a dated receipt in those instances when tax returns are given to the client at the accountant's office.

**Accounting Services.** Claims typically result from an accountant's negligence in performing write-up work, compilations and reviews, and unaudited financial statement work. Even when no opinion is expressed, liability may result because of the accountant's assurance that there were no violations of generally accepted accounting principles (GAAP).

**Audit Engagements.** Claimants attempting to recover for negligently performed audits allege that their accountants failed to conform to generally accepted auditing standards (GAAS) when examining and reporting on clients' books and records and failed to report on whether the financial statements are presented in conformity to generally accepted accounting principles (GAAP). (Claimants can include both clients and, in some circumstances, third parties; the extension of the accountant's liability to third parties is discussed in chapter 5.) Industries particularly susceptible to audit-related negligence claims are financial institutions and construction companies.

**Business and Investment Advice.** Accountants' negligence in this category derives from their involvement with clients in investment matters, specifically in making forecasts and projections and in evaluating and promoting tax shelters and other investment opportunities. Accountants usually overstate an investment's tax benefit and profit potential without disclosing any potential risks. When an investment or enterprise fails,

or when the IRS disallows it, disgruntled investors may bring negligence claims against the accountant, who is usually the only insured or financially viable defendant. An accountant may be liable even when he or she was responsible only for examining an investment's tax implications. The accountant's situation is worsened if it is determined that he or she also promoted or invested in the affected enterprise, because such an involvement is deemed a conflict of interest.

Practitioners must always distinguish between their functions as accountants and as investment counselors. With the increase in clients' demands for financial services and the IRS's heightened scrutiny of investments, the incidence of claims in this category is expected to increase. Also, due to the involvement of multiple investors, most of whom may have acted on an accountant's recommendation, multiple or class action litigation may result, accompanied by increases in defense costs and indemnity.

**MCS.** Litigation may be based upon an accountant's negligent advice to clients concerning methods by which they could improve efficiency, increase profits, or make maximum use of their resources.

## Other Causes

Other common causes of malpractice claims arise when accountants sue for unpaid fees, which is discussed in chapter 13; fail to detect defalcations; or are negligent in financial-management engagements in cases where they act as fiduciaries.

## Specific Transactions

Specific transactions that most frequently give rise to malpractice liability are—

- New financings.
- Audits of clients raising capital for a new business.
- Buy-sell situations.

- Disputes between clients and third parties.
- Unusual or complex tax issues.
- Liquidations, bankruptcies, going-concern issues, or receivership engagements.
- Tax returns, financial statements, or tax opinion letters for limited partnerships.
- Divorce proceedings (specifically, valuations of community property).
- Value determinations in which an accountant represents both the buyer and seller of stock.
- Related-party transactions.
- Determinations of the sale price of a business in accordance with book values or audited earnings.
- Absentee-investor transactions.
- Engagements to design and install computer systems.

## Claims by Industry

Industries identified as risky include savings and loans; health care, including hospitals, HMOs, and nursing homes; property and casualty insurance; and not-for-profit organizations.

Although the list of possible grounds for a malpractice claim is infinite, practitioners can greatly reduce their risk of malpractice losses by recognizing high-risk clients, engagements, and industries.

# → CHAPTER 12
# Quality Control

A system for quality control should be established and applied to all engagements, accompanied by the documentation of engagement planning, assignment, and supervision. Firm procedures should also facilitate adherence to GAAP, GAAS, and Statements on Standards for Accounting and Review Services (SSARSs). Authoritative literature, such as Statement on Quality Control Standards No. 1, *System of Quality Control for a CPA Firm* (AICPA, *Professional Standards* vol. 2, QC sec. 10), mandates that firms follow the principles of quality control. Adhering to a system of quality control will motivate practitioners to evaluate those aspects of their practice that are fertile territory for malpractice claims. The following quality-control procedures play a vital role in the prevention of malpractice claims. Statement on Quality Control Standards No. 1 discusses nine elements that make up an effective quality-control system. However, each of these elements is not discussed in this chapter.

## Quality-Control Procedures

### Staffing

Engagements should be staffed with competent, properly supervised personnel who have a complete

understanding of the requisite degree of care. The primary responsibility for an engagement should be assigned to staff members who are knowledgeable concerning the engagement, the client's business and industry, and any problems unique to the client, engagement, or industry. Before accepting an engagement, the accountant should consider the availability, expertise, and qualifications of the staff; the complexity of the engagement; and the degree of supervision needed to ensure that the firm has the time, staff, and competence to handle the engagement.

The importance of the review process should be regularly stressed by structuring staff evaluations so that merit increases and promotions are contingent not only upon the accountants' technical skill and ability to increase billable hours and generate new business, but also upon their ability to critically review engagements and question unusual or questionable transactions. If firms want their accountants to exercise vigilance in all aspects of an engagement, they should provide an incentive to do so.

Some practitioners assign more routine engagements to junior personnel without investing time in planning, supervising, and reviewing each engagement. However, doing so leaves the accountant vulnerable to accusations that the engagement was negligently planned and supervised when a malpractice claim is then brought. By closely scrutinizing each engagement when it is first assigned and periodically thereafter to consider any necessary modifications, and by involving senior staff in engagement planning and supervision when necessary, accountants will be able to argue more affirmatively that their firm adhered to principles of quality control.

## Supervision

Accountants should institute and remain faithful to a system of staff supervision that ensures that each engagement receives the attention it deserves. This

includes an initial consultation between the supervisor and the appropriate staff member(s), the creation and maintenance of communication channels throughout the course of each engagement, and a "cold review" of the accountant's work product by an accountant not assigned to the particular engagement, all tailored to the specific requirements of each engagement. The internal review verifies that the conclusion and all findings leading to it are consistent with professional accounting principles and standards. It also guarantees that any outstanding questions have been resolved. To ensure the effectiveness of engagement supervision, the services of an outside specialist should be retained if none exists in the firm or if specialists within the firm are unavailable. As a final precautionary measure, the reviewer should initial each reviewed document. Naturally, the smaller the firm, the less likely it is that specialists will be available for consultation within the firm. For particularly complex matters, outside consultation may be advisable.

## Resources

A network within the firm should be established that encourages staff members to obtain assistance from resources within the firm or from the AICPA and state CPA societies when they encounter complex situations requiring additional guidance, such as the application of newly issued standards to a particular engagement. By meeting periodically with staff to discuss clients and projects, a firm can identify existing and potential problems and properly direct staff to resolve the issues.

## Practice Reviews

In addition to implementing internal review procedures for all completed engagements, accountants may improve the quality of their work by participating in practice-monitoring programs offered by the AICPA.

Once voluntary, this type of program is now mandatory for all AICPA member firms. It provides practitioners with further opportunities to ensure that quality services are being provided to their clients. A reduction in substandard services will reduce the likelihood of malpractice litigation.

Participating in such a program sends a message to the public that a firm has invested its time and resources in improving its operations for the benefit of those it serves. Practitioners are able to discuss among themselves, in a direct and objective fashion, any existing or potential problems in their firms and possible improvements or solutions. Firms receive the objective viewpoint of outside practitioners that is sometimes necessary to identify practice areas in need of further attention and to provoke necessary changes.

The report resulting from participation in a practice-monitoring program should be reviewed by the firm, and all questions and deficiencies that surfaced during the review should be immediately addressed. Failure to resolve all issues may allow weaknesses in the firm to fester, thereby increasing the likelihood of malpractice exposure. Participating in a practice-monitoring program and addressing improvements recommended by reviewers can play a pivotal role in determining whether it should be named in a lawsuit; or, if a lawsuit is filed, it makes an impressive statement in the accountant's defense to the judge, jury, and claimant's attorney.

## Documentation

The hallmark of professional accounting services is maintaining complete, detailed working papers that document in a clear, straightforward fashion all aspects of each engagement. In malpractice litigation, the first items to be subpoenaed by a claimant's attorney will be the accountant's working papers, files, firm manuals and guidelines, and time sheets that pertain to the

engagement. By fully documenting all professional activity, any unusual matters or problems, and any risks associated with professional advice, accountants will make an attorney's job of proving malpractice liability that much more difficult. Accountants may ultimately be required to demonstrate to a judge or jury that quality services were rendered throughout the engagement, something that is less credibly done without a written record. For this reason, immediately documenting all conversations, representations, confirmations, and agreements with clients, lawyers, creditors, bankers, and all others involved in an engagement is mandatory and should become part of the way accountants conduct business.

One important distinction that accountants need to make, and one that deserves special recognition, is that between inquiries from clients, usually by telephone, that can be resolved immediately, and questions that require a researched, written response. Even for routine matters, an accountant should complete a form that records the date of an inquiry and describes the nature of the inquiry and the accountant's recommendation. This documents the client's inquiry. The completed form should be kept in the client file. A sample Client Inquiry Sheet is included in appendix D. In those particularly sensitive aspects of an engagement from which malpractice liability more frequently arises, such as changes in services, confirming such communications with the client in writing is recommended. Moreover, by keeping meticulous records of time spent on engagements, the destinations of their work product, and the dates of receipt and delivery, practitioners can do much to reduce malpractice exposure. Any language limiting financial statements should be in a form that clients and third parties can understand and be free of any unnecessary technical terms that are understood only by accountants or others knowledgeable in the particular specialty.

With respect to third-party liability, accountants can reduce their likelihood of malpractice exposure by applying the following controls to all engagement letters:

- Stipulate the specific purpose of the engagement and the party or parties entitled to rely on the information.
- Prohibit the client from sharing the report with others without the accountant's prior written consent.
- Disclaim liability to anyone other than intended users.

As an added precaution, these points should be addressed in all client meetings and discussions.

By drafting all engagement-related documents as if such material might ultimately be the subject of litigation and have to withstand the scrutiny of a judge, jury, or other third parties (for example, state boards of accountancy, insurance claims personnel, or an arbitration panel), accountants will be able to supply working papers that can prove compliance with professional standards and due care. It is not uncommon for clients and third parties to document all communications. By assuming that this is the case, accountants will be more inclined to document their own.

Potentially damaging documents that were not disposed of in the normal course of an engagement cannot be legally disposed of once they become a part of or subject to a legal proceeding. Once documents become evidence in a legal proceeding they fall within the custody of the court and cannot be destroyed until the legal proceeding is concluded. It is therefore in an accountant's best interest to be certain that damaging circumstances are detected by review and follow-up procedures and are addressed promptly.

In terms of settlement negotiations, the more effectively defense counsel can verify a negligence-free engagement using the accountant's documentation of services performed and professional conduct, the less willing a claimant's attorney will be to present the case to a judge or jury. The result will more likely be a refusal

of payment to the claimant on the grounds that the accountant was not liable, or a reduced settlement and timely resolution of the claim.

When a system of documenting all aspects of an engagement is combined with an effective system of communicating with the client, accountants further improve their position with respect to malpractice litigation. Maintaining clear and direct communication channels between accountants and their clients cannot be overly stressed. Informing clients, orally and in writing, of all changes, problems, and questions results in professional services that will more likely meet the clients' expectations and the accountants' standard of care. Good communication also prevents clients who subsequently suffer a loss from claiming at a future time that they were unaware of a particular situation or circumstance. This is another situation in which memorializing all substantive aspects of an engagement works to the accountant's advantage.

A more positive accountant–client relationship results when clients, at the beginning of an engagement, are informed in writing of—

- The name of the staff person assigned to the engagement. If warranted by the engagement or circumstances, a meeting may also be arranged.
- The approximate time frame within which the engagement will be performed.
- Any other possible methods or approaches to completing the engagement.

Following up engagement-related communications in writing and providing the client with periodic progress reports foster a healthy accountant–client relationship.

Standardized procedures, checklists, and questionnaires should be used to—

- Ensure adherence to professional standards.

- Properly complete and review working papers, tax returns, or tax opinions whenever possible.
- Record all significant deadlines.

All procedures should be strictly followed and all items on checklists should be completed; they serve as important reminders of engagement-completion matters and document the completion of a review of working papers. The effectiveness of a reminder system is greatly influenced by the particular needs of each engagement. Sample review forms are included in the following appendixes:

| *APPENDIX* | *FORMS* |
|---|---|
| *E* | *Short-Form Checklist for a Compilation Engagement* |
| *F* | *Short-Form Checklist for a Review Engagement* |
| *G* | *Review of Financial Statements—Illustrative Inquiries* |
| *H* | *Audit Supervision, Review, and Approval Form* |

These illustrations are only one approach to documenting supervision and review.

An engagement characterized by well-documented communications and confirmations can be the key to an accountant's successful defense; however, the absence of such documentation can literally destroy it.

### Awareness Program

A member of the staff may be enrolled as a firm representative in a defensive practices seminar. Such seminars are sponsored by state societies and professional liability insurers. Loss-prevention videos entitled "Preventing Malpractice Claims: Compilation, Review, and Other Services" (No. 118700) and "Tax Malpractice Claims and How to Prevent Them" (No. 118600) can be obtained from the AICPA by calling (800) 334–6961 (outside New York) and (800) 248–0445 (New York only).

A system should be in place within the firm—for example, firm meetings can be scheduled or a newsletter can be distributed—so that the representative can readily share this knowledge with other members of the firm. If no program is in effect within a firm's geographic region, the firm could sponsor such a program.

### Firm Manual

A firm manual explaining firm policies, procedures, forms, and questionnaires should be prepared and made available to staff.

### Overseeing Quality Control

A member of the firm—an audit or tax partner, the office manager, or a firm administrator—should be appointed to oversee quality controls, ensure their continued effectiveness, and make any necessary improvements.

### Discussion

Obviously, some of the preceding suggestions are not applicable to a sole practitioner who has no assistants. Sole practitioners, of necessity, have to review their own working papers. Professional standards do not require that audit work necessarily be reviewed by someone other than the person who provided the service. This does not mean, however, that a review of completed audit work should be neglected. It is still necessary to make a critical review of completed work and evaluate whether it adequately supports the conclusions reached. The review checklists in appendixes E through H can be adapted for use by sole practitioners.

Once a firm has created a quality-control system and has instructed the staff to follow its procedures, it must periodically review the program and make necessary adjustments so that its effectiveness is not diminished by neglect.

## Professional Limitations

By undergoing professional introspection, a firm can identify its professional capabilities and accept engagements that it is competent to handle, reject those that it is not competent to assume, and accept only marginally appropriate engagements if it is willing to obtain additional education and training for the assigned staff, hire trained staff, or establish contact with an expert in the field. Accepting engagements that exceed a firm's resources, which often occurs with ancillary legal and investment services such as drafting corporate minutes or recommending investments, is fraught with risk because it may result in substandard services and invite malpractice claims. This is a particularly sensitive issue for small, growing firms that are overzealous when attempting to increase their client base, services, and fees. Obviously, competency limits may become stretched.

Although much depends upon the particular circumstances of the firm, administrators of the AICPA Professional Liability Insurance Plan found that firms with total staff sizes ranging from eleven to twenty-five were the most prone to malpractice litigation in 1990. As the smallest firms grow, they often become more prone to litigation. One reason for this may be that a firm establishes quality-control standards that are effective up to a certain staff size, but once staff exceeds this amount, new, more sophisticated standards become necessary. The risk of malpractice exposure increases, then, when new standards are not established. Moreover, heightened competition for clients has resulted in a professionwide emphasis on expanding services to maintain or expand a client base, making the attendant increased risk of malpractice exposure a problem for firms of all sizes.

Acquiring new clients, expanding services, and merging practices can have a detrimental effect on the

quality of an accountant's services, which can take any of the following forms:

- Limited supervision due to staff shortages
- Insufficient documentation and review of engagements due to deadline pressures
- The performance by new staff of services with which they are unfamiliar
- New problem clients
- Decreases in overall effectiveness due to increased hours

By effectively lowering the quality of a firm's services, such circumstances give rise to malpractice claims. Should practitioners realize after accepting an engagement that it is beyond the limits of their firm, they should immediately withdraw from the engagement. The risk of litigation and both the quantifiable and nonquantifiable costs of defending and indemnifying a claim resulting from substandard professional services will outweigh any of the perceived benefits of such an engagement.

Practitioners can do much to thwart malpractice claims emanating from professional incompetence. They can expand their range of knowledge and expertise (discussed in the next section) and closely monitor the impact of growth on the quality of service. Effective practice management is merely providing existing and potential clients with expanded services while maintaining quality in the process.

## Continuing Education

CPAs are required to conform to professional standards when rendering accounting services to their clients. Failure to do so will result in substandard services, making the accountant vulnerable to malpractice

liability. An awareness of professional standards and new concepts in practice management serves as the accountant's first step toward reducing malpractice exposure.

By participating in continuing professional education (CPE) programs, practitioners can maintain and improve their knowledge of existing and new standards that apply to their current engagements as well as to those that they may wish to undertake in the future. All professional staff should be required to earn a specified number of annual CPE credits and read practice-oriented publications on a regular basis. Practitioners should enroll in CPE courses not solely to fulfill a state licensing requirement, but, more importantly, also to expand their technical knowledge and better serve their clients.

## Risk Manager

Firms should appoint one member of their staff to serve as a risk manager. Firms operate under the assumption that malpractice is the concern and responsibility of all staff; however, when any organization entrusts a responsibility to everyone, it frequently becomes no one's responsibility. A loss-control program, regardless of its early success, will rapidly become ineffective if not given the attention it deserves.

A risk manager's responsibilities primarily are to establish and supervise loss-control measures, keep abreast of developments in malpractice litigation, and improve and expand the firm's program, as necessary. Some qualities to look for in candidates for this position include strong communication skills, knowledge of the firm and of liability matters in general, and effective negotiating ability. The position is traditionally filled by a firm's audit, administrative, or managing partner.

# ⇥ CHAPTER 13

# Defensive Billing Practices

When confronted by mounting delinquent fees, some practitioners resort to litigation against a client as a logical recourse. This approach to fee recovery is fraught with risk. Frequently, the client's standard response is to file a counterclaim against the accountant alleging that quality services were not provided and that the engagement was not completed as contracted or scheduled.

◇ ***Example***

*An accountant sued a client for $2,500 in unpaid fees, which prompted the client to counterclaim against the accountant for malpractice. After nearly two years of time-consuming litigation, both claims were dismissed by the court; however, it was only after it had cost the accountant $70,000 in lost billable time and travel expenses and the $5,000 deductible under the professional liability insurance policy.*

Accountants contemplating suing a client for fees should consider—

- The detrimental effect of litigation on insurance premiums.
- The possibility that litigation costs may surpass any recoverable outstanding fee. A limit on delinquent fees

should be set before considering whether to sue for payment.

- The diversion of time from financially productive firm endeavors to litigation-related responsibilities.
- The effect of negative publicity on their client base and further growth potential.
- The possibility that even if their suit for fees is successful, they may discover that the client has no recoverable funds.
- The possibility that recovery may take several years. Under the AICPA Professional Liability Insurance Plan, the life of an average claim, from first notice to the accountant to settlement or verdict, is four years.

