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1992

## Accountant's Liability Newsletter, Number 28, Second Quarter 1992

American Institute of Certified Public Accountants. Professional Liability Insurance Plan  
Committee

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vention activities, such as the AICPA peer review or quality review programs. Additionally, the AICPA Plan publishes newsletters, loss prevention manuals, and/or loss prevention videos bringing to the Plan insureds' attention potentially dangerous practices and loss prevention measures.

Set forth below is a list of the various loss prevention techniques which have been utilized in the past with an assessment as to their ability to curtail claims:

### **Loss Prevention Seminars**

Both the AICPA and many state societies of CPAs have sponsored loss prevention seminars at various times since the late 1970's. Such seminars have not been wholly successful, largely because most accountants have been unwilling to spend the time and money to attend them and further do not feel they will be subject to a liability suit — "it's always the other guy, not me." Even where premium credits have been awarded by insurers for attending such seminars, attendance has not been overwhelming. Notwithstanding these drawbacks, such seminars are believed to be helpful in reducing claims and the AICPA and at least one state society have sought to include a loss prevention presentation as a part of their normal professional education programs.

### **Engagement Letter Form Books**

Over the years, there have been numerous publications containing sample forms of engagement letters with instructions as to how such engagement letters are to be employed. To be sure, the accounting profession since the Max Rothenberg decision<sup>1</sup> in 1967 has encouraged accountants to utilize engagement letters and virtually all insurers include in their malpractice insurance applications, questions regarding the extent to which the applicant utilizes engagement letters.

To be sure, the use of engagement letters will help eliminate client (but not third-party) claims arising out of misunderstandings as to the scope of the accountant's engagement. The need for such engagement letters is particularly acute where the accountant is performing a unique engagement or where the accountant's services are somewhat limited, giving rise to the possibility that

**Liability,**  
*continued from*  
*page 1*

the client may claim that the accountant undertook to provide more extensive services. As the plaintiffs' bar grows and clients become more accustomed to asserting claims against their accountants, this type of loss prevention measure will take on an even greater importance.

### **Loss Prevention Newsletters**

This type of loss prevention activity is generally considered to be effective because it serves as a constant reminder to accounting firms of the ever-present danger of liability suits. The *Accountants' Liability Newsletter* of the AICPA Plan generally provides discussions of current liability trends and frequently highlights the types of claims that are being asserted against accountants and ways for preventing or mitigating those claims. Although most accounting firms do receive a constant barrage of professional literature, short and well written newsletters are effective in raising the consciousness level of practicing accountants to the potential dangers that may arise out of their practices. The problem with such newsletters is that they may not receive full circulation within the accounting firms and firms are encouraged to route these valuable loss prevention tools throughout the office.

### **Loss Prevention Manuals**

Loss prevention manuals are probably only useful loss prevention techniques if there is some mechanism to insure that they are, in fact, read and absorbed by all insured accountants. Needless to say having a loss prevention manual in the firm's library does not provide a very effective shield against litigation claims. Most loss prevention manuals do, however, contain sections on how to deal with potential claims once they surface and, to this extent, probably serve some useful purpose even if the individual insureds are not required to read them at the outset.

### **Peer Review/Quality Review**

In an effort to enhance the level of practice of accountants, the AICPA, a growing number of state CPA societies of accountants, and an increasing number of state boards have adopted requirements that accounting firms undergo peer or quality reviews at least once every three

<sup>1</sup> 1136 Tenants' Corp. v. Max Rothenberg & Co., 27 App. Div. 2d 830, 277 N.Y.2d 996 (1967) wherein an accountant was found to have undertaken an audit even though the accountants' services were simply to complete the client's financial statements.

years. In both peer and quality reviews, an evaluation is made of the appropriateness of the firm's quality control systems and of the firm's adherence to the systems. In addition, the AICPA Tax Division has developed a program of self-assessment to measure a member's tax practice for similar quality control systems.

There is no question that undergoing peer review requires an accounting firm to establish and implement a pervasive system of quality control procedures. While this does not necessarily guarantee that the firm will not make mistakes in the course of providing accounting services to its clients, it does tend to enhance the defense's position so that the plaintiff will have a more difficult time of proving his case.

