

LOSS PREVENTION

Introduction

This section explores the factors that can create a basis for the assertion of a malpractice claim against an accountant. Against this background, the discussion also posits general precepts for practicing defensively and identifies specific techniques for avoiding claims. Finally, because even the most careful practitioner faces a substantial risk of being sued at some point in a lengthy career, this chapter also focuses on ways to minimize the risk of an adverse impact when the (inevitable) claim is presented.

Importance of Claim Avoidance

Although it hardly bears noting that every CPA should seek to avoid malpractice and malpractice claims, it is important to discuss the reasons why all CPAs should focus on their potential exposure to malpractice litigation. It may be true that the incidence or frequency of assertion of new claims against accountants is no longer burgeoning at an ever-increasing rate, but the profession has been riddled by steadily mounting “shock” verdicts from juries and faces an increasingly sophisticated and determined bar of plaintiffs’ lawyers. One national accounting firm has even been forced into liquidation proceedings by adverse litigation results. The profession estimates that it annually faces upwards of \$30 billion worth of damage claims and that litigation costs exceed 10 percent of audit income. See “Big 6 Respond to the Liability Crisis,” *Accounting Today*, Sept. 21, 1992, at 3; Telberg, “Turning the Tide on Liability,” *Accounting Today*, Sept. 7, 1992, at 1.

Although most accountants still insure themselves against professional liability claims, the deductibles under such policies are significant and are often quickly consumed by defense costs and defense attorneys’ fees, and a surprising number of CPAs (estimated to be as high as 40 percent) are uninsured. See “Big 6 Respond to the Liability Crisis,” *Accounting Today*, Sept. 21, 1992, at 3. Occasionally, coverage limits are inadequate. Most policies now have a cost-inclusive feature in the coverage limits, which diminishes coverage for each dollar of defense costs and attorneys’ fees incurred by the insurance company over the deductible. Although rare, it is possible for these defense costs to eviscerate all insurance coverage, or to diminish it significantly below the accountant’s damage exposure.

Moreover, a number of hidden litigation costs can be substantial for both the accountant who performed the work and the accounting firm:

- *Emotional.* The strength and broad range of debilitating emotions felt by accountants sued for malpractice is a virtually universal response to a claim or lawsuit.
- *Professional reputation.* Negative publicity about a notorious lawsuit or even a large settlement can devastate a hard-earned reputation for excellence.
- *Loss of productivity.* A trip to “litigation land” is like an unpaid vacation. Litigants almost always spend enormous amounts of time educating the lawyers, experts, judges, and juries involved in a dispute about the highly technical and detailed

professional standards and fact patterns found in most accountant liability cases. In addition, pretrial procedures (conferences, motions, depositions, discovery responses) and trial itself consume vast quantities of otherwise productive time.

- *Distraction.* Like a toothache, an accountant facing a malpractice claim never quite forgets that it is there – with obvious consequences for efficiency and productivity in the office.

Clearly, the best way to beat the litigation system is to avoid it altogether.

Litigation in a “No-Fault” Society

Even though the observation that we live in a litigious society is commonplace, a brief consideration of the social or cultural forces that spawn litigation is critical to the adoption of techniques to avoid claims and minimize their impact. At a very fundamental level, the notion that individuals ought to bear responsibility for their own decisions to act or not is seriously eroded. In its place is the “no-fault” society. Thus, American jurisprudence has evolved to include no-fault tort liability and no-fault divorces. Notions of pure comparative fault in some states even allow a party who is 90 percent to blame for its own damage (versus a 10 percent blame attribution against the defendant) to recover 10 percent of its losses.

Other important hallmarks of the litigation landscape include access to the courthouse and low cost to plaintiffs. Under current notice pleading standards and relaxed views about the sufficiency of evidence required to sustain a lawsuit, most claimants are allowed to pursue their allegations trial on the merits. In addition, contingent fees and the normal prohibition against the award of attorneys’ fees to a prevailing defendant often leave the defendant accountant (and plaintiff’s lawyer) as the sole parties financing a litigation.

In sum, changing notions of individual responsibility and structural features of the American system of jurisprudence have combined to produce a treacherous claims environment for the professional who supplies accounting services.

Risk Identification

Knowledge of the sources of claims against accountants allows the careful practitioner to identify potential trouble spots and take appropriate measures to guard against claim exposure. There are two basic types of risk:

- *Engagement risk*, which measures the risk of claims by classifications of engagements.
- *Client risk*, which identifies the clients who are most likely to propagate a claim.