With effective client screening procedures and, if necessary, a lawyer's letter, accountants can avoid some collection problems. Claims statistics from the AICPA Professional Liability Insurance Plan indicate that the majority of lawsuits for fees by accountants resulted in counterclaims for malpractice. An accountant who sues for fees is clearly courting a lawsuit. Seasoned practitioners consider a lawsuit for unpaid fees a rarely used option that is only considered in the most extraordinary circumstances.

Before bringing suit, accountants should review the history of the engagement, their relationship with the client, and the quality of services provided. How did the situation deteriorate to the point that a lawsuit is looming? Was there a lack of communication between the parties? Did the accountant overlook any aspect of the engagement, no matter how insignificant, or fail to provide a timely bill? Was there absolute compliance with the terms of the engagement and representation letters? Were quality services provided in a timely fashion and in accordance with the accountant's duty of care?

Further, before resorting to legal recourse, the practitioner should consult legal counsel to determine if the effort is worth the potential reward. Each situation

should be evaluated on its merits. Only if there is no real exposure, if practitioners can answer the questions above in their favor, and if they are willing to risk the consequences of a lawsuit should litigation for an unpaid fee be considered. After all the options have been evaluated, it may be in the accountant's best interest to accept the lost fees. If, on the other hand, the accountant decides to pursue a lawsuit, the accountant should be sure that the decision was prompted not by emotion or principle, but by well-founded business judgment. A close evaluation of the anticipated rewards and potential risks, and a good attorney specializing in the field, are essential.

Collection becomes an even more pressing problem for practitioners in poor economic times when many clients are scrutinizing and questioning bills more zealously than ever. Prompting clients to pay for services can be a sensitive issue, but when it is compounded by the possibility of a lawsuit for malpractice, it assumes greater importance. Moreover, there is a clear trend indicating that as receivables mount, the quality of service declines. This creates potential liability problems for accountants. Collection problems can be reduced through improved client communication, partner cooperation, and billing and collection procedures that are well planned and well maintained.

Recognizing the potentially negative consequences of suing for fees, practitioners should adhere to billing philosophies and practices that go to the root of the problem and are designed to prevent an escalation in the aging and buildup of unpaid fees. Most clients respect a direct, professional approach to billing and collection. Accountants' use of a clear, unambiguous billing system characterized by the following procedures will facilitate payment, keep accounts current and manageable, and prevent the client's financial woes from becoming their own.

- Address the firm's billing and collection practices at the beginning of the professional relationship by informing each client during a private consultation that the firm adheres to a strict policy of prompt payment of fees. Include in the engagement letter, or as a separate attachment (see appendix I), language clarifying fees and payment terms. Also include a clause stating that services will be suspended if the account becomes more than thirty days past due and that work will be resumed only when the account is made current. (Although such language should be included in the engagement letter, it should not be enforced without serious consideration.) Acknowledge that clients agree to the fee and billing system and that binding arbitration will apply to fee disputes; doing so prevents the filing of a lawsuit and deprives clients of the opportunity to counterclaim for malpractice. Establish and enforce payment deadlines. Explain these procedures orally to prospective clients, document them in the engagement letter when a client is accepted, and remind the client of these policies as necessary throughout the engagement.
- Request a retainer (money paid for professional services before an engagement begins), or provide for replenishment of the retainer if the fund becomes depleted, from all new clients, all high-risk engagements, and all engagements for which a problem is foreseen. (High-risk engagements are identified in chapter 11.) Some retainers are equal to the lowest fee charged for a particular engagement, or 50 percent of the fee. A prospect's unwillingness to comply with this policy may be indicative of future payment problems.
- Assume a billing philosophy that requires the payment of professional services upon the completion of the engagement. This policy should be clearly stated in the engagement letter, and clients should be reminded of it when they are informed of the final bill, when exit conferences are scheduled, or when they are asked to pick up completed work.

For those practitioners who do not use a retainer arrangement or receive payment upon completion of an engagement, including the following controls in their billing system is recommended.

- Promptly bill clients every thirty days (more frequent billing may be appropriate in certain engagements, such as for new audit clients). Mail invoices the day after the billing cycle ends and indicate that payment is due thirty days after billing. Prompt billing results in the receipt of the invoice by clients when the value of the services is still fresh in their minds.
- Issue reminder statements every thirty days. Invoices can reach those clients whose first bill was overlooked or lost in the mail.
- Bill for work in progress whenever practical, because it eases the firm's cash flow and because it makes payment by the client less of a hardship than would be the case if one large bill was sent at the conclusion of an engagement. Consider personally delivering to the client any invoice that significantly exceeds the client's expectations. However, the client should be made aware of what is happening during the engagement, not after it has been completed. Any item causing a significant increase in the bill should be adequately described. Any conflicts can be worked out face-to-face.
- Provide sufficient information on the bill so that the client can determine the substance of the services rendered and the time period covered. Prepare the bill so that it can sell itself. However, remember to consider the potential legal implications of the wording on the bill. Careless wording, broad generalizations, and verbosity could mislead clients to believe that more services were rendered than were actually performed. An unclear invoice that does not reflect the work performed is not only apt to incur delays in payment but also to be challenged.

- Separate out-of-pocket expenses—for example, those for travel and photocopies—and support staff time from the charges for professional services.
- Specify the period and work covered, particularly if more than one job is being performed for the client.
- Keep billing practices consistent with the engagement letter and explain any deviation.

For those practitioners who are encountering collection problems or are willing to consider alternative payment methods, the strategies included in the following list have been successful:

- Maintain regular collection contact with clients, either through a member of the administrative staff or the engagement partner, so they are aware that there is a systematic billing review procedure in force that results in regular follow-up for unpaid invoices.
- Accept post-dated checks or promissory notes. An attorney can assist you in drafting such notes. Ask for a note at the first indication of trouble and when your work is not yet complete. An advantage of using a promissory note to collect past-due fees is that insurance carriers do not always view a lawsuit on a promissory note to be functionally equivalent to suing for fees when asking in their policy application if the accountant has ever sued a client for unpaid fees.
- Impose a finance charge on balances that have not been paid after thirty days. Software is available that calculates monthly finance charges. Compliance with state and federal law is necessary; therefore, consult an attorney.
- Accept payment by credit card.
- Offer a discount for prompt payment or for services performed off-season.
- Develop a revised payment plan that can be accommodated by a client's particular financial condition.

- Inform clients that new work will not begin until prior billings have been paid. Clients must not be allowed to form the impression that such a payment pattern is acceptable on a continuing basis.
- Utilize the services of a collection agency, small claims court, or your attorney. When choosing a collection agency, you should review all form letters that will be sent to clients to ensure that they are consistent with prevailing legal and ethical standards. Check the collection agency's references. This course of action should be followed only in unusual circumstances and, in many cases, only when you expect to terminate an engagement.
- As a last resort, compromise the bill and accept that it is better to receive some payment than none at all. However, acknowledge in writing to the client the reason for the compromise—for example, the client's financial situation or the lack of communication between the parties; also, be sure to make clear that the compromise does not represent a diminution in the value of professional services, and that the adjustment is a one-time occurrence and a deviation from the firm's standard policy.
- If a decision to sue for unpaid fees is made, entrust one partner and the firm administrator with the task of overseeing all collection-related litigation. Doing so results in consistency in the firm's decisions, heightens accountability, and frees the engagement partner to attend to other income-producing activities.

Under no circumstances should accountants withhold clients' administrative and financial records as a means of obtaining payment. In addition to reflecting poorly on the profession, it violates Rule 501 of the AICPA Code of Professional Conduct. Practitioners who engage in this activity will lose clients and cause irreparable damage not only to their reputation, but to their growth potential as well.

By adhering to effective billing procedures, practitioners can significantly decrease the acceleration in unpaid fees, which results in the infusion of more capital into the firm, fewer write-downs or writeoffs, advancement in the accountant–client relationship, fewer lawsuits for fees, and a corresponding decrease in malpractice counterclaims.

# CHAPTER 14

# Other Defensive Practices

In addition to following the specific guidance given in the preceding chapters, accountants may be able to reduce the risk of a malpractice claim by adhering to the following general guidelines.

1. Retain a firm attorney and consult him or her regularly.
2. Reject offers to be a dispute arbiter or establish prices for products or services.
3. When asked by a business that is making a public offering to provide an opinion on the financial statements to be included in offering materials, review the working papers of the accountant who conducted the original audit to ensure their accuracy. If you detect deficiencies, ask to take whatever steps are necessary to cure such deficiencies; if the client is unable to pay for the additional services, reject the engagement.
4. Pay close attention to the work environment and be alert to certain broad inquiries by clients, third parties, and successor accountants. They can take the form of requests to meet with clients, attorneys, investors, officers and directors, and agents of regulatory agencies, or to inspect documents. They may indicate that a claim is approaching.

5. Respect the confidentiality of all client communications and avoid discussing client matters when other clients are present in the office.
6. Issue a disclaimer or qualified report if you and your client disagree over the application of accounting principles in the engagement.
7. Require clients to post a fidelity bond for those employees who have access to funds.
8. Do not become overly friendly with clients; doing so may detrimentally affect judgment and objectivity. Remain approachable and be friendly, but always remember that the accountant–client relationship is a professional one.
9. Never suggest that a client violate any rules, regulations, or laws.
10. Avoid any engagements excluded by your professional liability insurance policy.
11. Make a conscientious effort to keep the client satisfied. Promptly return telephone calls, remain accessible to resolve problems and answer questions, and be understanding when providing professional advice.
12. Perform only necessary or requested services.
13. Refrain from using the word *audit* in nonaudit engagements.
14. Never represent or advise both parties in any transaction or give the appearance of doing so.
15. Keep files and records well organized, with documents pertaining to a particular client or engagement located in one place.
16. Never accept an unreasonably low fee; quality will suffer.
17. Refrain from providing professional advice to nonclients. Requests for advice usually are made at informal social occasions. Recommend that an

appointment be scheduled so that the issue can be fully discussed at your office.

18. Deliver reports only to the client.
19. Take special precautions in high-risk engagements.
20. Consider practicing as a professional corporation. Chapter 8 discusses the liability aspect of this form of practice.
21. Become an informed participant in the defense of any claim. Keep current on trends in litigation involving accountants and other professionals. As part of your firm's program of defensive practices, become educated by attending conferences offered by the state societies and the AICPA and by reading professional publications.
22. Use representation letters; they can serve as tangible evidence that certain information is the representation of the client's management. (Refer to appendix J for a sample representation letter.)
23. Trust your professional instincts. If, despite all defensive measures, you continue to feel uneasy concerning a prospective client or an engagement, then reject it.

# Section III

# Preparing for Your Defense

# → CHAPTER 15

# Preparing for Your Defense

## Counsel's Role in Claims Prevention

Although accountants are expected to recognize their professional limitations and to be alert for opportunities to enhance the value of their own defensive measures, they are not expected to be experts in legal matters. Accordingly, they should solicit the assistance of others in matters outside their own field of expertise.

An accountant's personal attorney, defense attorney selected by the accountant, or counsel appointed by an insurance carrier when a claim is brought will play a pivotal role in the accountant's program of defensive practices and in the investigation and defense of a malpractice claim. Any attorney employed on an accountant's behalf should be informed of—

- All aspects of the firm's audit function.
- The procedures followed by the firm when providing professional services.
- The firm's program of defensive accounting practices.
- All quality-control measures.

- The manner in which staffing assignments are made.
- The training program and related materials.
- Any sensitive financial, management, or personnel issues.

Knowledge of all pertinent conditions and circumstances will help an accountant's attorney effectively formulate a defense for any malpractice claim.

Specific contributions made by an attorney in malpractice matters include—

- Contributing to and reviewing a firm's risk-management program to ensure its continued effectiveness.
- Advising the staff of common sources of liability and the techniques that can be applied to avoid liability.
- Reviewing the firm's policy and training manuals.
- Explaining to staff the potential scope of liability for an engagement and the legal effect of statutes and court decisions regarding their professional responsibilities.
- Analyzing engagement letters, particularly with respect to the scope of liability assumed by an engagement, and assisting in the creation of procedures to follow once an engagement is accepted.
- Investigating high-risk clients, a function that may be inappropriate for a firm to perform on its own.

# CHAPTER 16

# Selection of an Attorney

The first step taken when an accountant is sued is the selection of an attorney. Some insurance policies provide for consultation with the insured in this selection, while others place the right to select counsel with the carrier. A carrier makes a concerted effort to assign counsel only to those cases within his or her area of expertise, since doing so helps the insurer and accountant work toward a common goal: a timely, favorable disposition of the claim. Insurance companies are expected to have their own panel of defense attorneys consisting of specialists in the defense of accountants. In those situations where the insurance company will consider the accountant's request to have his or her own attorney defend the claim, the carrier will evaluate the attorney's expertise in accountants' malpractice. Assuming that the attorney's competence level is satisfactory and that an agreeable rate can be decided upon, the accountant may use, at the carrier's expense, his or her personal attorney to defend the claim. Some practitioners decide to have their personal attorney monitor the performance of defense counsel appointed by the carrier to ensure that their interests are being fully protected. While the cost of defense

counsel is assumed by the insurance carrier, the fees incurred by the accountant's personal attorney while monitoring the defense of a claim are the accountant's responsibility.

Although the terms of most insurance policies allow the accountant to change counsel only in conflict-of-interest situations, some carriers may allow a change of counsel in the rare event that the insurer assigns an attorney unknowledgeable and untrained in the theories and strategies of defending accountants' malpractice claims or when the attorney and accountant are unable to forge an effective working relationship. The carrier may then replace the attorney with someone who is more competent and accommodating. The potentially devastating consequences of having an incompetent or uncooperative attorney provide a defense in a malpractice claim leave no room for professional error. Issues vital to the accountant's professional reputation and competence are being placed in defense counsel's hands. Accountants want to be represented by an attorney in whom they have confidence.

There is one time when accountants may be able to select their own defense counsel even when they have policies that grant this authority to the carrier: when the insurer defends the insured while reserving its right to deny coverage at a later date should its investigation reveal that the claim at hand is not covered. Some accountants retain their own attorney to review the coverage issues raised by the carrier and to provide a defense addressing those issues until the carrier's coverage investigation is concluded. By reserving its rights under the policy, the carrier has created an obvious conflict of interest: It has appointed an attorney to represent the insured accountant when it has yet to confirm coverage. An insurance company's defense under a reservation of rights usually arises from allegations of fraud, RICO violations, or activities

beyond the scope of coverage—for example, trading securities or acting as a real estate broker. Under certain circumstances and in specific states, an accountant has the right to select his or her own defense counsel because of the potential conflict of interest between the accountant and carrier.

## The Potential for Conflicts of Interest

The accountant's right to select counsel in certain circumstances has its roots in the California Court of Appeals' 1984 decision in *San Diego Naval Federal Credit Union v. Cumis Insurance Society*. This case held that whenever an insurance company defended a claim under a reservation of rights that created a conflict of interest between the carrier and its insured, the insured could choose its own defense counsel at the carrier's expense. In *Cumis*, the claimant's complaint against the defendant sought recovery for both compensatory and punitive damages. However, because the policy did not cover punitive damages, the insurance company defended the insured under a reservation of rights. Concerned over the carrier's possible build-up of uncovered punitive damages and reduction of covered compensatory damages, the insured defendant employed its own attorney to collaborate with counsel appointed by the insurance company. The insured's personal counsel controlled the defense of the claim and appointed counsel assumed what could be termed secondary status.

This situation creates some obvious problems for both the insured and the insurer:

- Attorneys who are less qualified than appointed counsel specializing in the particular claim may make potentially damaging decisions with respect to an insured's defense.

- Defense fees may be higher than those charged by a carrier's appointed counsel, and the carrier must pay two legal bills: those of selected counsel and those of appointed or monitoring counsel. It should be kept in mind that the accountant is responsible for any money spent or costs incurred in claim-related matters that are not authorized by the carrier.
- Reports to a carrier and appointed counsel on claim developments may be inadequate because selected counsel is usually unfamiliar with the insurance company's reporting requirements. Attorneys do not generally report to clients periodically; therefore, they must be educated in the reporting requirements of insurance companies.

When the accountant's personal counsel is making fundamental decisions pertaining to the defense of a claim, there is likely to be a difference of opinion between the accountant's personal attorney and counsel appointed by the carrier, especially given that personal counsel is being paid by the carrier, which could have retained more experienced attorneys for less money. In *Cumis*, this was certainly the case. Even in California, *Cumis* has been restricted by the state's Civil Liability Reform Act which provides that true conflicts of interest must exist before an insured can retain personal counsel, at the expense of the carrier, to defend a claim. Mere allegations of uncovered acts, punitive damages, and damages exceeding the policy limit will not suffice. Moreover, personal counsel must cooperate with the carrier's appointed counsel. The defense provided by personal counsel must also be consistent with that of appointed counsel regarding—

- The fees charged.
- The frequency and quality of reports to the insurance company. (Since the insurance company pays for the time spent drafting status reports, counsel chosen by

the accountant under *Cumis* should not be reluctant to report on all unprivileged information.)

- The experience and qualifications in tort litigation and in the defense of the type of claim at hand.

The *Cumis* decision intended to create a system that best meets the defense needs of an insured involved in litigation, and its legislative restrictions were designed to prevent the loss by an inexperienced attorney of a case that counsel appointed by the carrier could have won.

## Qualities to Look for in an Attorney

When an accountant has no professional liability insurance with which to defend and indemnify a malpractice claim, either the accountant's own personal attorney should be used (if he or she is competent in the specialty), or the accountant's professional contacts or state CPA societies, the AICPA, state bar associations, or the American Bar Association should be asked for a referral. With the escalation in accounting malpractice claims, the number of competent attorneys is growing.

Whether an accountant's defense is being provided by an attorney selected by the insurance carrier or by the accountant, the qualities to look for in defense counsel are the same. They include—

- Extensive civil litigation experience, particularly in defending accountants.
- Knowledge of accounting principles and procedures. Obviously, a lawyer who is also a licensed CPA would be ideal.
- Demonstrated success in arguing a case before a judge and jury.
- The ability to aggressively yet positively engage in settlement negotiations, which is typical of a confident and committed communicator.

- An understanding of the relationships among the accountant, the attorney, and the insurance company representatives in matters pertaining to reporting requirements, authority, and responsibility.
- An awareness of the demands placed upon accountants involved in litigation and an ability to obtain all necessary information from them without unnecessarily impinging upon their time and disrupting their practice.

When selecting a law firm, the practitioner may want to choose a stable firm with low turnover so that the attorney(s) assigned to the claim will not be likely to change frequently. Moreover, the accountant should avoid a firm that presents a conflict of interest that would require the law firm to withdraw from representing the CPA firm or that would force the accountant to seek other counsel. Other practitioners, as well as clients, attorneys, bankers, and state bar associations, serve as prime sources of referral.

# CHAPTER 17

# A Ten-Step Defense Plan

Knowing the legal theories upon which malpractice litigation is based, adhering to defensive accounting practices, and having competent, effective defense counsel are not the only requirements for a successful defense. An accountant's informed and immediate response to actual and potential claims is equally important. On the other hand, a failure by the accountant to react properly and work productively with counsel throughout defense may not only handicap counsel's efforts in formulating and providing a quality defense, but it may result in an unfavorable settlement or judgment.