### **Continuing Professional Education**

Most states today mandate continuing professional education requirements for all licensed accountants. The nature and composition of these continuing professional education programs do differ from state to state with respect to the number of hours of continuing education required and composition of the courses which must be taken. To be sure, this requirement has greatly enhanced the quality of practice within the accounting profession, although because of the pervasive nature of the accounting professional education requirements, there is little, if any, need for insurers to offer credits to those firms participating in continuing professional education programs. On the contrary, insurers should think twice about even offering insurance to those firms who do not participate in such programs.

### **Client Retention Programs**

It has long been understood by professional liability insurance underwriters that a large percentage of claims brought against accountants result from the accountant rendering services to clients who are either in severe financial difficulty or who lack basic integrity. Because of this fact, many of the large accounting firms have formal procedures for accepting clients requiring the engagement partner to fill out long forms addressing a number of criteria commonly associated

### **Liability, continued**

with "problem clients." The AICPA annually publishes the "Audit Risk Alert," which identifies problematic industries affected by economic or other current conditions and has proved helpful to the auditor in better understanding the client's business.

While there has been a great deal written about client acceptance procedures, client retention issues are generally much more sensitive since they could involve the termination of services to clients which form the basis of one or more partner's compensation. Several loss prevention specialists are currently designing programs for accountants whereby they can evaluate, on the basis of objective standards, the potential liability risks associated with their various clients. This loss prevention technique should prove quite effective in that it will require the insureds to reflect upon the potential liability dangers posed by each of their clients and where that potential is deemed to be high to either terminate the client or to employ additional procedures to safeguard the firm against liability.

### **Hotline Services**

While most large accounting firms have legal counsel on their staff or have ready access to an attorney experienced in professional liability claims, most small accounting firms have in the past no one to whom they can go for help in avoiding or responding to liability threats. The AICPA Plan has a toll free number, whereby a Plan insured can call claim experts at Crum & Forster Managers Corporation (800-879-4272) for guidance on such matters. Other liability insurers have followed the lead and have also adopted similar programs.

These programs have proven successful in guiding insureds caught in potential liability situations to act in a manner designed to avoid (or, at least, minimize) their liability exposures.

### **Conclusion**

Loss control techniques have proven effective in other industries and there is likely to be a great deal more emphasis placed upon loss prevention techniques during the 1990's in the accounting profession.

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*Mr. Goldwasser is a Senior member of Solinger Grosz & Goldwasser, P.C., a New York City law firm, which represents the New York State Society of CPAs and approximately 110 CPA firms. Mr. Goldwasser is actively involved in the development of Defensive Loss Prevention Techniques/Practices for CPAs. This article is the third of a series of articles that Mr. Goldwasser has contributed to this Newsletter, portions of which may have previously appeared in other periodicals or presentations by the author.*

# Selecting Clients You Don't Want

By Charles A. Werner, CPA, J.D.

**W**hen pundits analyze what causes CPA firms to have malpractice liability problems they usually focus on decision-making during audits or other professional work. Based on many situations I encountered during my years as chief technical officer of a large CPA firm, I suspect these problems arise much earlier.

One CPA put it this way, "If I never take a bad client or keep a bad client, I won't have any legal problems." The trouble is these judgments are much grayer than just good or bad. It's better to say we have to be careful about the clients we accept and will periodically weed out the undesirables.

Taking any client involves some risk. But there are obvious types of clients to avoid. For example:

- Clients with known or alleged connections to organized crime or other illegal activities. Even if the connection merely is alleged, take the position you don't want to find out if the allegations are true.
- Clients with transactions that are difficult or impossible to verify under generally accepted auditing standards. If such transactions are material, even a highly qualified report may be very risky.
- Clients that are so unstable financially, it is doubtful you could collect your fees. Bankrupt clients often sue CPAs who are perceived as having "deep pockets." Nothing could be worse than being sued when you have never been paid for your work. Some CPAs argue everyone deserves an audit, but I say, "just not by us."