Claims management skills are not readily acquired in the usual course of an accountant's education and professional experience. Unless practitioners have been personally involved in malpractice litigation, it is unlikely that they will know how to react to litigation. Practitioners should take advantage of every opportunity to master these skills by participating in pertinent national, state, and local practice management conferences and by reading professional publications on the topic.

The following ten-step plan will guide practitioners through malpractice litigation, beginning with the first

notice of the claim and concluding with its settlement or judgment.

## Step 1: Notify the Carrier

Regardless of their form, immediately notify your malpractice carrier and personal attorney, first by telephone or in a personal visit and then in writing, of all situations likely to give rise to malpractice exposure. To identify those situations that may give rise to malpractice liability, it is necessary to distinguish between occurrences and claims, both of which should be reported to your insurance company.

Occurrences arise in two situations:

1. When substandard accounting services are performed, even when the accountant is the only person aware of the substandard services.
2. When the client is aware that services were substandard, brings the matter to the accountant's attention, but makes no suggestion that a claim will be brought.

An occurrence should be brought to the carrier's attention because circumstances could change, resulting in the ripening of the occurrence into an actual claim.

A claim is a formal statement, whether oral or written, of a claim. It may be in the form of a verbal declaration, letter, memo, or summons and complaint by a client or third party. Obviously, if a notice of a claim first comes to a junior staff member, it should immediately be referred to the senior partner.

The insurer can be notified directly or through the insurance agent or broker. All documentation included with the notice from the claimant or claimant's attorney should also be provided. The terms of the malpractice policy will stipulate notice requirements; *absolute compliance is necessary*. Failure to provide prompt notice of

claims could be a violation of the policy and, as such, could void coverage. (The issue of notice as an insurance policy requirement is discussed in chapter 19.)

Early notice of a claim to the insurance carrier—

- Results in the insurer's timely confirmation of coverage, assignment of counsel, prompt investigation, and retention of experts (when it appears that an actual claim will be made). It also establishes an early attorney–client privilege.
- Better enables defense counsel to obtain and protect records and to ascertain facts. (Remember, vital information may still be fresh in people's minds.) Although the need for this measure is obvious, it is worth repeating: Lawsuits have been lost or compromised through the destruction of important documents by a party or member of staff who was unaware of their significance.
- Allows a more informal approach to the review of documents, requests for information, and the resolution of a claim. Some claimants are more receptive to overtures to settle when legal expenses have not yet escalated and battle lines have not become entrenched. Moreover, once a complaint is filed, the defense of the claim becomes more structured and is restricted by discovery and procedural requirements.
- Enables the insurance company to establish immediate contact with the claimant, which can result in the timely receipt of claim-related information and reassurance to the claimant that the claim is of high priority. During the first phases of a claim, some claimants are not yet represented by counsel, and by working with them toward a prompt, amicable settlement, you can reduce legal costs, and you may even be able to keep the client.

Moreover, the date on which a claim was made and the carrier was notified will be determinative in "claims made" policies for triggering coverage and identifying the policy under which the claim is brought. Under

such policies, coverage is triggered when a claim is made against the accountant.

It is only natural for accountants, as professionals who take pride in their work, to experience emotions ranging from guilt and depression to betrayal and anger when they are sued by a current or former client; however, the worst response is not to take immediate action once a claim is brought. Claims do not go away. Rather, failing to recognize a claim and inform the malpractice insurer and personal counsel will only compound the problem by jeopardizing coverage and hampering counsel's ability to defend.

## Step 2: Limit Communications With Third Parties

Inform others concerning a claim on a need-to-know basis. Avoid internal discussions or written communications concerning the claim unless you are directed to engage in such communication by counsel. This rule applies to staff, clients, family, friends, and members of the press. Only with an attorney's involvement are such communications considered privileged and out of the reach of discovery. When an accountant explains a lawsuit to others within and outside the firm, the likelihood increases that something may be said that could be construed as negligent conduct. Statements could come back to haunt an accountant in the form of trial testimony that injures his or her defense.

Moreover, never make statements concerning the engagement or admit liability. Do not reveal the existence and amounts of insurance coverage. Statements such as, "My insurance company will take care of everything," and offers to pay damages can be used against you in the claim and may void coverage.

The senior partner(s) should oversee all actual and potential claims and work with the insurance broker and

carrier. The firm's risk manager should be included in the selected group of informed persons who are privy to claim-related information. If there is no risk manager within the firm, create a position or assign to a designated staff person the responsibility for overseeing the progress of claims, coordinating communications, and assembling and safeguarding documents as directed by counsel. Place all claim-related documents under the control of this person. The choice of a person not involved with the engagement to oversee a claim (or claims) removes the emotional factor.

Identify all personnel, both current and former staff, who were involved in the engagement and inform them that it is now the subject of litigation. Do this before the claimant's attorney contacts them. Ask all staff involved to—

- Discuss no aspects of the engagement or claim with anyone under any circumstance.
- Refer all inquiries to designated defense counsel.
- Be available to answer any outstanding engagement-related questions or participate in discovery.

In an attempt to prompt the accountant's staff and former staff to cooperate, some claimants' attorneys may make friendly overtures in an effort to allay their anxiety concerning the claim. Be aware that claimant's counsel may tell staff that they are not considered culpable or deeply involved in the engagement and that preliminary background information, which claimant's counsel may say is easily obtainable from other sources, is all that is being requested. Too many staff members have been duped into believing these statements and have provided confidential information that subsequently proved damaging to the accountant's defense. They are often surprised to learn that such conversations were documented or tape-recorded and used against the accountant in the claim.

If a claim is brought by a current client, you may consider terminating your professional relationship. If it is brought by a third party, you may wish to analyze the relationship with the client involved. In most instances, the accountant–client relationship is terminated before or at the time of a malpractice claim. Subsequent communications are made through counsel. Should chance meetings occur, either at social gatherings or at community events, you should maintain professionalism and courtesy; doing so can only have a positive effect on the claim.

There are those rare occasions when a client decides to maintain the professional relationship. These situations usually occur when there has been an unusually strong relationship between an accountant and client and the client has not considered the loss substantial. If after seriously considering all possible ramifications of a continued relationship with the client you decide to continue providing professional services to the client, maintain professionalism, strictly adhere to defensive practices, and never discuss the claim with the client, even when prompted to do so by the client. Remind the client that all claim-related discussions are best addressed by counsel.

## Step 3: Respect Legal Boundaries

Do not attempt to contact a client or client's attorney to attempt settlement, make statements, release documents, probe into the facts of the claim, or begin an investigation without counsel's approval and participation. Most malpractice policies require that the accountant cooperate with defense counsel, and priority should be placed on working with the attorney in defending the claim. Accountants should recognize that they are outside their field of expertise when a malpractice claim is brought against them and that

functioning in a legal capacity at this time can have devastating consequences: Any statements made or documents released independently by accountants can subsequently be used against them and may give the appearance of liability, particularly in the case of settlement attempts. Consult with counsel concerning the extent and content of any internal memoranda relating to the claim *before* creating them. Any information uncovered, analyses made, or conclusions reached without counsel's involvement are outside the boundaries of the attorney-client relationship, are not privileged, and therefore are discoverable by the claimant's attorney. This does not mean that the accountant's role in malpractice defense is insignificant. Rather, the accountant is a collaborator who contributes to the defense by assisting in the resolution of factual questions and in the choice of expert witnesses.

## Step 4: Review and Preserve Documents

With the assistance of counsel and the participation of appropriate staff, collect, examine, and preserve all documentation, such as working papers, financial statements, reports (including those pertaining to peer reviews), correspondence, documents pertaining to evaluation and supervision of staff, and file notes pertaining to the engagement and claim. Doing so gives you opportunities to detect any possible deviations from GAAP, GAAS, SSARSs, and firm or industry policy, and to become reacquainted with all aspects of the engagement. By comparing the services rendered with those mandated by professional standards and those discussed in professional literature, you can determine the strengths and weaknesses of the services. You will also want to ensure that questions raised in the review process have been properly addressed. Further, identify

and obtain all information and documents being held by the client, former client, or third party. These records may be requested during discovery and may assist in the defense of the claim.

You should try to anticipate which written statements may be requested during discovery or what facts concerning postclaim activity you may be called upon to testify. Written statements or testimony could lead a judge or jury to conclude that you were not knowledgeable in all aspects of the engagement. The accountant who worked on the engagement should identify all pertinent material for the defense attorney's review. After the review, you and your attorney should discuss the materials together to consider which document(s) may be at issue in the claim. All communications and conclusions, as well as the fact that research into the engagement occurred, are protected by the attorney–client privilege.

Remember that, with regard to the importance of document preservation, nothing will anger a judge or jury more, be more destructive to the defense of a claim, or hurt an accountant's credibility more than the alteration or destruction of engagement-related records after a claim has been brought. Such activity is usually undertaken to reduce or eliminate evidence of actual negligence or the appearance of negligence. It is also unethical and illegal and can easily be detected by a claimant's attorney.

Further, any inconsistencies in records will usually surface in the following manner. Upon completion of an engagement, the client is provided with all pertinent documents. When a claim is subsequently brought, the documents generated by the engagement will be closely scrutinized. Any discrepancy between the documents produced by the accountant and the copies of the documents in the client's possession will be detected. The claimant's attorney will be able to produce copies of any destroyed documents, and any alterations will

immediately be made evident by the existence of two conflicting versions of the same document(s). The discovery of such conduct can seriously impair or destroy counsel's ability to defend an accountant. In such cases, the issue of whether an accountant was actually negligent in providing accounting services will be made moot because his or her professionalism, credibility, and ethics will have been destroyed.

Altering financial records pertaining to an engagement after a claim has been made is a serious mistake. The only time when such conduct should occur is when counsel directs that changes be made, the changes are dated and initialed, and counsel's instruction to do so is documented. However, even then the alteration of records can have a detrimental effect on an accountant's credibility. The accountant's defense is strengthened if, instead of altering records, the accountant prepares notes, with counsel's knowledge and approval, regarding any hitherto undocumented conversations and accounting issues that pertain to the engagement. Obviously, such action can work to an accountant's favor by protecting him or her from an unsavory claimant who alters or destroys records in an attempt to show negligence.

## Step 5: Collaborate With Counsel

Work closely with your defense attorney during all stages of the claim. Upon its receipt of a claim and confirmation of coverage, the carrier will appoint defense counsel. Meet with the defense attorney to ascertain facts and discuss possible defense strategies. This meeting is an opportunity for the accountant to make an objective appraisal of defense counsel by gauging counsel's abilities in accountants' malpractice claims and by establishing the rapport necessary for a positive working relationship.

A thorough investigation, preparation, and presentation by defense counsel are the hallmark of a successful defense. An optimal defense can only be prepared when the accountant and staff fully cooperate with counsel. The accountant's responsibility in this regard begins with the first notice of the claim and continues until settlement or judgment. Too many potentially defensible or minor malpractice claims have been lost or resulted in higher-than-necessary settlements solely because the accountant and attorney failed to communicate throughout the defense of the claim, or because the accountant failed to give full attention to the claim.

In most cases, such lapses occur not because accountants are apathetic to the proceedings against them, but because they are so involved in maintaining their practices and responding to client needs. Recognizing the importance of pending malpractice litigation, giving it the attention it deserves, cooperating with defense counsel, and delegating routine firm responsibilities to other staff members when litigation-related responsibilities arise can increase the effectiveness of a defense.

## Step 6: Chronicle the Engagement

With the involvement of defense counsel, write a candid, chronological account of all events pertaining to the engagement, beginning with the first consultation with the client and concluding with the assertion of the claim. Documents generated by the engagement, such as bills, telephone logs, diaries, and memos, will assist in reconstructing events. At this stage absolute honesty and objectivity on the accountant's part are necessary, and the importance of documenting all engagements to prove that quality service was rendered is demonstrated. Since your defense attorney is involved in its creation, the history becomes a privileged attorney–client communication. Should defense counsel decide to share it with representatives of the insurance carrier, it will remain a privileged communication.

This process also serves as an effective mechanism for informing defense counsel of the facts surrounding the claim and the reasons for the accountant's opinions on engagement-related issues. Defense counsel needs an honest, complete disclosure of all facts and circumstances surrounding the claim so that quality services can be recognized, questionable ones explained, and a defense prepared. Defense attorneys can more successfully defend a claim if facts detrimental to the case are brought to their attention by the accountant during the first stages of the claim, when there is still time to prepare a response, rather than if the claimant's attorney reveals such information during discovery or trial, when an inference of deception may be made and there is less time for response preparation.

## Step 7: Assist in Expert Selection

Share your expertise with defense counsel in determining whether expert witnesses are needed, identifying and screening possible candidates, and preparing experts for deposition or trial testimony.

This step illustrates the accountant's role as collaborator, which was mentioned in step 3. Accountants are best able to critique the qualifications of potential expert witnesses. Qualities to look for in an expert include impressive academic credentials and professional experience, as well as the ability to communicate intelligently, yet in a way that is readily understood by a lay jury, and to credibly explain any shortcomings in the accountant's services. For less sophisticated engagements involving a sole practitioner or small firm, experts with local or regional reputations make more of an impact on a judge or jury, while in more complex engagements involving a larger firm, a nationally known one will have more of an effect. Set forth below is further guidance on the selection and use of expert witnesses:

- Avoid using friends or colleagues. Claimant's attorney may discover and disclose a pre-existing relationship between the accountant and the expert that may affect the objectivity of the witness's opinion. A judge or jury could construe that the testimony is influenced by loyalty and friendship rather than the rules, standards, and procedures governing the engagement.
- Attend depositions of the claimant's experts, even if you must do so at your own expense. The investment will pay for itself in strengthening the defense of the claim. The best defense is one that recognizes and combines the individual strengths of the accountant and attorney. The accountant can ensure that no erroneous testimony is provided, detect the use of any overly technical, unnecessary terms or phraseology intended to confuse the attorney, and identify issues or raise questions that may not otherwise come to the attorney's attention. The accountant's presence at depositions is also valuable because the claimant's expert may be less critical of someone who is seated across from him- or herself.

## Step 8: Approach Settlement Negotiations With Care

Some practitioners agonize endlessly over whether to settle a claim or proceed to judgment. When the accountant believes, either subjectively or objectively, that he or she has rendered quality, negligence-free services, this choice becomes especially difficult. Considerations of pride in their work, professional reputation, and the effect of a settlement on the cost of premiums and on the ability to obtain malpractice coverage in the future all come into play. However, when the hazards of trial and the possibility of a judgment exceeding settlement demands, the cost and stress of continued defense and trial, and the time taken from customary firm responsibilities are considered, settle-

ment may be appealing, if for no other reason than to cut losses. In the following situations, settlement is almost always preferable to judgment, even when quality services were provided:

- The quantifiable and unquantifiable costs of defense surpass any advantages to litigation.
- The engagement is not sufficiently documented to prove quality services.
- The accountant would make a poor witness.

Although the ultimate decision regarding claim resolution is largely a personal one made by the accountant, you should carefully consider the recommendation of defense counsel and insurance company representatives. They are educated and trained in this specialty, and can answer any questions you may have regarding the future effects of settlement, as well as the advantages and disadvantages of settlement and trial. Moreover, they also serve as your most objective allies and are able to place the claim in proper perspective. However, most policies that make settlement contingent upon the accountant's consent may stipulate that if the accountant withholds consent to a settlement recommended by the carrier and the claim proceeds to trial, the accountant will be personally liable for that portion of judgment exceeding the amount of the recommended settlement.

Should you eventually decide in favor of a negotiated settlement, let defense counsel carry out all settlement negotiations.

## Step 9: Prepare Your Testimony

Thoroughly prepare for deposition and trial testimony by reeducating yourself in all aspects of the engagement and examining all possible alternatives. Could you have done anything differently? If so, what? Why

was a particular choice made or not made? Identify other possible approaches and the reasons why they were not taken. Claimant's counsel will be sure to explore these issues, so preparation and logical responses are necessary.

During deposition and trial testimony, make every effort to convey the image of a positive, credible, competent, likable professional. The accountant's attire, demeanor, and speech will be influential in this regard. Pompous, indignant, and uncooperative behavior will not favorably impress the judge or jury. It will only reinforce the negative image that the claimant's attorney is trying to prove. Listening to the judge and being courteous, cooperative, and direct when responding to questions, particularly during the trying times of cross-examination, will more likely win you friends on the bench and in the jury box. When testifying, you should direct responses to the judge and jury and not to counsel. Remain cooperative throughout testimony so that the jury can see that you are able to exhibit confidence and professionalism even when your professional services are being scrutinized.

## Step 10: Attend the Trial

Be present at the trial from the first day to the last. Dutiful attendance sends a message to the judge and jury that you are concerned about your client's or former client's interests, any matters that attempt to diminish the quality of your professional services, and the judicial system. Your absence from the courtroom may create an image of a practitioner who does not place a high value on professional services, clients, or reputation; accordingly, a judge or jury could infer that the necessary time, attention, and care were not given to the engagement at issue. This rule holds true even when the usual demands of your practice are especially

pressing or a long trial is expected. Delegate other responsibilities to members of the firm; nothing can be as detrimental to the interests of your firm, clients, and personal financial position than an unfavorable, excessive settlement or judgment.

# SECTION IV

# INSURANCE CONSIDERATIONS

# CHAPTER 18

# Insurance Considerations

Professional liability insurance does not prevent litigation; however, when adequate coverage is purchased, the insurance provides practitioners with the peace of mind that comes from knowing that lost billable time will not be compounded by the cost of defending and satisfying a claim. It also enables practitioners to emerge from a claim with their personal assets and accounting practice intact. This section provides guidance on obtaining the full value of insurance protection.

Because of the technical terminology, the unique procedures, the wide range of options and policies, and the time needed to review policies, many professionals entrust the selection of their firm's malpractice coverage to the experts: their insurance broker or agent and their attorney. However, because firms' insurance needs are intertwined with those of the owners, coverage that meets the distinctive needs of the firm is best obtained with the accountant's involvement. Professional liability insurance plays a vital role in practice management, and by understanding the policy, reviewing the adequacy of coverage, and becoming insurance-literate, practitioners can defensively monitor their practices, act

more knowledgeably, and more effectively defend their interests when a claim is brought.

Only accountants are able to gauge the impact of policy terms and exclusions on the management, operation, and future growth of their practice. Moreover, because of the cost of premiums, the increased exposure, and the prominent role that insurance procedures and terms play in the defense and supervision of malpractice claims, practitioners must have a thorough understanding of the features of their malpractice policy. Decisions need to be made about a range of issues, from the choice of insurance companies, policy limits, deductibles, and counsel to the types of risks covered and settlement provisions. Accountants' education in these areas assumes heightened importance when one considers the fact that their failure to comply with policy terms can jeopardize coverage. By relying on the expertise of the insurance broker and the carrier's staff and attorneys, and by analyzing their own professional needs in selecting coverage, accountants can obtain the full protection of their malpractice policy and select coverage that best meets the needs of their firm.

A thorough knowledge of the policy helps accountants—

- Identify circumstances that could lead to future problems.
- Respond to notices and communications from the carrier, defense counsel, claimant, and claimant's attorney.
- Work with their broker, insurer, and attorney to obtain the best coverage for their practice.

Although there is no standard accountants' malpractice insurance policy, commonalities in policy terms, conditions, and exclusions do exist among policies. All aspects of the professional liability insurance policy

must be considered in terms of the accountant's particular practice needs. A discussion of those issues likely to confront practitioners follows.

## The Malpractice Insurance Policy

When accountants purchase professional liability insurance, they purchase protection for their firm. An insurance policy insures the practitioner, up to the policy limit, for all covered losses and legal expenses that arise from the performance of professional accounting services and that he or she becomes legally obligated to pay. The carrier must act in good faith in all of its dealings with the insured; this means investigating and defending the accountant against any covered claim regardless of its merits. The typical professional liability insurance policy describes—

- The scope of coverage.
- The conditions of and exclusions from coverage.
- The limits of liability.
- The insured's duty to cooperate with defense counsel.
- The insured's duties when a claim is brought.
- The definitions of terms such as *insured*, *professional accounting services*, and *policy period*.

The carrier's responsibility to the accountant, which works to the insured accountant's benefit, is twofold: to defend insureds against all covered claims, and to indemnify them for all settlements and judgments up to the policy limit. Generally, the carrier has a more far-reaching obligation to defend the accountant than it does to pay damages. If the allegations in a complaint

are based solely on excluded acts and are therefore not covered, the insurance company has no duty to defend or indemnify the accountant, and the claim will be denied for lack of coverage. However, the majority of lawsuits allege acts both within and beyond the scope of coverage. In these situations, most policies stipulate that the carrier's obligation to indemnify is restricted to covered allegations, and that the duty to defend on all counts exists so long as covered allegations remain at issue in the lawsuit. The carrier's duty to defend terminates when covered allegations are dismissed or otherwise resolved.

## Policy Organization

Firm members can more easily obtain answers to coverage questions and more expeditiously notify their carrier of both occurrences and claims by keeping all insurance-related documents, including previous policies, in the custody of one person. Due to the increase in litigation and the severity of damage awards, this responsibility frequently rests with a firm's management or executive committee.

## Insurance Control Form

When a firm has several policies in effect that insure against different risks, it is sometimes difficult to determine the full extent of a firm's insurance coverage. A control form that provides information on a firm's total coverage enables the practitioner to determine at a glance all specifics concerning coverage and the adequacy of coverage. The control form should be reviewed annually and updated as changes in coverage occur. A well-maintained system may prevent the firm

from paying for unnecessary coverage or overlooking required coverage. An insurance control form typically includes—

- Each type of policy and the loss covered. (If possible, coverages should be placed with the same carrier.)
- The broker's full name, address, telephone number, and contact.
- The insurance company.
- The policy number.
- The expiration date.
- The policy limit.

A sample form is included in appendix K.

## Policy Types

Accountants' malpractice policies generally fall within two distinct categories.

### Occurrence

This type of coverage insures accountants against claims as long as a negligent act or omission resulting in a claim occurred during the policy period. The date on which a claim was made is irrelevant to a coverage determination.

### Claims-Made

This type of coverage insures accountants against claims as long as a claim arising from an alleged act, error, or omission is made within a policy's effective dates. The date on which an allegedly negligent act was actually committed is irrelevant to a coverage determination so long as it did not occur prior to the policy's retroactive date. As long as such a policy is continuously

maintained, protection is provided. If coverage is allowed to lapse—for example, upon an accountant's retirement—the practitioner will have no protection against claims made after the policy's effective date, even if a negligent act or omission occurred within the policy's effective dates. However, by purchasing extended "tail" coverage, which extends the period within which claims can be made under the terms and conditions of the policy that has expired, accountants can maintain protection against claims made after the expiration of the standard policy. Tail coverage generally follows the terms and limits of the standard policy, and its term can extend from one to three years. The most efficient way for a firm to achieve the protection offered by tail coverage is to select a malpractice policy that extends protection to retired partners. In the absence of this policy feature, tail coverage can be purchased at a reduced rate, since the retired accountant will no longer be practicing. Some firm agreements provide for continued insurance for retired partners for negligent services rendered while practicing for the firm.

### Considerations

There is a clear trend away from occurrence policies and toward claims-made policies. The main reasons for this movement are the following:

- Carriers believe they are able to more accurately project and calculate reserves because the period of coverage is defined.
- Much of the guesswork of determining the exact date of negligent professional services, and, therefore, the proper policy under which to bring a claim, is eliminated. This problem is particularly pronounced in accounting malpractice claims. An accountant's professional services are rarely performed in one day; rather, they extend over a period of time, sometimes from one policy period to the next.

- Claims are usually made three or more years after the rendering of professional services.

When a practitioner decides to change carriers (but before the termination date of the current claims-made policy), the accountant should review all claims-related circumstances with counsel and provide the current carrier with notice of all potential malpractice claims. The policy will protect the accountant only against claims made during the policy's period. There is no grace period beyond the policy's expiration date for reporting claims.

Practitioners should avoid purchasing occurrence coverage if they were previously insured with claims-made coverage because a coverage gap could result, leaving them uninsured against negligent services that occurred during the claims-made policy period but were reported during the term of the occurrence policy. Lapses in coverage resulting from changing policies can be avoided by purchasing prior-acts coverage from the new carrier to insure for negligence that occurred before the new policy's effective dates, or by purchasing tail coverage from the former carrier to protect against claims made after the expiration date of the former policy.

Prior-acts coverage protects accountants against negligence that occurred before the purchase of the new policy, provided that—

- The accountant did not know of the error or omission when the application for the current policy was completed.
- The claim was reported to the carrier during the policy's effective dates.

## Premiums

Although the amounts of the policy limit and deductible have the most obvious effect on the cost of

malpractice coverage, premiums are also influenced by the number of professional and, under some policies, administrative staff members to be covered. The larger a firm's staff, the greater the possibility of errors and the higher the incidence of claims will be. Accountants will want their insurance broker to evaluate premiums while the broker is accepting proposals from insurance companies. Some carriers adhere to an equitable premium-computation formula—one that includes in the determination of premiums the firm's claims history, type of services, client base, practice management, and the state(s) in which its practice is located. Under a risk-classification system, those firms involved in engagements that have proven to be less risky and have a favorable claims history are assigned a standard rate and premium that represent their individual risk. A carrier that spreads risks over its entire risk pool without establishing categories among firms results in the subsidization by low-risk practitioners of the high-risk activity of others. Those firms having a history of claims, engaging in high-risk activity, and accepting high-risk clients may be required to pay a higher premium or deductible for the same amount of coverage provided to other firms with more favorable ratings. Other factors affecting premiums include the establishment and maintenance of a defensive-accounting program and the states(s) in which a firm practices. States most prone to litigation include California, Florida, New York, and Texas.

By becoming aware of those circumstances possibly resulting in a surcharge, which can range from 5 percent to 50 percent of the standard rate, practitioners can more effectively monitor their own defensive-practices program. Set forth below are some of the more prevalent causes of surcharges:

- Claims activity
- Failure to use engagement letters

- Performance of high-risk engagements (discussed in chapter 11)
- Filing of lawsuits to recover uncollected fees
- Large percentage of billings from one client

Practitioners should conduct an engagement analysis to determine if the income generated from a particular engagement exceeds the additional cost of premiums resulting from that engagement.

## Limits

One of the most difficult insurance-related decisions accountants must make concerns the limits of their malpractice coverage. Because the possibility always exists that a claim exceeding the selected limit may arise, calculating malpractice exposure with any degree of precision is a daunting task. Accountants could conceivably practice for years without any claims activity and then, during one particular year, have several claims brought against them even though they maintained or even improved the quality of their services. The difficulty of projecting future malpractice exposure is exacerbated when policy limits are reduced by defense costs, which in all but the most minor claims can be difficult to estimate and can range from thousands to millions of dollars.

By evaluating the following factors, accountants can make an informed coverage decision and choose policy limits that protect their firm's assets and professional interests as well as their continued ability to provide quality services to clients.

- *Firm Size and Client Base.* A broad client base that includes high-risk clients requires higher limits of coverage.
- *Claims History (Number and Severity) and Disposition of Prior Claims.* The fewer serious claims brought against the

insured and the more claims dismissed or resolved through nominal settlements, the lower the limits will be.

Policy limits are created on a per-claim/per-occurrence or aggregate basis. A per-claim limit restricts the amount paid for each claim to a specified sum. A per-occurrence limit applies to each incident rather than to each claimant. An aggregate limit is used together with both a per-claim or per-occurrence limit and is the amount that the carrier will pay in any one policy year. For example, a policy with limits of $500,000/$1,000,000 will pay up to $500,000 for any one claim (or occurrence) and a total of $1,000,000 for the policy year. When the limits are stated solely as $1,000,000, the per-claim and aggregate limits are the same. Thus, should one or several claims deplete the aggregate limit of liability, there will be no funds available to satisfy future expenses, judgments, or settlements arising during that policy year. These will become the responsibility of the accountant.

The importance of working closely with the insurance broker and personal attorney when reviewing policy limits and annually renewing coverage is reinforced by the fact that interim increases in policy limits are rarely allowed. The following calculations have been used to measure policy limits:

- The greater of the total claims asserted or paid during any policy period
- The sale price for the firm's largest client
- One year's revenues

Accountants may be personally responsible for damages exceeding their policy limit, and while it is still unusual for an accountant to have to pay a portion of damage out of his or her own pocket, the increased severity of claims has resulted in ever larger numbers of accountants who must. This point illustrates the importance of establishing and maintaining policy

limits that reflect as closely as possible a firm's possible malpractice exposure.

The following table, provided by Rollins, Burdick, Hunter & Company and based on 1990 statistics, does not recommend coverage limits; however, it does inform practitioners of the percentage of firms, rounded to the nearest tenth, purchasing various limits of coverage.

| | *LIMITS OF LIABILITY* | | | | | | |
|---|---|---|---|---|---|---|---|
| *STAFF SIZE* | *$250,000 (%)* | *$500,000 (%)* | *$1MM (%)* | *$2MM (%)* | *$3MM (%)* | *$4MM (%)* | *$5MM (%)* |
| *1–2* | *51* | *19.8* | *22.2* | *0.89* | *0.5* | *0* | *0.02* |
| *3–4* | *51.8* | *22.5* | *23* | *1.1* | *0.47* | *0* | *0.06* |
| *5–10* | *32.7* | *24.9* | *38.7* | *2.4* | *1.1* | *0* | *0* |
| *11–25* | *0.78* | *23.3* | *66.7* | *6.2* | *2.4* | *0* | *0.5* |
| *26–50* | *0* | *0.2* | *77.1* | *13.2* | *5.9* | *1.2* | *2.3* |
| *51–100* | *0* | *0* | *61* | *21* | *14.4* | *0.9* | *2.7* |
| *101–150* | *0* | *0* | *44* | *24* | *8* | *4* | *20* |
| *151+* | *0* | *0* | *21* | *0* | *43* | *7* | *29* |

## Deductible

Most accountants' malpractice policies require a deductible, which is the amount of money paid by the insured before the carrier's payment obligations for defense or indemnity are triggered. Deductibles for malpractice policies range from $1,500 to $750,000 for large firms, and under most policies, the deductible applies to both defense costs and indemnity. Practitioners must also select a deductible that they are confident they can afford, and they must review the policy to determine that they have received a discount on their premium for assuming any sizeable deductible.

◇ ***Example***

*An accountant who purchases $2,000,000 in malpractice coverage with a $5,000 deductible per claim has total cover-*

*age of $2,000,000 per policy period, less $5,000 for each claim reported during the policy period. If a claim is resolved for $5,000, the accountant would be obligated to pay $5,000 because indemnity and defense costs do not exceed the deductible.*

## Exclusions

All professional liability policies carry exclusions for acts outside the scope of coverage for which the accountant is personally liable. Although exclusions vary among policies, the more frequently recurring ones are for claims arising from—

- Dishonest, fraudulent, malicious, or criminal activity.
- Bodily injury, sickness, death, or property damage.
- The insured's activities as an investment advisor, officer, director, trustee, fiduciary, or employee of any enterprise other than that of the named insured.
- Criminal libel, slander, or defamation of character.
- Conduct resulting in punitive damages.
- The sale and promotion of securities, computer products, real estate, or other investments.
- Violations of the Employee Retirement Income Security Act of 1974 (ERISA) and RICO.

An exclusion almost universally included in accountants' malpractice policies is for claims known to the insured at the effective date of the coverage for which he or she is applying. This prevents the insurance company from insuring losses that have already occurred and are the responsibility of a former carrier. For instance, should a firm receive notice of a claim on the last day of its claims-made policy (again, a policy for which coverage is triggered on the date the claim is made) and it reports the claim to the subsequent carrier instead of the current carrier, coverage will be denied by the subsequent carrier.

To protect accountants from personal exposure for acts excluded by a policy, firms can obtain insurance coverage for damages arising from particular types of conduct, such as general liability insurance for bodily injury, sickness, death, or property damage to others and errors and omissions coverage for officer's and director's liability, or they may purchase a special policy endorsement, if one is available, for other uncovered acts. There is a nationwide consensus among insurers that coverage applies only to compensatory damages, and does not apply to fines, penalties, or punitive damages. The reasoning is that at-fault parties should be required to bear the responsibility for their own misconduct.

A firm can also take steps to reduce the likelihood of becoming engaged in activities excluded from its professional liability insurance policy. It can include in its partnership agreement or corporate documents a provision (or provisions) prohibiting firm members from participating in activities excluded by the firm's professional liability policy. Engagements should be monitored to ensure compliance with this rule, and each firm's agreements should be updated to maintain consistency with any changes in the policy.

As previously discussed, the insurance company is required to defend the insured in a claim that alleges covered and uncovered acts. However, the carrier's defense is provided under a reservation of rights. In such a case, the carrier will issue to the insured a reservation of rights letter acknowledging receipt of the claim, stating that a defense is being provided, but reserving its right to reject the claim if the carrier's investigation determines that no coverage is warranted. If the carrier begins to defend a claim without reserving rights to contest coverage, it is generally liable for judgments on all covered and uncovered acts.

Not all allegations can be clearly categorized as covered or excluded. Some exclusions are less clearly

defined by the policy, and usually involve management consulting, SEC and bankruptcy-related engagements, and real estate and investment transactions. If the practitioners decide to provide services that frequently fall within this gray area of coverage, they should inform their insurance agent and carrier in writing of their intention to provide such services and determine if coverage will be provided. They should also ask the carrier to confirm such coverage in writing or ask what steps are necessary to adjust the policy and premium, if necessary, so that such coverage can be obtained. Assuming that these services are covered by the policy without first checking with the carrier will likely give rise to future coverage problems and personal exposure.

# CHAPTER 19

# The Responsibilities of the Insured

## Duties of the Insured

With the protection and subsidiary benefits that are associated with malpractice insurance coverage come responsibilities for the accountant. The two most prominent ones are the duty to disclose and the duty to notify.

### Duty to Disclose

When completing an insurance application, a firm is required to identify all pending lawsuits, claims, or circumstances likely to give rise to a claim against itself, its predecessor, or any principal or partner who is retired or deceased. The carrier is also likely to inquire whether the firm ever had its malpractice insurance canceled or refused, or whether coverage was canceled or refused within the last five years. Because the carrier relies upon the accountant's responses to these questions when determining whether coverage will be provided, and if so, which risk classification and premium will be

applied, the accountant should exercise extreme care when answering these questions and enlist the assistance of counsel if necessary. Because in most cases the application becomes part of the policy, any inaccurate statements in the policy, if material, may be interpreted by the carrier as misrepresentation and result in the cancellation of the policy.

In addition to disclosure of claims-related circumstances, most policies require accountants to disclose all material facts affecting the insurability of their firm. This holds true even when such information is not specifically requested in the application. An accountant's failure to do so may result in the cancellation of the policy. Disclosure of material facts or circumstances must be made not only when an accountant applies for coverage, but whenever material changes occur while a policy is in effect. Although it is largely a matter of judgment whether a circumstance is or is not material, facts are generally considered to be material if they would result in a different coverage disposition—for example, in the denial of coverage or in a premium adjustment—had the insurer been so informed. If accountants are unsure of how a change in their firm might affect their classification, they should seek assistance from their attorney or insurance broker. Although the identification of material facts depends upon a firm's particular circumstances, the following list includes some frequently recurring ones:

- The change in the name of the firm
- The opening or closing of an office
- The admission of a new partner
- The retirement of a partner
- A change in the management or financial structure of the firm
- A change in the types of engagements

- A merger with another firm
- The dissolution of the firm

## Duty to Notify

As a condition of most policies, the insured is required to immediately report an occurrence or claim to the carrier. (Occurrences and claims are discussed in chapter 17.) The importance of doing so increases when a claims-made policy is involved, since coverage is activated on the date on which the actual or potential claim is received by the carrier, not on the date on which the alleged negligence occurred. The following case best illustrates this point.

◇ ***Example***

*A small accounting firm provided auditing services to a small financial institution for several years. The financial institution ultimately failed. As an auditor, the accounting firm believed that it had rendered quality services. It did not foresee a claim, and this belief was supported by the fact that the receiver solicited its input when assessing the damages and controlling future activity.*

*In the following year, the firm's insurance premium was slightly increased due to changes in its business. The firm, after protracted internal discussion, decided not to renew its liability insurance. It was a small firm that had good relationships with its clients and had never experienced a claim; from a financial standpoint, the benefit of insurance coverage was thought to be outweighed by its cost.*

*The attorneys for the Federal Savings and Loan Insurance Corporation (FSLIC) eventually became involved and sent to the accounting firm a notice of an intent to file a claim for negligence. The accounting firm responded in a timely manner, sending the FSLIC attorney's demand letter to its former insurer. A review of the claims-made policy indicated that coverage had expired. Notice of the claim, or potential claim, had not been received within the policy period. The insurance company had to advise its former insured that there was no*

*coverage for a potentially serious claim. While some limited advice on what they could do was offered, the fact remained that the accounting practice was now in jeopardy.*

What could this firm have done differently? What would have provided protection for the firm, even though it felt that it had not committed malpractice? It should have reported the potential claim upon first learning of the exposure when the institution failed. (The manner in which the accountant notifies the insurer of claims is discussed in chapter 17.) Had it done so, the insurance carrier would have had notice of the claim. In all likelihood, the insurance company would have contacted the insured, discussed the engagement, secured relevant papers, and taken no further action. Then, if in one month, or in five years, the FSLIC, shareholders, or any other entity had tried to assert a claim, the insured would have been protected up to the limit of liability. The insurance company would have a record of the claim. It would have made no difference when, if ever, a claim had been formally asserted.

As shown by this actual situation, not reporting questionable activities can result in financial disaster. If an accountant receives notice of a situation that could result in a claim, it must be reported to the carrier, whose involvement should be solicited. If no further activity occurs, the matter will remain inactive; however, should the matter develop further, the accountant will be protected.

Timely notification results in an effective investigation and defense of a claim. An accountant's mere reporting of occurrences and claims has no effect on future insurability or premium charge; however, a failure to report a claim or an attempt to independently resolve a claim may void coverage and result in the accountant's personal responsibility for any damages.