- Clients where the risk is clearly out of proportion to the fees you might receive over a short period. For example, imagine a fee of \$10,000 for the audit of a questionable tax shelter offering of \$10 million.

Every CPA firm ought to have written client acceptance procedures (refer to sample questionnaire on the facing page). These procedures typically include the preparation of responses to a check list and required approvals by one or more senior officials of the firm. The checklist should include procedures for compliance with the profession's literature on predecessor/successor auditors.

While checklists are helpful, don't ignore your instincts. The potential client who is too flashy or makes you uncomfortable invariably will turn out to be someone you should avoid. Finally, make a regular practice of reviewing the firm's client list for those client relationships you ought to end. Clients change over time. The client that was not risky when they first engaged you may now be very risky. Also, a periodic review of the firm's client base will help to weed out undesirable clients for reasons other than potential legal liability. For example, every firm has difficult clients who demand a great amount of time, are irritating personally and refuse to pay appropriate fees. You are better off spending your time giving good clients more services and attention.

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*Mr. Werner is a Professor of Accounting at Loyola University of Chicago. This article previously appeared in Insight, a monthly magazine published by the Illinois CPA Society and is used with permission.*

## Errors or Omissions

In last quarter's Newsletter we incorrectly printed the telephone number for the Technical Division of the AICPA to call for sample Engagement Letters. We have now been instructed that you should contact the AICPA Practice Management Division at 212-575-3814 for sample engagement letters and/or guidance. We apologize to all for this error.

**SAMPLE  
NEW CLIENT ACCEPTANCE QUESTIONNAIRE**

This questionnaire is to be prepared and submitted for approval to \_\_\_\_\_ for any potential new client where the annual fees can reasonably be expected to exceed \$\_\_\_\_\_.

Name of Potential Client \_\_\_\_\_  
 Address \_\_\_\_\_  
 Phone \_\_\_\_\_  
 Principal Contact Person \_\_\_\_\_

**Information to Be Assembled**

Obtain copies of the following and attach to this questionnaire:

- Three most recent years of audited or unaudited annual financial statements.
- Interim Financial Statements for the current year if available.
- Three most recent federal income tax returns.
- Copies of filings with regulatory agencies (such as the SEC) for the three most recent years as well as the interim year to date.

Name and contact person at predecessor CPA firm, if any:

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

<b>Predecessor Accountant Procedures</b>	<i>Yes No N/A</i>	<b>Other Matters</b> (Attach Appropriate Comments)	<i>Yes No N/A</i>
1. Do we have written authorization to talk to the predecessor accountant?	__ __ __	1. In your judgment, is the client financially stable?	__ __ __
2. Did the predecessor limit responses to our inquiries?	__ __ __	2. Do we anticipate any accounting principles problems?	__ __ __
3. Have we attached a memorandum about our discussions with the predecessor including reasons for change in accountants, and/or disagreements on accounting principles, auditing procedures or other matters?	__ __ __	3. Do we anticipate any auditing problems?	__ __ __
4. Does our memorandum on contacts with the predecessor set forth the response to our inquiries about client integrity?	__ __ __	4. Are the accounting records up to date and in good condition?	__ __ __
5. Will the predecessor allow us complete access to their working papers? (Include any restrictions in a memo)	__ __ __	5. Have there been any recent significant adverse developments in the client's industries?	__ __ __
		6. Does the client have significant related party transactions?	__ __ __
		7. Do we anticipate that our fees will be at usual per diem rates?	__ __ __

**Community Reputation** *Yes No N/A*

After obtaining authorization from the potential new client

1. Have we made inquiry of client's outside law firm about integrity and attached the results of such inquiry in a memo? \_\_ \_\_ \_\_
2. Have we made inquiry of client's major outside lender about integrity and attached the results of such inquiry in a memo? \_\_ \_\_ \_\_

**Recommendation and Approval**

I recommend that the firm accept this potential new client.

\_\_\_\_\_  
 Recommended by Date

I approve acceptance of this potential new client.