The policy's notice requirement applies to the primary and all excess insurers. Notifying each carrier at each

level of coverage is best accomplished by certified mail to both the broker and carrier. Because of the difficulty, and in some situations impossibility, of appraising the ultimate recovery on a malpractice claim at its earliest phase, particularly when the possibility exists that one claim may trigger others, practitioners are advised to err on the side of safety and notify carriers at each layer of the actual or potential claim. The primary and excess carrier(s) may claim that the accountant's late notice prejudiced their ability to properly investigate and defend the claim—for example, that documents were lost or destroyed, that memories faded, or that witnesses were deceased or could not be located—thereby placing coverage in jeopardy. However, what constitutes late notice depends upon the circumstances of the particular claim, and under most policies, the carrier must show that the delay in notice actually prejudiced the defense of the claim.

## Claim Reporting

A common concern voiced by accountants addresses the occurrences that should be reported to the carrier. Most malpractice policies require timely notice of occurrences and claims. Should practitioners report even the slightest intimation of a claim that may never materialize? Claims do not always assume the form of a summons and complaint. They also come in the form of a letter, event, or other verbal or written communication from a client or third party, and regardless of their form, they convey actual or possible dissatisfaction with professional services. The accountant's best interests are served by promptly reporting to the insurance broker or carrier in writing, by certified mail, all claims or circumstances that are likely to give rise to a claim—including those that may first appear to be totally spurious allegations. Accountants should consult with

their personal attorney on this issue. The following information should be included in this notice:

- The firm's name and address
- The policy number
- The policy's effective dates
- A brief description of the circumstances of the claim
- Copies of all documents pertaining to the actual or potential claim

The determinative factor for the accountant when reporting occurrences is not the practitioner's opinion concerning the merits of the potential claim but the client's or third party's belief that it has suffered damage from negligently performed professional services. Liability and damage determinations are best made by defense counsel and the malpractice carrier. If a claim ultimately develops, accountants can reap the benefits of their policy by being defended and indemnified according to the policy terms. If no claim ever develops, the accountants have lost nothing but the possibility that they may be responsible for defending and indemnifying an otherwise covered claim.

The following red flags may indicate that a claim is likely:

- A client's request to provide free additional services to correct an error
- A client's refusal to pay a bill because of dissatisfaction with professional services
- A client's complaint about the quality of services that nonetheless are regularly paid for
- The closing by any regulatory board of an institution that the accountant audited
- A present or former client's filing for bankruptcy, regardless of whether any intention of bringing a malpractice claim is expressed.

Some circumstances unlikely to give rise to a claim include requests for further information or for an explanation of professional services and inquiries to negotiate payment of a bill because it appears to be "too high."

## Legal Expenses

In addition to satisfying a settlement or judgment for covered claims against the accountant up to the policy limit—that is, an indemnity—most accountants' malpractice policies will pay for the cost of defense. However, practitioners should closely examine the defense cost feature of their policy to determine whether the cost of investigating and defending claims is separate from or a part of the policy limit. If defense costs are a part of the policy limit, they will reduce the limits of coverage and the funds available for the payment of damages. Obviously, a policy that separates defense dollars from the indemnity is the preferred one for the accountant; however, these policies are increasingly difficult to find.

The defense costs incurred in any but the most minor claims can be exceedingly high, and having defense costs included in the policy limit can seriously affect the availability of coverage and can conceivably result in the exhaustion of funds before any settlement or judgment can be satisfied. Uninsured damages thus become the accountant's personal responsibility. The significant impact of defense costs upon the policy limit is supported by the fact that under the AICPA Professional Liability Insurance Plan, 30 percent of the monies paid under the plan in 1989 were applied to defense costs. These statistics make the exhaustion of the policy limit by defense payments a real possibility and show that when the accountant is responsible for legal expenses, a significant benefit of malpractice coverage is lost.

## Primary and Excess Coverage

The prevalence of large verdicts; prolonged, complex litigation; and class-action lawsuits has made it a common practice, particularly in the case of larger firms, for accountants to purchase excess liability insurance coverage to cover those claims for which damages exceed the limits of their primary insurance policy. With the expanded protection afforded by multilayer coverage comes an additional responsibility for the accountant—achieving consistency among policies. Because primary coverage and each layer of excess coverage are usually provided by different insurance companies, the accountant will want to be sure that all policies from the primary level to the highest layer of excess coverage provide uniformity in policy scope, effective date, and type. The full effect and benefit of accountants' multilayer coverage are best realized when each excess policy follows all agreements, terms, and conditions of all underlying policies.

The role played by the excess carrier in the defense of a claim is far less dynamic than that played by the primary carrier. When a claim is first brought against an accountant, the primary carrier is the first to act by assigning defense counsel, conducting an investigation, formulating a defense, and directly supervising the progress of litigation. The excess carrier's involvement rarely occurs when a claim is first made, unless the seriousness of the claim is such that it becomes immediately apparent that the claimant's damages will surely exceed the primary layer of coverage and impact the excess layer(s). However, in most cases the excess carrier relies on the primary carrier to represent and protect the insured accountant's interests and to keep itself apprised of developments in the claim via periodic status reports.

The excess carrier's role in the defense of the claim becomes far more prominent when damages begin to exhaust the underlying layer(s) of coverage and approach their excess layer. Moreover, unless it has been previously agreed upon by the primary and excess carriers, the excess carrier is not responsible for paying defense costs incurred prior to the exhaustion of the primary limits, regardless of the extent of such costs. The excess carrier's obligation for defense costs arises when the underlying coverage, whether it be primary or lower layer excess, is exhausted by payments or is tendered for settlement; such obligation continues until the claim is resolved or the excess coverage is exhausted or tendered, at which time defense costs become the responsibility of the next layer of excess coverage.

The limits of excess coverage will equal the difference between the firm's projected liability exposure for the policy year and the maximum limits of the primary policy. The excess amount is then distributed among succeeding layer(s) of excess policies until total insurance coverage equals the firm's projected exposure. For example, if a firm's malpractice liability is projected to be $3,000,000 and the maximum primary coverage available was $1,000,000, one possible coverage allocation could be $1,000,000 in primary coverage, $1,000,000 in first-layer excess, and $1,000,000 in second-layer excess coverage. Obviously, the individual limits and number of excess layers will be determined by the limits of available primary and excess policies. The excess carrier is entitled to notice of any changes to underlying primary policies.

# CHAPTER 20

# Purchasing and Reviewing Malpractice Coverage

## Obtaining Coverage

Although the overwhelming majority of practitioners, including those with claims histories, are able to obtain malpractice coverage, accountants should not automatically assume that it will be readily available. When purchasing coverage, they should adhere to the following guidelines.

### A Timely Search

Begin your search for coverage at least four months before the expiration of your current policy.

### Comparison of Features

Once the carriers have been identified, obtain specimen policies and compare them against one another and the needs of the firm. Although similarities exist among policies with respect to terms, conditions, and exclusions, there is no standard accountants' malpractice policy. Policies vary and subtle differences exist that may have a substantive effect on coverage.

## Review of the Policy

Read and understand the entire policy, particularly the exclusions and deductible features. A careful review of the policy may reveal that the exclusions section is longer than the description of coverage. Learn, among other things, which professional services are covered and whether the deductible applies to defense costs. Too many practitioners postpone reading their policy until a claim is brought, at which time they discover that they do not have the coverage they thought they had or that certain services are not covered because of exclusions or restrictions. Reading and understanding all aspects of the policy before a claim is brought keep the practitioner aware of the possibility of malpractice litigation, promote adherence to defensive practice, and result in the accountant's prompt response to claims.

## Identification and Resolution of Questions

Discuss any questions concerning the application or coverage with the broker. Insurance premiums entitle actual or potential insurers to the expertise of the carrier's brokers. Enlist the help of an attorney if necessary. Identifying and resolving questions during the application process will avoid delays occasioned by the return of the application and coverage disputes when a claim is brought.

## Timely Submission of Application

Submit the insurance application to all potential insurers approximately ninety days before the desired effective date of the policy. Because practitioners want to be perceived by the carrier in the most positive light, they should discount any circumstance that could reflect negatively on the firm. For instance, the firm's involvement in high-risk engagements could be offset by a favorable claims history or a period of claims activity

could be offset by a description of the firm's recent program of defensive-accounting practices. The complete disclosure requirement of the insurance application process applies as much to information that enhances the firm's image as it does to information that may alert the carrier to a high-risk policy holder.

## Description of Claims History

Answer truthfully and directly all inquiries concerning the firm's claims history. It will keep the broker and carrier from assuming the worst. Although it would be ideal if a firm could say that a malpractice claim had never been brought against it, statistics provided by Rollins, Burdick, Hunter & Company indicate that the increase in accountants' malpractice litigation has resulted in fewer such responses every year. Soften the impact of a not-so-perfect claims history by explaining actions taken by the firm to reduce the likelihood of claims, and by identifying any claims that were settled for nominal, nuisance-value amounts or were without merit. Involve the attorney who defended the claim in this process, particularly for those claims that resulted in a large settlement or judgment. The attorney's opinion concerning the merits of the claim, the advantages of settling, and the unpredictable nature of a trial will likely make a favorable impression on the broker.

## Avoiding a Denial of Coverage

Withdraw the application before a formal decision is made if it appears that coverage is going to be denied. Most policy applications ask whether the accountant has been denied insurance in the past. An affirmative response to this inquiry will likely result in higher premiums or a denial of coverage. Terminating the application process when it appears that coverage will likely be denied, and before an actual denial of coverage

is made, will allow the accountant to honestly state to future carriers that the firm has not previously been denied coverage. Conduct exhibited by the broker, underwriter, or other insurance representative that may indicate an impending denial of coverage includes the carrier's frequent requests for further information.

### Balancing Cost and Stability

Balance the cost of premiums with the carrier's stability and reputation for quality services. There is often a direct relationship between the cost of coverage and the stability of the carrier. The carrier offering the lowest premiums may not be the one whose policies best meet the needs of the firm or who will be able to defend and indemnify accountants when a malpractice claim is brought. Decisions to choose or change carriers should be based not solely on price, but on an objective analysis of all facts pertaining to coverage.

### Establishing a Rapport With the Broker

Regular personal contact with the broker—who has influence with the carrier—may increase the likelihood of coverage and the accountant's obtaining more complete coverage. Also, remain faithful to the malpractice carrier that offers complete coverage for the firm and provides it with the attention and service it deserves. Insurers will remember, or should be reminded of, a policyholder's loyalty particularly when the policyholder has foregone switching to a competing carrier offering the same coverage for a reduced premium. This is especially beneficial to accountants when they encounter an uncharacteristic period of claims activity when other carriers may decline coverage. This is another reason for not basing coverage decisions solely on premium rates. Ask the broker for a list of carriers writing the particular line of coverage in question.

### Execution of the Application

Have the application signed and dated by all partners and principals; the policy will otherwise be incomplete. Having the policy fully executed increases the likelihood that each partner or principal has reviewed the application, verified the accuracy of the information, and agreed that the policy meets the firm's insurance needs. Remember to keep copies of all previous policies.

## What to Look for in Your Professional Liability Insurance Program

Practitioners formerly had difficulty finding professional liability coverage. However, as more carriers entered the market and began writing this line of coverage, accountants were no longer required to purchase whatever coverage was available. They are now able to select policies that are more suited to the individual needs of their practices and that provide a more stable and complete scope of coverage. The following are features that the practitioner may want to consider when selecting malpractice insurance coverage.

- *Reputation of the Carrier.* Choose a reputable, stable carrier that is committed to the CPA market and is likely to be operational and able to defend and indemnify future claims. Practitioners can refer to the AICPA, state CPA societies, and other professional organizations that sponsor plans. These organizations have committees and programs that evaluate insurance companies. Carrier stability and commitment can be demonstrated by continued coverage during litigious periods. The same criteria can be applied to the carrier's reinsurer. A price-cutting carrier may retreat from the market when claims are brought and it has not charged

enough in premiums to cover the claims. The accountant's receipt of a nonrenewal notice when claims accelerate could possibly jeopardize the practice. A carrier's risk rating can be confirmed by Best's Reports. Because the insurance industry is regulated, the states review the financial condition of all approved carriers, and the reports generated by this review are filed and made available by each state's insurance department.

- *Staff of Specialists.* Look for a responsive, accessible, well-trained staff of insurance specialists, at both the broker and carrier levels.
- *Claims Supervision.* Make sure that the carrier has a reasonable approach to claims supervision, particularly with respect to assuming defense and indemnity obligations, making coverage determinations, and appointing qualified, attentive defense attorneys to represent their insureds. The accountant wants to avoid the carrier's cancellation of the policy, reluctance to defend or indemnify, or appointment of an incompetent attorney when called upon to protect him or her in a claim.
- *Claims Program.* The claims program should stress early claim reporting and allow the policyholder to become involved in the direction of the program. The program should also offer discounted premiums for the insured's own loss-prevention measures and the option of alternative dispute-resolution procedures to minimize litigation.
- *Extended Coverage.* Make sure that retired partners and employees as well as new employees joining the firm during the policy period will be covered.
- *Extended Protection.* Look for protection for partners against claims resulting from past actions with another firm or for work as trustees.
- *Territory.* Coverage should apply to claims filed within broad territorial limits.

- *Consent to Settlement.* Policy terms should condition settlement of all claims on the accountant's written consent. The resolution of a malpractice claim is a personal matter and can have a significant effect on the practitioner's reputation and the manner in which he or she is perceived by clients.
- *Selection of Defense Counsel.* The insured should be able to participate in the selection of defense counsel.
- *Tail Coverage.* Look for a policy that continues to insure retired partners under the firm's policy and obligates the firm, if it intends to cancel the policy, to notify the retired partners so that they can purchase tail coverage.
- *Reduced Premiums.* Some policies offer reduced premiums for those practitioners who choose higher deductibles.
- *Flexibility of Coverage.* Determine the ease with which policy coverage, deductibles, limits, and exclusions can be adjusted to meet the needs of the firm.
- *Innocent-Partner Coverage.* This type of coverage affords insurance protection to those members of the firm who had no knowledge of and were not involved in the affirmative dishonesty, fraud, misrepresentation, or other criminal activity of other partners and employees that, under ordinary circumstances, would not be covered by the policy. Further protection can also be achieved by obtaining a fidelity bond for those employees who have access to client funds.
- *Basis for Surcharges.* Consider a policy that follows a system of imposing surcharges that is not automatic but is based upon an analysis of the accountant's entire application.
- *Appeal Bonds.* Make sure that appeal bonds are covered if the accountant is unsuccessful in a malpractice lawsuit and an appeal is sought.

## Policy Review

Because professional liability insurance is a top priority for any firm, the policy should be reviewed annually or whenever circumstances warrant. Any changes in coverage should be made to reflect changes within the firm. With the size of a firm's staff and available professional services rarely remaining the same from one year to the next, policy limits and exclusions are particularly subject to the accountant's close scrutiny. Policy review should occur at least thirty days prior to the expiration date so that any changes can be made before the policy's new inception date.

# Conclusion

# CHAPTER 21

# Maintaining a Positive Attitude

Undoubtedly, the filing of claims against accountants will continue, and practitioners must realize that becoming a party to malpractice litigation is not something that happens only to someone else. All professionals make mistakes, but even if practitioners were able to guarantee that they could fully serve their clients without committing any errors, there would still be no certainty that a malpractice claim would never be brought and that no recovery would be paid. Some claims are paid even when quality services are performed, because—

- Settlement is frequently used as a method to cap not only quantifiable and unquantifiable costs but also the risk of trial.
- Defects exist in the judicial system.
- Professional standards may extend beyond those established by a firm.

Practitioners must realize that there may never be a perfect engagement and that trained attorneys may uncover, by scrutinizing all engagement-related materials,

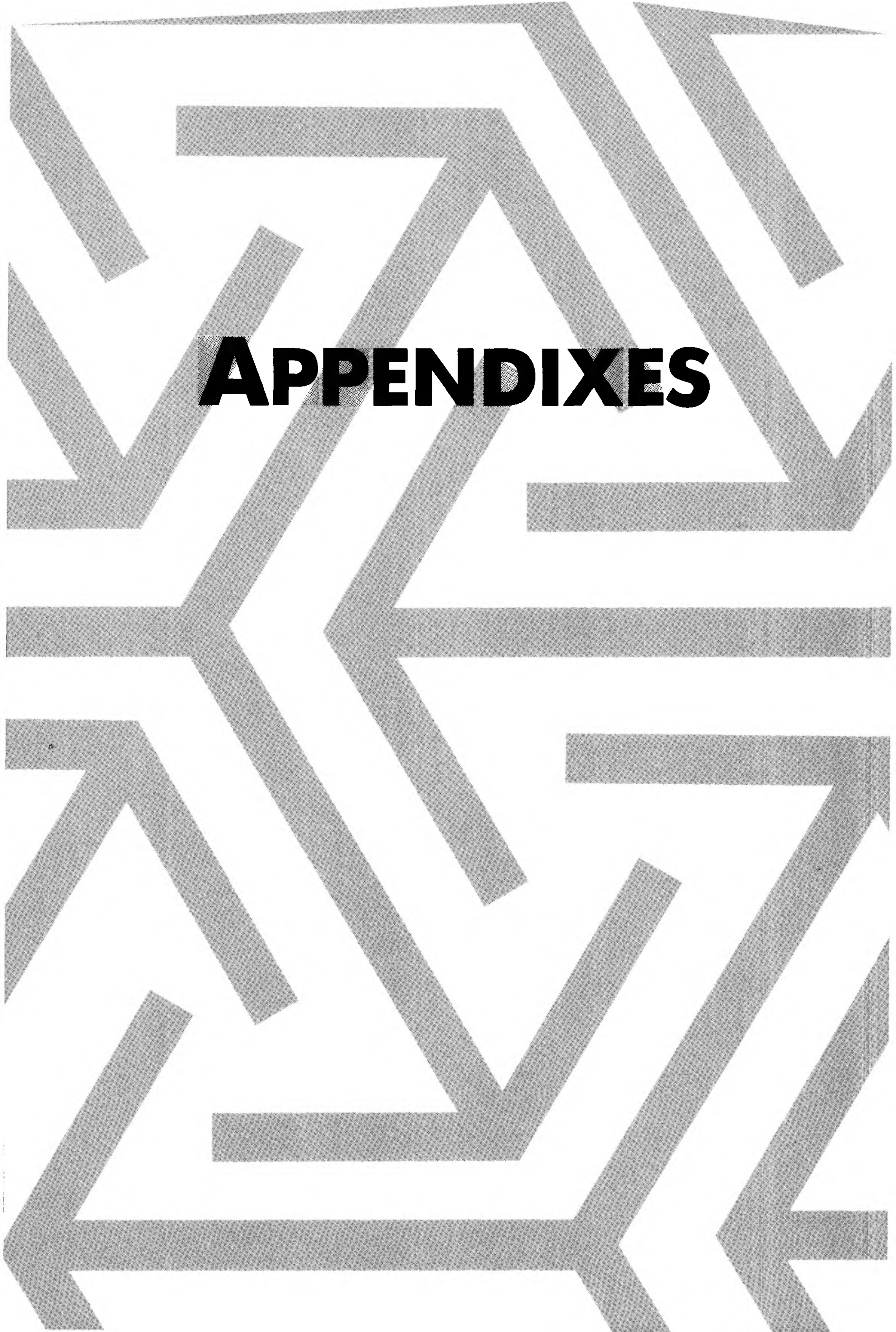
circumstances that may be considered by a judge or jury to be damaging to an accountant's case. However, giving into pressure and settling meritless claims creates a domino effect, thereby encouraging more members of the general public to sue accountants when no wrongful act has been committed.