\_\_\_\_\_  
 Approved by Date

# Auditing Through Work Papers

By Dolores M. Lydon  
Account Representative,  
Rollins Burdick Hunter Direct Group

**D**espite the rise of litigation involving Certified Public Accountants, despite the countless findings of deficiency by the Quality Review Board, and despite the countless articles stressing the importance, CPAs are failing to use work papers to their full advantage. Documentation — good, sound, documentation — is a key to protecting the firm in a malpractice claim. To show that the proper procedures were followed, that reasonable judgment was applied and that professional standards were met, well prepared work papers are essential. Here you have established critical quality control measures to assist in defending yourself in a potential malpractice suit.

Preparing work papers just to comply with the standards of GAAS or SAS may *not* be sufficient in a malpractice claim. The work papers for the engagement will be the principal evidence in the malpractice case. If procedures are missing from the work papers, the CPA can give oral testimony; however, the plaintiff can raise doubt of such information by highlighting the fact that the procedures should have been in written form in the work papers. GAAS in some instances, specifically requires the type of documentation for an audit engagement and SSARS will reference similar documentation for reviews and compilations of financial statements. In addition to these required work papers, it is extremely advantageous to the CPA to document conversations, consultations, confirmations, and other matters that aren't specifically required, but would strengthen the defense if challenged in court. In this respect, this article will focus on one specific area, audit engagements, and what types of work papers are required and what the CPA may want to add.

## Content

According to SAS, work papers serve mainly to "Provide the principal support for the auditor's report, including his repre-

sentation regarding the observance of the standards of field work." (Auditing Standard No. 1, Section 339.) Work papers should include all procedures applied, tests performed, information obtained, where the information was obtained and the conclusions reached. In addition, documentation of recommendations, whether in written correspondence or through oral conversations, along with an engagement letter, should be included.

The content of the work papers may vary with the circumstances surrounding the audit engagement. The work papers should show that the accounting records agree with the financial statements. Upon preparing a review of the internal accounting system of a client, a CPA may find material weaknesses that should be fully documented. Since the auditor's review is based on testing select elements of the accounting system, the auditor is subject to the risk that not all material defects in the accounting system will be disclosed. The communication of such weaknesses should be brought to management's attention to reduce the possibility of misunderstanding. Every communication should *always* be noted in the work papers. If the auditor has found no material weaknesses, this too should be communicated and noted in the work papers. If the auditor communicates weaknesses that management feels cannot be corrected, the auditor is required to issue a statement highlighting the irregularities and note that management did not feel that corrective action was feasible.

## Planning

Planning is the primary standard of field work and should be documented throughout the audit. The documentation should encompass all considerations and procedures to planning and supervising, obtaining knowledge of the entity and preparing the audit program.

According to SAS (Section 311), when preparing the examination, "the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program." This would aid in instruction of staff assistants and outline the objectives

of the audit. Ultimately, if a claim should ever arise this documentation would enable the court to understand the direction the audit was to proceed and if the auditor followed the initial program or plan.

### **Evidential Matter**

Developing an opinion of a client's financial statements requires the evaluation of evidential matter, which is the underlying accounting data and corroborating information that supports the financial statements. Upon review of the evidential matter, the auditor should be able to determine whether or not there is internal consistency, that the data supports the financial statements, and being unbiased — presents the auditor with the information to issue either a qualified opinion or a disclaimer of opinion.

Generally, the auditor may want to not only obtain evidential matter, but also maintain it in the work papers. Again, if a claim were to arise, the physical presence of the evidential matter could make the difference in a solid defense.

### **Common Deficiencies**

Finally, when planning to take on an audit engagement, the potential auditor may want to keep several "common deficiencies" found by the AICPA, in mind. Most of the deficiencies related to the work papers and documentation of procedures are as follows:

### **Auditing, continued**

1. Failure to use or incomplete use of standardized audit forms, checklists, and questionnaires used in the performance of the audit.
2. Inadequate documentation of materiality and audit risk considerations.
3. Failure to use or properly complete audit or other work papers.
4. Inadequate documentation of preliminary evaluation of internal control structures, the flow of transactions and the control environment.
5. Inadequate documentation of analytical review procedures.
6. Failure to obtain management representation letters.
7. Inadequate documentation of consultation performed.
8. Failure to contact predecessor auditors.
9. Failure to document contact with predecessor auditors.
10. Failure to disclose lack of independence in issuance of a review or audit report where independence was impaired.

Work papers, as discussed, are a key defense in a malpractice suit against CPAs today. The papers should document sound judgment, show proper procedures, and serve as evidence that professional standards were met. Obviously, being a conscientious Certified Public Accountant in this respect, could only increase the likelihood of successfully defending yourself in the event of a malpractice claim.

## **Underwriter's Corner**

The Underwriter's Corner was developed as a service to provide AICPA Plan insureds with answers to frequently asked questions. Should you have any questions which you would like answered in the publication, please address your questions to:

**Michael J. Chovancak, Editor**  
**AICPA Newsletter**  
**c/o RBH Direct Group**  
**4870 Street Road**  
**Trevoose, PA 19049**

*My accounting practice is considering the inclusion of an arbitration agreement in our standard engagement letter. Would this be something you recommend? Also, how would it affect our accountants professional liability insurance?*

To respond to this question, Crum & Forster Managers Corporation, as principal underwriter and claims handler for the AICPA Plan, was consulted. Mr. Dennis L. Bissett, Assistant Vice

President of Crum & Forster Managers Corporation, replied:

Crum & Forster Managers Corporation works very closely with the AICPA Professional Liability Plan Committee. Part of our responsibility with the Plan, is to stay abreast of legal liability trends and ways to curtail the rapidly escalating legal costs. One aspect that has been widely discussed in recent months has been arbitration of professional liability disputes. This has worked well with some other professions, and the thought was that it could work well with accountants. Based upon this premise, we undertook an extensive study of arbitration, and a host of other alternative dispute resolution forums. Based upon that study, it was our recommendation that we do *not* endorse the insertion of arbitration clauses in engagement letters.

*continued on next page*



The reason behind this is unilateral insertion of such an agreement into an engagement letter could be a violation of the policy terms and conditions. While not definitive, and not universal in all states, we have had research conducted that would indicate that in some jurisdictions the unilateral insertion of such an agreement in an engagement letter by an insured accountant would void the policy for that particular claim. (Note this is not universally held, but it is of sufficient concern.)

We have determined, additionally, that arbitration and the other alternative dispute resolutions were not the cure for the legal liability crisis in accountants' liability. While some time and legal expenses could be saved, we found that oftentimes the arbitrator would merely split the amount in dispute. This was not an appreciable savings when ultimately measured. Moreover, as an insurer specializing in accountants' legal liability, we oftentimes want to take cases through trial to establish good law. In fact, in recent years we have been successful in establishing privity in jurisdictions wherein it was not otherwise allowed. We had ample opportunity to settle each of those cases, but felt that the good of the profession would be served by proceeding through trial. Had engagement letters been used with arbitration clauses inserted, such favorable outcomes would not have been attainable.

Finally, we have had experiences wherein an arbitration clause was inserted, and the plaintiff thereafter did not care for that forum. He hired a lawyer who had the agreement overturned, regardless. Thus, as we hope you can see, we have significant contractual and practical concerns about the use of arbitration clauses in engagement letters.

Our recommendation to the AICPA Professional Liability Insurance Plan Committee, was to encourage insureds to use engagement letters for all clients. This would be the standard type engagement letter. However, if a claim or dispute arose, we preferred that the insured and claims technician work *together* to decide what the best procedure and forum was to conclude the claim. If it was determined that the court system was best, that track would be followed. However, if arbitration or mediation or one of the other alternative dispute resolution forums seem preferable, it would be up to the claims technician, *after agreement with the insured*, to recommend to the claimant and/or their attorney. We have been very successful in the mediation of cases, achieving a nearly 100% success ratio. This has saved time and money. Moreover, it in no way jeopardizes the insurance coverage an insured has by their unilateral insertion of mandatory arbitration.

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## FLASH! AICPA BASIC POLICY HAS NOW BEEN APPROVED IN CALIFORNIA

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*The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.*

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