Despite the seriousness of the malpractice liability situation, the outlook is far from hopeless. Judges are becoming increasingly aware of the objectives and design of accounting and auditing services. Strong defenses by attorneys and stricter settlement philosophies assumed by insurance companies have resulted in victories for accountants. Practitioners are not entirely defenseless. Accountants must respond to today's litigious environment no differently than they would to any other problem, by—

- Applying their technical competency and professionalism.
- Becoming educated in matters of malpractice.
- Instituting defensive accounting practices.
- Identifying engagements that involve the greatest risk.
- Obtaining a sound professional liability insurance program suited specifically to their firm.
- Supporting their professional societies and the AICPA in efforts to achieve tort reform.
- Retaining the best possible attorney.

By following these guidelines, accountants may substantially reduce the likelihood of malpractice litigation, be protected if a claim is brought, and influence the creation of laws that will govern the profession in the years to come.

# APPENDIXES



# APPENDIX A

## Departures From the Original Engagement Letter

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

### *Exhibit 1*

#### Conditions Encountered That Do Not Permit Expression of Opinion as Anticipated in the Original Engagement Letter[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Mary Delong, President
Delong's Design Interiors
187 Kent Street
City, State 10000

Dear Ms. Delong:

Our March 15, 19XX, letter described our present engagement as an audit for the purpose of expressing an opinion on the company's [*date*] financial statements. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $180,000 for

[1]Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA, 1991), AAM sec. 3175.

the three fiscal years ended [*date*]. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your [*date*] financial statements, nor do you feel any is necessary. You agreed, however, that the proposed assessment and its present status will be disclosed in the notes to the financial statements.

Because of the uncertainty as to your ultimate liability, we will be unable to express an unqualified opinion. Our report will state that the financial statements are subject to the effects of such adjustments, if any, as might have been required had the outcome of this income tax matter been known.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.[2]

Very truly yours,

ANTON, BONNER & CONVERY

____________________________

Partner

APPROVED:

By: ____________________________________

Date: __________________________________

[2]The client is not asked to sign this letter. Its purpose is to inform him or her of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it in the case of—for example—a problem client, or when there has been a history of misunderstandings.

*FOR DISCUSSION PURPOSES ONLY*

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## Exhibit 2

### Change in Circumstances From Those Contemplated in the Original Engagement Letter[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Mr. James J. Walker, Treasurer
Cavalier Country Club
336 North Street
City, State 10000

Dear Mr. Walker:

As we agreed in our original engagement letter dated [*date*], we are notifying you that our audit of your [*date*] financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your internal control structure policies and procedures allow us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the $X,XXX fee quoted in our previous letter.

[1]Adapted from the AICPA *Audit and Accounting Manual* (AICPA: New York, 1991), AAM sec. 3175.

The problem has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

Please indicate your acceptance of these added terms by signing the copy of this letter and returning it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

____________________________

Partner

APPROVED:

By: ____________________________________

Date: __________________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "Please indicate your. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our audit. . . ."

*FOR DISCUSSION PURPOSES ONLY*

# Appendix B

## Engagement Letters

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

### *Exhibit 1*

#### Individual Tax Services[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Mary Kay Haggerty
1417 Beacon Street
City, State 10000

Dear Ms. Haggerty:

We appreciate the opportunity of working with you and advising you regarding your income tax. To ensure a complete understanding between us, we are setting forth the pertinent information about the services which we propose to render for you.

We will prepare your 19XX federal and requested state income tax returns from information which you will furnish to us. We will make no audit or other verification of the data you submit, although we may need to ask you for clarification of some of the information. We will furnish you with questionnaires and/or worksheets to guide you in gathering

[1]Adapted from "Sample Engagement Letters," AICPA *Tax Practice Guides and Checklists* (New York: AICPA), sec. II.

the necessary information for us. Your use of such forms will assist us in keeping our fee to a minimum.

The law provides for a penalty to be imposed where a taxpayer makes a substantial understatement of their tax liability. If you would like information on the amount or circumstances of this penalty, please let us know.

You have the final responsibility for the income tax returns and, therefore, you should review them carefully before you sign and file them.

Our work in connection with the preparation of your income tax returns does not include any procedures designed to discover defalcations or other irregularities, should any exist. We will render such accounting and bookkeeping assistance as we find necessary for preparation of the income tax returns.

We will use our judgment in resolving questions where the tax law is unclear, or where there may be conflicts between the taxing authorities' interpretations of the law and other supportable positions. Unless otherwise instructed by you, we will resolve such questions in your favor whenever possible.

Our fee for these services will be based upon the amount of time required at our standard billing rates, plus out-of-pocket expenses. All invoices are due and payable upon presentation.

Your returns may be selected for review by the taxing authorities. Any proposed adjustments by the examining agent are subject to certain rights of appeal. In the event of such government tax examination, we will be available upon request to represent you and will render additional invoices for the time and expenses incurred.

If the foregoing fairly sets forth your understanding, please sign this letter in the space indicated and return it to our office.[2]

---

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*FOR DISCUSSION PURPOSES ONLY*

We want to express our appreciation for this opportunity to work with you.

Very truly yours,

ANTON, BONNER & CONVERY

______________________________

Partner

APPROVED:

By: ______________________________

Date: ______________________________

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## *Exhibit 2*

## Compilation of Financial Statements and Tax Services[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Michael E. Reisman, President
Reisman Acting Studio, Inc.
507 East Seventy-Third Street
City, State 10000

Dear Mr. Reisman:

This letter confirms our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and cash flows of Reisman Acting Studio, Inc. for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of Reisman Acting Studio, Inc. is presently expected to read as follows:

   We have compiled the accompanying balance sheet of Reisman Acting Studio, Inc. as of December 31, 19XX,

[1]Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 3175.

> and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with standards established 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).
>
> 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.

Our report on your interim financial statements, which will omit substantially all disclosures, will include an additional paragraph that will read as follows:

> 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.

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will assist your bookkeeper in adjusting the books of account so that he will be able to prepare a working trial balance from which financial statements can be compiled. Your bookkeeper will provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify states*] income tax returns for Reisman Acting Studio, Inc. for the fiscal year ended December 31, 19XX.

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that may

exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fees for this service will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________
Partner

APPROVED:

By: ______________________________________

Date: ____________________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*FOR DISCUSSION PURPOSES ONLY*

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## *Exhibit 3*

## Compilation of Personal Financial Statements[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

George and Martha Thaxton
4402 Mentone Street
City, State 10000

Dear Mr. and Mrs. Thaxton:

This letter confirms our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will compile, from information you provide, the statement of financial condition of George and Martha Thaxton as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

[1]Adapted from the AICPA *Personal Financial Statements Guide* (New York: AICPA), appendix A.

[*Standard Compilation Report*]

If, for any reason, we are unable to complete our compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will also [*discuss other services, if any*].

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that might exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________

Partner

APPROVED:

By: ______________________________

Date: ______________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## Exhibit 4

### Review of Financial Statements and Tax Services[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Joseph Martin, President
MFM Company, Inc.
Sixty-Eight Fetherston Avenue
City, State 10000

Dear Mr. Martin:

This letter confirms our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

1. We will review the balance sheet of MFM Company, Inc. as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not perform an audit of such financial statements taken as a whole, and, accordingly, we will not express an opinion on them. A review does not contemplate obtaining an understanding of the internal control structure or assessing control risk, tests of accounting

[1]Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 3175.

records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Our engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention, unless they are inconsequential.

Our report is presently expected to read as follows:

> We have reviewed the accompanying balance sheet of MFM Company, Inc. as of [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of MFM Company, Inc.
>
> 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, we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

If for any reason we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will provide your chief accountant with such consultation on accounting matters as he or she may require in adjusting and closing the books of account and in drafting financial statements for our review. Your chief accountant also will

provide us with a detailed trial balance and any supporting schedules we require.

3. We will also prepare the federal and state [*identify state*] income tax returns for MFM Company, Inc. for the fiscal year ended [*date*].

Our fees for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________

Partner

APPROVED:

By: ______________________________

Date: ______________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## *Exhibit 5*

## Review of Personal Financial Statements[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

George and Martha Thaxton
4402 Mentone Street
City, State 10000

Dear Mr. and Mrs. Thaxton:

This letter confirms our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will review the statement of financial condition of George and Martha Thaxton as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, in accordance with standards established by the American Institute of Certified Public Accountants. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them. Our report on the financial statements is presently expected to read as follows:

[1]Adapted from the AICPA *Personal Financial Statements Guide* (New York: AICPA), appendix A.

[*Standard Review Report*]

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

2. We will also [*discuss other services, if any*].

Our engagement cannot be relied upon to disclose errors and irregularities, including fraud or defalcations, that might exist. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________

Partner

APPROVED:

By: ______________________________

Date: ______________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*FOR DISCUSSION PURPOSES ONLY*

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## Exhibit 6

### Audit Services[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Sherry Holmes, President
Holmes' House of Health, Inc.
555 Second Avenue
City, State 10000

Dear Ms. Holmes:

This letter confirms our understanding of the arrangements for our audit of the financial statements of Holmes' House of Health, Inc. for the year ending [*date*].

We will audit the Company's balance sheet at [*date*], and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material

[1]Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 3175.

misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We will review the Company's federal and [*identify state*] income tax returns for the fiscal year ended [*date*]. These returns, we understand, will be prepared by the controller.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

*FOR DISCUSSION PURPOSES ONLY*

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________
Partner

APPROVED:

By: ______________________________

Date: ______________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If this letter. . ." and spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our audit. . . ."

*FOR DISCUSSION PURPOSES ONLY*

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## Exhibit 7

### Audit of Personal Financial Statements[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Philip and Beth Wilson
One Oxbow Road
City, State 10000

Dear Mr. and Mrs. Wilson:

This letter confirms our understanding of the terms and objectives of our audit and the nature and limitations of the services we will provide.

We will perform the following service(s):

1. We will audit the statement of financial condition of Philip and Beth Wilson as of [*date*], and the related statement of changes in net worth for the [*period*] then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of Philip and Beth Wilson. Our responsibility is to express an opinion on the financial statements based on our audit. We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit

[1]Adapted from the AICPA *Personal Financial Statements Guide* (New York: AICPA), appendix A.

includes examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by Philip and Beth Wilson as well as evaluating the overall financial statement presentation.

[*Standard Audit Report*]

2. We will also [*discuss other services, if any*].

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fees for these services [*specify fees or terms*].

We shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[2]

Very truly yours,

ANTON, BONNER & CONVERY

____________________________
Partner

APPROVED:

By: __________________________________

Date: ________________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the foregoing. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*FOR DISCUSSION PURPOSES ONLY*

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## Exhibit 8

### MCS Engagement[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

*[Date]*

Mr. John Mulberry, Executive Director
Memorial Hospital
Sixty-Eight Holland Avenue
City, State 10000

Dear Mr. Mulberry:

This letter confirms the services we discussed last week with you and your administrative staff about ways our firm might help Memorial Hospital achieve and maintain one of its major goals: progressive leadership in the community and the region in the delivery of quality health care services at a reasonable cost. In particular, we discussed potential operating efficiencies in systems, methods, and organizations.

Problem Areas

Memorial Hospital's systems operate relatively smoothly and without major disruptions, but substantial improvements can be achieved in a number of areas.

[1]Adapted from the AICPA *Management of an Accounting Practice Handbook* (New York: AICPA), chapter 204.

*Communications*

Memorial, as do most hospitals, faces a continuing problem of maintaining the flow of essential, detailed information among its many departments, shifts, and specialties. Also, the hospital's responsibilities to the local medical practice, the patients, and the community require an elaborate and complex information network extending far beyond the hospital.

Because of its complexity, this network frequently fails to provide essential, timely information. As a result, extra workloads tend to be created throughout the hospital.

Closing the gaps in this network will eliminate the extra workloads and unnecessary associated risks and will result in more reliable and efficient internal operation.

*Paperwork*

Again, in common with other hospitals, Memorial faces massive paperwork requirements. From internal accounting records and insurance forms to medical records and charts, the total record-keeping is a major portion of Memorial's workload, perhaps equaling direct patient care in man hours and labor costs.

A concentrated effort to streamline this paperwork could save much time and money in almost every hospital function.

*Organization, Staffing, and Work Assignments*

As the cost of services has increased, the traditional methods of organizing and operating a modern hospital have come under close scrutiny from administrators, insurance departments, legislators, and the public.

Hospitals must reexamine their methods and restructure their activities for higher efficiency and economy than was expected in past years.

Aside from the economics of this problem, Memorial Hospital has grown to a point where this type of reexamination is essential to maintain leadership among the area hospitals.

*FOR DISCUSSION PURPOSES ONLY*

Operations Improvement Program

Working closely with hospital personnel, we will make a careful and comprehensive review of the full range of your activities —from Nursing Services and ancillary departments, to Administration, Maintenance, and Housekeeping—to identify and evaluate—

- Formal and informal organization structures.
- Paperwork systems and procedures.
- Current work assignments.
- Staffing and staff utilization.
- Supervisory, managerial, and administrative requirements.
- Communications network and information requirements, including management reports.
- Facilities scheduling methods.

We will extensively interview administrators, department heads, supervisors, and selected staff members, as well as members of key medical staff committees. You have assured us of their full cooperation. We will also examine in detail all currently used forms and documents, and thoroughly analyze reports and records covering hospital operations. In our review, we will consider Memorial Hospital's near-term growth and expansion.

After we review and evaluate each area listed above, we will prepare two types of detailed recommendations for operational improvements:

- Those that can be implemented rapidly (without extensive systems design or conversion efforts)
- Those that require a system design and implementation project to install

Each recommended change will be supported by an analysis of project benefits—increased efficiency, improved communications, and prospective cost reductions. Each change will also show a proposed implementation schedule.

We consider this integrated program the most economic and effective approach to Memorial Hospital's objectives.

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## Expected Benefits

A project of this type can be expected to yield the following:

*Recommendations for Rapid Improvements*

- Modify the existing communications network to materially improve communications and response. For the short term, we would expect to close major communication gaps and eliminate major redundancies.
- Reduce paperwork volume through consolidation of forms, minor form modifications, and elimination of unnecessary paperwork.
- Improve operational efficiency through limited adjustments of work loads and work assignments.

Our experience with similar projects has shown 1 percent to 2 percent payroll reduction arising directly from these types of recommendations. From this experience and our preliminary review of your hospital operations, we estimate a potential annual cost reduction of more than $50,000 without impairing operational efficiency.

*Implementation Projects*

Until the detailed review is complete, we are not prepared to identify the prospective benefits of major recommendations, although our experience is that substantial additional improvement will result.

In presenting each major recommendation, we will clearly identify the specific benefits, the expected cost to implement, and the proposed plan. Thus, Memorial Hospital will be able to judge the value and priority of each project before proceeding with it.

## Project Organization

The project will be under the overall supervision of a partner from our firm's MCS division, who will work closely with the Hospital-designated project manager. The staff will consist of a supervisory consultant, a senior consultant, a team of

four analysts, and one or two hospital employees assigned full-time to our analyst staff.

We also ask that the hospital assign part-time liaison representatives from the nursing and medical staffs to provide technical support in those areas.

Fee Estimate and Timetable

We estimate that our fee for this project will range from $XX,XXX to $XX,XXX. Our policy is to bill every two weeks for services and costs. Payment is due when invoices are rendered.

We will keep you informed of our progress during the engagement. If time actually spent is less than our estimate, you will be billed for the lesser amount. If we encounter extraordinary problems that could increase the quoted fee, we will inform you immediately. You have agreed to pay us a $XX,XXX retainer to apply against the final billing.

We are pleased to have you as a client and hope this will begin a long and pleasant association.

If the above agrees with your understanding of the terms of our engagement, please sign the copy of this letter in the space provided and return it to us together with a check for $XX,XXX.[2]

Very truly yours,

ANTON, BONNER & CONVERY

______________________________

Partner

APPROVED:

By: ______________________________________

Date: ____________________________________

[2]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If the above agrees. . ." and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

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*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## *Exhibit 9*

## SEC Engagement: Initial Registration, Form S-1[1]

ANTON, BONNER & CONVERY
CERTIFIED PUBLIC ACCOUNTANTS

[*Date*]

Karen A. Kelly, President
Kelly Promotions, Inc.
Six Lake Street
City, State 10000

Dear Ms. Kelly:

This letter confirms the arrangements for our services for the registration statement Kelly Promotions, Inc. will file with the Securities and Exchange Commission.

We will audit the consolidated balance sheets of Kelly Promotions, Inc. as of December 31, 19XX and 19XY, and the related statements of income, retained earnings, and cash flows for the three years then ended, which will be included in a Form S-1[2] registration statement. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance

[1]Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 3175.

[2]This should be edited to agree with the particular form to be filed.

about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion. We will also audit the financial information necessary for the schedules required by Regulation S-X of the SEC.

We will perform these services as expeditiously as possible. Your accounting personnel will assist us and cooperate in the timely preparation of trial balances, schedules, and account analyses, and provide clerical assistance as needed. Mr. Blane Holmes of the law firm of Holmes & Williamson will be liaison with counsel.

If during our audit we find that we are unable to express an unqualified opinion on the financial statements or that we are otherwise unable to comply with the requirements of Form S-1, we will notify you of the problems encountered.

We will also fulfill the portion of the underwriter's agreement directed to the independent accountants, provided the requirements are within the purview of Statement on Auditing Standards No. 49, *Letters for Underwriters*, issued by the American Institute of Certified Public Accountants, and provided the material can properly be reported by accountants pursuant to that Statement. In this regard, we require that a copy of the tentative underwriting contract be given to us as soon as it is available. Should that portion of the underwriting contract that deals with the details of the comfort letter be available before the balance of the underwriting contract is completely drafted, you will arrange for us to receive a copy of it.

Subsequent to issuance of our auditor's report, we will perform certain procedures required by Statement on Auditing Standards No. 37, *Filings Under Federal Securities Statutes*, issued by the American Institute of Certified Public Accountants, regarding execution of consent letters required for certain

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SEC filings. In connection therewith, all printer's proofs of reports to be filed with the Securities and Exchange Commission are to be submitted to us for review. This requirement extends to the entire registration statement and all other material which accompanies the financial statements.

Our audit is subject to the inherent risk that material errors and irregularities, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of irregularities that come to our attention, unless they are inconsequential.

Our fee for services will be computed at our standard per diem rates, and will be billed to you, together with out-of-pocket costs, every two weeks. Invoices are due and payable on presentation. Before our services begin, you have agreed to pay us a $XX,XXX retainer, which will be applied to the final billing for this engagement.

We appreciate the confidence in our firm that you have expressed by retaining us as your independent certified public accountants.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us, together with your check for $XX,XXX.[3]

Very truly yours,

ANTON, BONNER & CONVERY

____________________________

Partner

APPROVED:

By: ____________________________________

Date: __________________________________

[3]Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning "If this letter correctly expresses. . ." and spaces for the acknowledgment. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

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# APPENDIX C

## New Client Acceptance Form*

Name of prospective client: ______________________

Address: ______________________

Telephone and fax numbers: ______________________

Name and title of contact at prospective client: ______________________

______________________

Attorney: ______________________

Principal bank: ______________________ Contact: ______________________

**Instructions**

This form provides for information necessary to assess whether to accept a prospective client and it is to be prepared prior to submission of an engagement letter to the client. The information should be obtained from discussions with the prospective client's management, banker, attorney, and, if applicable, current or former independent CPA, from reviewing the client's financial statements and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

**Services and Reports Required**

1. Describe the service and reports requested. ______________________

   ______________________

   ______________________

*Adapted from the *AICPA Audit and Accounting Manual* (New York: AICPA), AAM sec. 2200.

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ______________________

_____________________________________________

_____________________________________________

3. What is the required completion date? ______________

_____________________________________________

_____________________________________________

4. Describe any other services not requested for which there appears to be a need. ______________________________

_____________________________________________

5. Indicate how we became aware of the client's need for service. ______________________________________

_____________________________________________

6. Describe any required staff or expertise that is beyond the firm's capabilities. ______________________________

_____________________________________________

**Industry Practices and Conditions**

7. In what industry does the company operate? __________

_____________________________________________

8. Describe any specialized tax or accounting practices applicable to the industry. ___________________________

_____________________________________________

9. Describe any economic, technological, or competitive conditions or other recent developments in the industry that may affect the company's operations. ____________

_____________________________________________

_____________________________________________

_____________________________________________

_____________________________________________

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10. Describe any special regulatory requirements applicable to the industry. ______________________

______________________________________________

### Organization and Personnel

11. Company's legal name: ______________________

    Fiscal year end: ______________________

12. Type of legal entity (corporation, S corporation, partnership, proprietorship, etc.): ______________

13. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

| *Name and (if Applicable) Title* | *Percent of Ownership* |
|---|---|
| | |
| | |
| | |

14. List the principal members of management.

| *Name and Title* | *Stated Qualifications (Education, Training, and Experience)* |
|---|---|
| | |
| | |
| | |

15. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, and method of computation), stock option, or pension (profit-sharing) plans that may affect the engagement. ______________

______________________________________________

______________________________________________

______________________________________________

16. List each location maintained by the company (including foreign locations, if any), the nature of the activity performed at each, and the approximate number of employees at each (for example, plant, sales office, executive offices, etc.).

| *Location* | *Activity* | *Number of Employees* |
|---|---|---|
| ______ | ______ | ______ |
| ______ | ______ | ______ |

17. Inquire about possible transactions with related parties that may affect the engagement.

| *Name of Related Party* | *Relationship* | *Type of Transaction* |
|---|---|---|
| ______ | ______ | ______ |
| ______ | ______ | ______ |

**Operations**

18. Describe the nature of the company's major assets and liabilities (attach a copy of financial statements).

______

______

19. What are the company's sources of revenue and marketing methods (describe major products, customers, etc.)?

______

______

20. If the company is economically dependent on a major customer, name the customer and provide the approximate percentage of total revenue generated by this customer.

______

______

21. Describe the components of cost of goods sold and the company's production process. ______

______

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22. What are the major expenses of the company other than cost of goods sold? ______________________

______________________________________________

______________________________________________

23. Describe the company's compensation methods—for example, salary, hourly wage, commissions, piece work, union scale, etc. ______________________

______________________________________________

______________________________________________

24. What are the company's major sources of financing—for example, working-capital loans, long-term debt, leasing, equity, etc.? Describe restrictive covenants on any loan agreements. ______________________

______________________________________________

______________________________________________

25. Review the most recent income tax returns. Inquire about IRS or state audit examinations. Describe any significant book and tax differences, unusual elections, loss carryforwards, obviously aggressive positions, status of audits, etc. ______________________

______________________________________________

______________________________________________

______________________________________________

26. Are banking arrangements satisfactory? If not, explain.

______________________________________________

______________________________________________

______________________________________________

## Accounting

27. Does the company maintain the following items? [*Attach description, if appropriate.*]

    a. Accounting manual? ______________________

    b. Budget? ______________________

c. Cost accounting system? ______________________

d. EDP equipment? (Indicate the types of equipment and software.) ______________________

______________________

e. Written credit policy? ______________________

28. Briefly describe the accounting system and accounting responsibilities.

| *Description of Accounting Record* | *Name of Person Responsible* | *EDP* | *Manual* | *N/A* |
|---|---|---|---|---|
| General ledger | ______ | ___ | ____ | ___ |
| Subsidiary ledgers: | | | | |
| Accounts receivable | ______ | ___ | ____ | ___ |
| Fixed assets | ______ | ___ | ____ | ___ |
| Loans payable | ______ | ___ | ____ | ___ |
| Accounts payable | ______ | ___ | ____ | ___ |
| Perpetual inventory | ______ | ___ | ____ | ___ |
| Physical industry summarization | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| Journals: | | | | |
| Cash receipts | ______ | ___ | ____ | ___ |
| Cash disbursements | ______ | ___ | ____ | ___ |
| Sales/purchase/ voucher | ______ | ___ | ____ | ___ |
| Payroll | ______ | ___ | ____ | ___ |
| General journal entries | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| Financial Reporting [*Indicate basis of accounting*] | ______ | ___ | ____ | ___ |

| *Description of Accounting Record* | *Name of Person Responsible* | *EDP* | *Manual* | *N/A* |
|---|---|---|---|---|
| Annual financial statements | ______ | ___ | ____ | ___ |
| Monthly financial statements | ______ | ___ | ____ | ___ |
| Management reports | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |
| Other: | | | | |
| Bank reconciliations | ______ | ___ | ____ | ___ |
| ______ | ______ | ___ | ____ | ___ |

29. Describe the company's completeness procedures and methods to ensure that accounting transactions enter into the accounting system, that is, that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded. ______

______

______

______

30. Describe any unusual features of the accounting system.

______

______

______

31. For audit engagements, does it appear that the accounting system provides accounting records sufficient to permit the application of audit procedures on a cost-effective basis? (If not, attach a memo explaining the possible scope limitation, its potential effect on the auditor's report, and the potential management reaction.)

______

______

______

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### Tax Matters

32. Who prepares the tax returns? ______________________

___________________________________________

___________________________________________

33. Describe major differences between book and tax income, unusual tax elections, carryforwards, or IRS examinations in process. If possible, review copies of the three most recent years' tax returns and attach them to this form.

___________________________________________

___________________________________________

___________________________________________

### Other Matters

34. Describe any significant problems that could affect the engagement, such as litigation or other contingencies; unusual agreements; and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of EDP equipment, etc. ______________________

___________________________________________

___________________________________________

___________________________________________

35. Identify the current or former independent CPAs for the last five years (obtain the client's permission).

___________________________________________

    a. Describe any disputes over accounting matters.

    ___________________________________________

    b. List comments made by the client's previous accounting firms. If no contact was established, explain why.

    ___________________________________________

    ___________________________________________

36. Describe any apparent problems or areas for improvement that were noted in which our firm could provide additional service or recommendations. ______________

___________________________________________

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37. Indicate whether any prior accountants or other professionals have been sued by the prospective client.

_______________

_______________

38. If we have no prior knowledge of the company, its management, or its officers, identify the references checked and their comments. Contacts include the client's principal lawyer, banker, Chamber of Commerce, or Better Business Bureau. Run a Dun & Bradstreet report. Make a list of the client's lawyers and inquire of others in the office as to any prior dealings with such lawyers. _______________

_______________

_______________

### Independence

39. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff? _______________

_______________

_______________

### Fees

40. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment. _______________

_______________

41. If possible, indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)

_______________

_______________

42. Describe our fee arrangements and attach a schedule showing an estimate of the gross and net fees. Indicate

whether the fee arrangements have been discussed with the client. Include a discussion of commitments from the client (for example, schedule preparation) and your assessment as to whether they can perform. ________

________

________

43. Describe any other indications that our firm might have a problem billing or collecting our fees. ________

________

**Management Integrity**

44. Have any of the following circumstances raised any concerns about management's integrity?
    a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries?

    ________

    b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to make an intentional error, irregularity, or misrepresentation? ________

    ________

    c. Disputes about accounting principles, engagement procedures, or similarly significant matters with an existing or former accountant, or doubts of the predecessor accountant about management's integrity? ________

    ________

    d. Comments by bankers, attorneys, creditors, or others having a business relationship with the potential client? ________

    ________

45. If the client is operating in an industry that might put the firm at a high-level risk of litigation or unfavorable publicity, please discuss. ________

________

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46. If the management is changing accountants, why is the change being made? ______________________________

______________________________________________

47. Is there any reason to suspect that management would be uncooperative, unreasonable, or otherwise unpleasant to work with? ______________________________

______________________________________________

### Other Comments or Observations

48. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary.

______________________________________________

______________________________________________

### Conclusion

We should accept______not accept______the engagement.

Form prepared by__________________ Date:__________

Engagement partner________________ Date:__________

Managing partner__________________ Date:__________

# APPENDIX D

## Client Inquiry Sheet

Date of inquiry: ____________

Received by: ____________

☐ Telephone ☐ Letter

Staff contact: ______________________________

Client: ______________________________

Client contact: ______________________________

Nature of inquiry: ______________________________

______________________________

______________________________

______________________________

______________________________

______________________________

______________________________

Responded by: ☐ Telephone ☐ Letter

☐ Referred to: ____________

Recommendation: ______________________________

______________________________

______________________________

______________________________

______________________________ ____________

Signature of Staff Contact Date



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# Appendix E

## Short-Form Checklist for a Compilation Engagement[1]

Client: ________________ Balance-Sheet Date: ________

| *Step* | *Action/Decision* | *AR Ref.*[2] | *Initials* |
|---|---|---|---|
| 1. | Obtain an engagement letter. | .08 | _____ |
| 2. | Acquire the necessary knowledge of client's industry accounting principles and practices. | .10 | _____ |
| 3. | Acquire a general understanding of the client's business transactions, the form of the accounting records, the stated qualifications of the accounting personnel, the accounting basis used, and the form and content of the financial statements. (It is not necessary to make inquiries or perform other procedures unless the information supplied is questionable.) | .11-.12 | _____ |
| 4. | Read the financial statements and determine if they are appropriate in form and free from obvious material error. | .13 | _____ |
| 5. | Consider whether all disclosures required by generally accepted accounting principles (GAAP) or | | |

[1]Source: AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 2300.

[2]The abbreviation "AR Ref." in this checklist means AR section 100 of *Professional Standards* (New York: AICPA). All references in this checklist are to paragraphs in AR section 100.

| Step | Action/Decision | AR Ref. | Initials |
|---|---|---|---|
| | an acceptable comprehensive basis of accounting are provided. If they are not, go to step 6. If they are, go to step 7. | .19 | _____ |
| 6. | If substantially all disclosures required by GAAP or another comprehensive basis of accounting are omitted, indicate this in a separate paragraph in your report; if a comprehensive basis of accounting other than GAAP is used, disclose this basis either in the financial statements or in your report. If the statement of cash flows is also omitted in GAAP statements, modify the scope paragraph and disclosure deficiency paragraph accordingly. If most, but not all, disclosures are omitted, notes to the financial statements should be labeled "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included." | .19-.21 | _____ |
| 7. | Consider whether the financial statements contain measurement departures from GAAP or an other comprehensive basis of accounting. If they do, go to step 8. If they do not, go to step 9. | .39 | _____ |
| 8. | Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. | | |

| *Step* | *Action/Decision* | *AR Ref.* | *Initials* |
|---|---|---|---|
| | If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies are not measurement departures if they are properly disclosed. See step 5.) Withdraw from the engagement if the GAAP departures are designed to mislead statement users. | .39-.40 | _____ |
| 9. | Determine whether the firm is independent. If the firm is not, go to step 10. If the firm is, go to step 11. | .22 | _____ |
| 10. | If the firm is not independent, add a separate paragraph to your report: "I am (we are) not independent with respect to XYZ Company." | .22 | _____ |
| 11. | If the financial statements are accompanied by information presented for supplementary analysis purposes, include such other data in the compilation report. | .43 | _____ |
| 12. | Mark each page of the financial statements, including any supplemental data, "See accountant's compilation report." | .16 | _____ |
| 13. | Date your report using the date the compilation was completed. | .15 | _____ |
| 14. | Issue the financial statements and related compilation report. | .14 | _____ |

| *Step* | *Action/Decision* | *AR Ref.* | *Initials* |
|---|---|---|---|
| 15. | If, subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561), Interpretation No. 4 of SSARS No. 1 (AR section 9100.13-.15), and your attorney. | .42 | _____ |

Completed by: ____________________ Date: ____________

*FOR DISCUSSION PURPOSES ONLY*

# Appendix F

## Short-Form Checklist for a Review Engagement[1]

Client: ____________________ Balance-Sheet Date: __________

| *Step* | *Action/Decision* | *AR Ref.*[2] | *Initials* |
|---|---|---|---|
| 1. | Obtain an engagement letter. | .08 | ______ |
| 2. | Determine whether your firm is independent; if not, go to step 3. If the firm is, go to step 4. | .38 | ______ |
| 3. | Stop. Do not issue a review report. (However, it may be possible to issue a compilation report.) | .38 | ______ |
| 4. | Acquire the necessary knowledge of the client's industry accounting principles and practices. | .24 | ______ |
| 5. | Acquire a general understanding of the nature of the client's business, including (a) its operating characteristics and (b) the nature of its assets, liabilities, revenues, and expenses. | .26 | ______ |
| 6. | Apply appropriate inquiry and analytical procedures in order to obtain a reasonable basis for expressing limited assurance that | | |

[1]Source: AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 2300.

[2]The abbreviation "AR Ref." in this checklist means AR section 100 of *Professional Standards* (New York: AICPA). All references in this checklist are to paragraphs in AR section 100.

| *Step* | *Action/Decision* | *AR Ref.* | *Initials* |
|---|---|---|---|
| | there are no material modifications that should be made to the financial statements. | .24-.27 | ______ |
| 7. | Read the financial statements to determine whether, based on the information presented, they appear to conform to generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. Obtain reports of other accountants for subsidiaries, investees, etc., if any. Indicate division of responsibility if reference is made to other accountants. | .27 | ______ |
| 8. | Perform additional procedures if information appears to be incorrect, incomplete, or otherwise unsatisfactory. | .29 | ______ |
| 9. | Document in your workpapers matters covered in steps 6 and 7 above. Also describe unusual matters that were considered and how they were resolved (step 8). | .30 | ______ |
| 10. | Determine whether the inquiry and analytical procedures considered necessary to achieve limited assurance are incomplete or restricted in any way. If they are, go to step 11; if not, go to step 12. | .36 | ______ |
| 11. | Consider whether a compilation report should be issued rather than a review report. (A review that is incomplete or restricted is | | |

| *Step* | *Action/Decision* | *AR Ref.* | *Initials* |
|---|---|---|---|
| | not an adequate basis for issuing a review report.) If the client has refused to provide additional or revised information, the accountant should withdraw from the engagement. | .12 & .36 | ______ |
| 12. | Consider whether the financial statements contain known departures from GAAP or an other comprehensive basis of accounting, including disclosure departures. If they do, go to step 13. If they do not, go to step 14. | .39 | ______ |
| 13. | Get client to revise the financial statements. Failing that, consider modifying your report by adding a separate paragraph or paragraphs. If the impact of the departure has been determined by management or is known by you, disclose the dollar effects in your report. (However, uncertainties and inconsistencies should not cause the report to be modified if they are properly disclosed.) Withdraw from the engagement if the departures are designed to mislead financial statement users. | .39 & .40 | ______ |
| 14. | Consider obtaining a representation letter from the client. | .31 | ______ |
| 15. | Determine whether the basic financial statements are accompanied by information presented for supplementary analysis purposes. | | |

| *Step* | *Action/Decision* | *AR Ref.* | *Initials* |
|---|---|---|---|
| | If they are, go to step 16. If they are not, go to step 17. | .43 | ______ |
| 16. | Indicate the responsibility assumed for the supplementary information in your review report or in a separate report. The report should disclose whether (a) the supplemental information has been reviewed (as part of the basic financial statement review) and you are not aware of any needed material modification or (b) the supplemental information has not been reviewed but only compiled. | .43 | ______ |
| 17. | Mark each page of the financial statements, including any supplemental data, "See accountant's review report." | .34 | ______ |
| 18. | Date your report using the date the inquiry and analytical procedures were completed. | .33 | ______ |
| 19. | Issue the financial statements and related review report. | .32 | ______ |
| 20. | If, subsequent to the date of the report, facts that would possibly cause the financial statements to be misleading are discovered (and were in existence at the report date), consult SAS No. 1, section 561 (AU section 561, Interpretation No. 4), of SSARS No. 1 (AR section 9100.13-.15), and your attorney. | .42 | ______ |

Completed by: ______________________ Date: ______________

*FOR DISCUSSION PURPOSES ONLY*

# Appendix G

## Review of Financial Statements—Illustrative Inquiries*

1. *General*
   a. What are the procedures for recording, classifying, and summarizing transactions (relates to each section discussed below)?
   b. Do the general ledger control accounts agree with subsidiary records (for example, receivables, inventories, investments, property and equipment, accounts payable, accrued expenses, noncurrent liabilities)?
   c. Have accounting principles been applied on a consistent basis?
2. *Cash*
   a. Have bank balances been reconciled with book balances?
   b. Have old or unusual reconciling items between bank balances been reviewed and adjustments made where necessary?
   c. Has a proper cutoff of cash transactions been made?
   d. Are there any restrictions on the availability of cash balances?
   e. Have cash funds been counted and reconciled with control accounts?
3. *Receivables*
   a. Has an adequate allowance been made for doubtful accounts?
   b. Have receivables considered uncollectible been written off?

*Source: AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 2300.

*c.* If appropriate, has interest been reflected?

*d.* Has a proper cutoff of sales transactions been made?

*e.* Are there any receivables from employees and related parties?

*f.* Are any receivables pledged, discounted, or factored?

*g.* Have receivables been properly classified between current and noncurrent?

4. ***Inventories***

*a.* Have inventories been physically counted? If not, how have inventories been determined?

*b.* Have general ledger control accounts been adjusted to agree with physical inventories?

*c.* If physical inventories are taken at a date other than the balance-sheet date, what procedures were used to record changes in inventory between the date of the physical inventory and the balance-sheet date?

*d.* Were consignments in or out considered in taking physical inventories?

*e.* What is the basis of valuation?

*f.* Does inventory cost include material, labor, and overhead where applicable?

*g.* Have writedowns for obsolescence or cost in excess of net realizable value been made?

*h.* Have proper cutoffs of purchases, goods in transit, and returned goods been made?

*i.* Are there any inventory encumbrances?

5. ***Prepaid Expenses***

*a.* What is the nature of the amounts included in prepaid expenses?

*b.* How are these amounts amortized?

6. ***Investments, Including Loans, Mortgages, and Intercorporate Investments***

*a.* Have gains and losses on disposal been reflected?

*b.* Has investment income been reflected?

*c.* Has appropriate consideration been given to the classification of investments between current and noncurrent, and the difference between the cost and market value of investments?

*d.* Have consolidation or equity accounting requirements been considered?

*e.* What is the basis of valuation of marketable-equity securities?

*f.* Are investments unencumbered?

7. ***Property and Equipment***

*a.* Have gains or losses on disposal of property or equipment been reflected?

*b.* What are the criteria for capitalization of property and equipment? Have such criteria been applied during the fiscal period?

*c.* Does the repairs-and-maintenance account only include items of an expense nature?

*d.* Are property and equipment stated at cost?

*e.* What are the depreciation methods and rates? Are they appropriate and consistent?

*f.* Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?

*g.* Does the entity have material lease agreements? Have they been properly reflected?

*h.* Is any property or equipment mortgaged or otherwise encumbered?

8. ***Other Assets***

*a.* What is the nature of the amounts included in other assets?

*b.* Do these assets represent costs that will benefit future periods? What is the amortization policy? Is it appropriate?

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  c. Have other assets been properly classified between current and noncurrent?
  d. Are any of these assets mortgaged or otherwise encumbered?

9. ***Accounts and Notes Payable and Accrued Liabilities***
  a. Have all significant payables been reflected?
  b. Are all bank and other short-term liabilities properly classified?
  c. Have all significant accruals, such as payroll, interest, and provisions for pension and profit-sharing plans, been reflected?
  d. Are there any collateralized liabilities?
  e. Are there any payables to employees and related parties?

10. ***Long-Term Liabilities***
  a. What are the terms and other provisions of long-term liability agreements?
  b. Have liabilities been properly classified between current and noncurrent?
  c. Has interest expense been reflected?
  d. Has there been compliance with restrictive covenants of loan agreements?
  e. Are any long-term liabilities collateralized or subordinated?

11. ***Income and Other Taxes***
  a. Has provision been made for current and prior-year federal income taxes payable?
  b. Have any assessments or reassessments been received? Are there tax examinations in process?
  c. Are there temporary differences? If so, have deferred taxes been reflected?
  d. Has provision been made for state and local income, franchise, sales, and other taxes payable?

12. ***Other Liabilities, Contingencies, and Commitments***

    *a.* What is the nature of the amounts included in other liabilities?

    *b.* Have other liabilities been properly classified between current and noncurrent?

    *c.* Are there any contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims? Are there any unasserted potential claims?

    *d.* Are there any material contractual obligations for construction or purchase of real property and equipment and any commitments or options to purchase or sell company securities?

13. ***Equity***

    *a.* What is the nature of any changes in equity accounts?

    *b.* What classes of capital stock have been authorized?

    *c.* What is the par or stated value of the various classes of stock?

    *d.* Do amounts of outstanding shares of capital stock agree with subsidiary records?

    *e.* Have capital stock preferences, if any, been disclosed?

    *f.* Have stock options been granted?

    *g.* Has the entity made any acquisitions of its own capital stock?

    *h.* Are there any restrictions on retained earnings or other capital?

14. ***Revenue and Expenses***

    *a.* Are revenues from the sale of major products and services recognized in the appropriate period?

    *b.* Are purchases and expenses recognized in the appropriate period and properly classified?

    *c.* Do the financial statements include discontinued operations or items that might be considered extraordinary?

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*15. **Other***

*a.* Are there any events that occurred after the end of the fiscal period that have a significant effect on the financial statements?

*b.* Have actions taken at stockholder, board of directors, or comparable meetings that affect the financial statements been reflected?

*c.* Have there been any material transactions between related parties?

*d.* Are there any material uncertainties? Is there any change in the status of material uncertainties previously disclosed?

# Appendix H

## Audit Supervision, Review, and Approval Form*

Client: ____________________ Balance-Sheet Date: __________

**Instructions**

This form should be completed as the last procedure before issuance of the signed auditor's report. Any item answered "No" should be explained in the "Comments" column or in an attached memorandum. File this form in the General File.

**Detailed Review** (to be performed by the staff in charge of fieldwork)

| | *Yes* | *No* | *N/A* | *Comments* |
|---|---|---|---|---|
| 1. I have reviewed all work papers prepared by the personnel in my charge on this engagement. Each schedule is complete, properly headed, initialed, indexed, and cross-referenced. | ___ | ___ | ___ | ________ |
| 2. I have reviewed the permanent file and general file, and all relevant information has been incorporated or cross-referenced. | ___ | ___ | ___ | ________ |
| 3. I have compared the work performed as evidenced by our workpapers with the procedures called for by the audit programs and find that our audit complies with the requirements of the program. | ___ | ___ | ___ | ________ |

*Reprinted from *Guide to Audits of Small Businesses*, 10th ed., Carmichael, McMurrian, and Anderson, with the permission of Practitioners Publishing Company, Fort Worth, Texas.

| | Yes | No | N/A | Comments |
|---|---|---|---|---|
| 4. I have compared the workpapers with the general ledger trial balance of accounts and find that satisfactory audit recognition has been given to all asset, liability, equity, income, and expense accounts. | ___ | ___ | ___ | ________ |
| 5. I have reviewed the completed audit program and am satisfied that our audit, as evidenced by the workpapers reviewed by me, was conducted in accordance with generally accepted auditing standards. | ___ | ___ | ___ | ________ |
| 6. I have compared the accounts in the general ledger trial balance with their summarizations, classifications, descriptions, and disclosures in the financial statements. | ___ | ___ | ___ | ________ |
| 7. I have obtained a review of the tax accrual and provision by the tax department and included their approval in the workpapers. (Optional step.) | ___ | ___ | ___ | ________ |
| 8. I have reviewed the financial statements and am satisfied that the financial statements meet accepted standards of presentation and disclosure and that they have been prepared in conformity with generally accepted accounting principles consistently applied. A financial statement disclosure checklist has been completed. | ___ | ___ | ___ | ________ |

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| | *Yes* | *No* | *N/A* | *Comments* |
|---|---|---|---|---|
| 9. I have reviewed the legal representation and management representation letters for consideration of all important representations. | ___ | ___ | ___ | ________ |
| 10. I have reviewed the auditor's report and am satisfied it properly expresses our opinion in accordance with generally accepted auditing standards. | ___ | ___ | ___ | ________ |
| 11. I have reviewed all other reports or communications, if any, required in conjunction with this audit, e.g., communication of reportable conditions or audit related matters to the audit committee or its equivalent, and am satisfied that they meet the acceptable reporting standards. | ___ | ___ | ___ | ________ |

Completed by: ______________________ Date: ____________

**Partner Review** (to be performed by the engagement partner. Omit all except the last two items if detailed review was performed by a partner.)

| | *Yes* | *No* | *N/A* | *Comments* |
|---|---|---|---|---|
| 1. I have reviewed all workpapers prepared by the personnel in my charge on this engagement that were not reviewed as a part of the detailed review. | ___ | ___ | ___ | ________ |
| 2. I have also reviewed sufficient additional workpapers to be | | | | |

| | Yes | No | N/A | Comments |
|---|---|---|---|---|
| satisfied with the adequacy of our audit and with the detailed review. | ___ | ___ | ___ | _______ |
| 3. I have reviewed the completed audit programs and am satisfied that our audit, as evidenced by the workpapers reviewed by me, was conducted in accordance with generally accepted auditing standards. | ___ | ___ | ___ | _______ |
| 4. I have reviewed the financial statements and am satisfied that they meet accepted standards of presentation and disclosure and that they have been prepared in conformity with generally accepted accounting principles consistently applied. | ___ | ___ | ___ | _______ |
| 5. I have reviewed the legal representation and management representation letters for consideration of all important matters. | ___ | ___ | ___ | _______ |
| 6. I have reviewed the auditor's report and am satisfied it properly expresses our opinion in accordance with generally accepted auditing standards. | ___ | ___ | ___ | _______ |
| 7. I have reviewed all other reports or communications, if any, required in conjunction with this audit, e.g., communication of reportable conditions or audit related matters to the audit committee or its equivalent, | | | | |

| | Yes | No | N/A | Comments |
|---|---|---|---|---|
| and am satisfied that they meet the acceptable reporting standards. | ___ | ___ | ___ | ________ |
| 8. I have reviewed documentation relating to any significant audit complications, significant consultations, unusual technical issues, and resolution of significant disagreements on technical issues between personnel assigned to the audit engagement. | ___ | ___ | ___ | ________ |
| 9. I approve issuance of our report on the financial statements and all other reports or communications, if any, issued in conjunction with the audit to which this form applies. | ___ | ___ | ___ | ________ |

Partner's Signature: ________________ Date: __________

**Review by Independent Partner or Independent Review Department** (required only at the engagement partner's option, or if the firm's quality control policies and procedures require this step)

| | Yes | No | N/A | Comments |
|---|---|---|---|---|
| 1. The other review sections of this form have been completed to my satisfaction. | ___ | ___ | ___ | ________ |
| 2. I have read the financial statements and our auditor's report thereon, and all other reports or communications, if any, issued in conjunction with the audit to which this form applies. | ___ | ___ | ___ | ________ |

*FOR DISCUSSION PURPOSES ONLY*

| | *Yes* | *No* | *N/A* | *Comments* |
|---|---|---|---|---|
| 3. I approve issuance of our report on the financial statements and all other reports or communications, if any, issued in conjunction with the audit to which this form applies. | ___ | ___ | ___ | ________ |

Completed by: ____________________ Date: ____________

**Partner Signing Auditor's Report(s)**

| | *Yes* | *No* | *N/A* | *Comments* |
|---|---|---|---|---|
| 1. The review sections of this Review and Approval Form have been completed. | ___ | ___ | ___ | ________ |

2. I have signed the following auditor's report on the financial statements or other communications (list reports on financial statements, communication of reportable control conditions, etc.):

| *Report Title* | *Number of Copies* | *Sent to* | *Date Sent* |
|---|---|---|---|
| ____________ | ________ | ________ | ________ |
| ____________ | ________ | ________ | ________ |
| ____________ | ________ | ________ | ________ |
| ____________ | ________ | ________ | ________ |

Completed by: ____________________ Date: ____________

# APPENDIX I

## Fee and Billing Attachments to the Engagement Letter

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

### *Exhibit 1*

**DISCOUNTS AND INTEREST CHARGES***
**Attachment—**

ANTON, BONNER & CONVERY
BILLING AND COLLECTION POLICY

Our billings are based on the amount of time required at the various levels of responsibility to perform such services. Invoices will be presented monthly as the work progresses. We offer a 2 percent discount on all invoices rendered if paid within 10 days of mailing. In order for you to take advantage of this discount, all prior balances must be paid. The discount is only available on current invoices and will not be accepted if old balances still exist.

Interest will be charged on all invoices outstanding over 30 days from the date the invoice was mailed. Interest on the outstanding balances will be charged at the rate of 1.5 percent per month or 18 percent per annum.

*Source: *AICPA Management of an Accounting Practice Handbook* (New York: AICPA), chapter 203.

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

## Exhibit 2

## VALUE-ADDED BILLING STATEMENT* Attachment—

ANTON, BONNER & CONVERY
BILLING AND COLLECTION POLICY

Our billings represent the degree of responsibility, assumed complexity of the engagement, special skills needed to solve problems, and the value of services rendered. Minimum fees are based on the amount of time required at the various levels of responsibility to perform such services. Invoices will be presented monthly as the work progresses. We offer a 2 percent discount on all invoices rendered if paid within 10 days of mailing. In order for you to take advantage of this discount, all prior balances must be paid. The discount is only available on current invoices and will not be accepted if old balances still exist.

Interest will be charged on all invoices outstanding over 30 days from the date the invoice was mailed. Interest on the outstanding balances will be charged at the rate of 1.5 percent per month or 18 percent per annum.

*Source: *AICPA Management of an Accounting Practice Handbook* (New York: AICPA), chapter 203.

*FOR DISCUSSION PURPOSES ONLY*

# → APPENDIX J

## Representation Letter—Review of Financial Statements*

*This sample should be used only as a guide in the design of specific letters tailored to the terms of a particular engagement. It does not represent an official AICPA position.*

[*Date*]

Joseph F. Convery, CPA
Anton, Bonner & Convery
240 Holland Avenue
City, State 10000

Dear Mr. Convery:

In connection with your review of the [*identification of financial statements*] of [*name of client*] as of [*date*] and for the [*period of review*] for the purpose of 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, we confirm, to the best of our knowledge and belief, the following representations made to you during your review.

1. The financial statements referred to above present the financial position, results of operations, and cash flows of [*name of client*] in conformity with generally accepted accounting principles. In that connection, we specifically confirm that—
   a. The company's accounting principles, and the practices and methods followed in applying them, are as disclosed in the financial statements.
   b. There have been no changes during the [*period reviewed*] in the company's accounting principles and practices.

*Adapted from the AICPA *Audit and Accounting Manual* (New York: AICPA), AAM sec. 7400.

c. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
d. There are no material transactions that have not been properly reflected in the financial statements.
e. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.
f. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, and there are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.
g. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.
h. There are no related-party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.
i. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
j. No events have occurred subsequent to the balance-sheet date that would require adjustment to, or disclosure in, the financial statements.

2. We have advised you of all actions taken at meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies, as applicable) that may affect the financial statements.

3. We have responded fully to all inquiries made to us by you during your review.

____________________________

[*Name of Owner or Chief Executive Officer and Title*]

____________________________

[*Name of Chief Financial Officer and Title, if applicable*]

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# Appendix K

## Insurance Policy Log*

Type of policy: ______________________________

Agent(cy): ______________ Telephone no.: ______________

Insurer: ______________________________

Policy number: __________ Location of policy: __________

Named insured: ______________________________
(Exactly as written on policy)

Annual premium: ______________________________

______________________________
(Enter the current annual premium with year covered. Line through and make new entries as premiums change.)

Expiration date: ______________________________

______________________________
(As above)

Basic coverage/Policy limits/Notes: ______________________

______________________________

______________________________

______________________________

Endorsements/Exclusions/Additional notes: ______________

______________________________

______________________________

Premium payment record:

| *Date* | *Amount Paid* | *Check Number* |
|---|---|---|
| | | |
| | | |
| | | |

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# APPENDIX L

## Services and Publications of the Management of an Accounting Practice Committee

### Conferences

Call (212) 575-3814 for additional information on conferences.

**National Practice Management Conferences,** targeted at the managing partners of local firms, offer a practical approach to practice management. They are geared to mid-size and larger local firms, but open to all. Two conferences annually: summer and fall.

**National Small Firm Conferences,** designed for sole practitioners and firms with two to four partners, provide practical guidance on operating a successful small firm. As with all MAP conferences, exchange of information on management problems and solutions with other practitioners is emphasized. Two conferences annually: summer and fall.

**National Marketing Conferences** are designed primarily for partners responsible for marketing and marketing directors of firms of all sizes. The conferences cover techniques for successful practice development. One annual conference in June.

### Services

**Local Firm Consultation Program** offers an intensive review of your firm's administrative procedures and advice on management practices. The two-day consultation, conducted by two experienced CPA practitioners with firm management responsibility, produces constructive suggestions, solutions to specific problems, and a fresh view of your practice. Call (212) 575-6437.

**The MAP Inquiry Service** responds to member inquiries concerning firm management and administration. If you

need more help, the MAP staff will put you in touch with experienced CPAs or consultants who can assist you with special problems. Call (212) 575-3814.

### Publications

Except where listed, call the AICPA Order Department at (800) 334-6961 (outside New York), (800) 248-0445 (New York state only), or (212) 575-7017 (outside U.S.).

***MAP Handbook,*** a comprehensive 1,000-page, three-volume, loose-leaf reference service on practice management, is updated annually. It includes more than 200 forms, sample letters, checklists, and worksheets, all easy to reproduce or adapt for your practice needs. It provides detailed financial data and policy information, for firms of various sizes, that enable you to compare your performance with that of comparable firms. Topics covered include developing an accounting practice, administration, personnel, partnerships, and management data. For information call (212) 575-3826; to order call (800) 323-8724.

***MAP Selected Readings,*** a companion book to the *MAP Handbook,* is a readers' digest of over 500 pages of articles on successful practice management, specially compiled from leading professional journals. The articles contain numerous profit-making ideas for your practice. A new edition is published annually. For information call (212) 575-3826; to order call (800) 323-8724.

***MAPWORKS—DOCUMAP*** contains on diskette documents from the *MAP Handbook* dealing with organization, client engagements, and personnel. Available in three formats: APG2—No. 016911, ASCII—No. 090080, and WordPerfect 4.2—No. 090081.

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***Organizational Documents: A Guide for Partnerships and Professional Corporations*** is a guide to drafting a partnership agreement and corporate documents. The book includes a sample partnership agreement with more than 100 provisions and a step-by-step approach to incorporating. Book: No. 012640; WordPerfect 4.2 disk: No. 090091; ASCII disk: No. 090090; Book and WordPerfect 4.2 disk set; No. 090096; Book and ASCII disk set: No. 090095.

**Management Series** booklets cover the issues your clients are dealing with now. Designed to help you help your clients solve their management problems, the series includes *Management of Working Capital* (No. 090060), *Financing Your Business* (No. 090061), *Making the Most of Marketing* (No. 090063), and *Managing Business Risk* (No. 090062).

***Practice Continuation Agreements: A Practice Survival Kit*** explains how you can preserve the value of your practice in the event of death or disability. A practice continuation agreement can prevent the value of your practice from dissipating, provide financial and emotional benefits to your family, and help fulfill your professional responsibility to your clients. Product No. 090380.

The ***MAP Roundtable Discussion Manual*** contains guidelines for organizing a MAP roundtable discussion group. Such a group can help firms find practical solutions to common problems through regular meetings and information exchange. The guidelines include sample correspondence, forms for administering a roundtable, and nearly forty suggested discussion outlines on topical management issues. To order call (212) 575-3814.

### Upcoming MAP Publications

Call (212) 575-3814 for additional information on upcoming publications.

***Winning Proposals: A Step by Step Guide to the Proposal Process,*** a combination of educational text and how-to manual, gives

accountants and their marketing professionals the specific know-how needed to win more proposals.

***The Marketing Handbook*** is a compilation of expert advice from over twenty authorities on particular marketing strategies or tactics.

## About the Author

Mark F. Murray is an honors graduate of Merrimack College and Suffolk University Law School in Boston, where he concentrated in accounting and corporate law. Prior to joining the staff of the AICPA Practice Management Division, Mr. Murray practiced law and managed the accountant's professional liability program for a prominent insurance company. Mr. Murray is the author of *Organizational Documents: A Guide for Partnerships and Professional Corporations,* and is an editor and contributing author of the *Management of an Accounting Practice Handbook,* both of which are published by the AICPA.

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