These risks can be quantified by measuring how often claims arise in various categories and the severity of claims, in terms of damage amounts.

Accountants are often surprised to learn that tax engagements generate the most liability claims, but they are often astounded to hear that compilation and review engagements are the

second largest category of all claims reported. Here is a breakdown of claims by frequency of incidence:

Tax	58%
Compilation and review	9%
Audits	13%
Investment advice	2%
Consulting	9%
Personal Financial Planning	2%
Other	7%

Notwithstanding these data, claims arising out of failed audits produce the biggest losses and comprise up to 40 percent of the losses incurred on all claims asserted.

Because tax claims are the largest source of malpractice exposure, a breakdown of these claims by the nature of the most common mistakes alleged is illuminating:

Filing Errors	20%
Tax advice/Improper treatment	14%
Election Mistakes	38%
Computation Errors	18
Engagement Scope Dispute	10%

Here is a synopsis of risk factors from SAS 82, "Consideration of Fraud":

- A motivation for management to engage in fraudulent financial reporting, including:
 - A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.
 - An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.

- A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
- An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process, such as:
 - An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.
 - Domination of management by a single person or small group without compensating controls, such as effective oversight by the board of directors or audit committee.
 - Inadequate monitoring of significant controls.
 - Management failing to correct known reportable conditions on a timely basis.
 - Management setting unduly aggressive financial targets and expectations for operating personnel.
 - Management displaying a significant disregard for regulatory authorities.
 - Management continuing to employ an ineffective accounting, information technology, or internal auditing staff.
- Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
- High turnover of senior management, counsel or board members.
- Strained relationship between management and the current or predecessor auditor. Specific indicators might include:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.
 - Formal or informal restrictions on the auditor that inappropriately limit his or her access to people or information or his or her ability to communicate effectively with the board of directors or the audit committee.

- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.
- New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity – including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity – such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult “substance over form” questions.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or individual(s) that control(s) the entity.

- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to change in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- Threat of imminent bankruptcy or foreclosure, or hostile takeover.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Defensive Accounting

The critical first step in adopting practice techniques intended to minimize malpractice claim exposure is the use of a mindset opposite to that of a claims-conscious client, *i.e.*, the defensive frame of mind. Such a view recognizes that it is important and proper to anticipate possible claims, to adopt ways to avoid them, and to use practices that will serve as evidence in favor of the CPA if a claim ensues.

Defensive practices include steps like client screening, adapting procedures to the risk inherent in particular engagements, using proper documentation techniques, and the like. For purposes of this discussion, defensive practices are not intended to encompass the sort of over practicing, or the performance of duplicative procedures intended merely to defend against a malpractice claim, as has been attributed to other professions. Indeed, it is highly unlikely that any accountant would be able to follow such an approach for any significant length of time, in today's increasingly competitive and cost-conscious market. Quite to the contrary, practicing defensive accounting will most likely lead to more productive and cost-efficient delivery of accounting services, at a higher quality, than might otherwise be the case. That is, a constant alertness to the possibility of professional error will almost certainly make any accountant less likely to err. Simplified written communications with a client will be more easily understood by the client, reducing the sorts of misunderstandings that lead to claims, as well as providing a clear record for possible use in litigation.

The central unifying concepts for the adoption of defensive accounting practices are:

- *Client communications.* Lawsuits often result from misunderstandings caused by poor communications. Communications with the client that are easily understood and timely are essential. It has been estimated that a breakdown in communications between the CPA and client is at the root of at least 70 percent of all malpractice claims, with the exception of tax compliance mistakes. Danziger, "How to be careful

and still be clear,” *Journal of Accountancy* (Jan. 2001), p. 65. (This helpful article includes tips on identifying “haze maker” language, solutions to common writing mistakes and a helpful bibliography of resources for “recovering obscurantists.”)

- *Client responsibility.* To counter the increasing reluctance of individuals to take responsibility for their own decisions, accountants should make it clear that they are not making ultimate decisions for their clients, nor give their clients reason to believe that they will do so. Rather, steps should be taken to make it clear that decision-making responsibility rests with each client.
- *Documentation.* All communication of any import with a client should be documented. This is necessary to show that the communication occurred, to establish the basis upon which a decision was made, and to verify that the client was responsible for making all decisions. Along the same lines, documentation of the exercise of professional judgment can also be critical if litigation occurs.

Finally, it is appropriate to view conduct and documentation with an eye toward how they might later appear to an outsider, whether it be legal counsel for a client pressing a claim, judge, or jury. This means that all writings should be simple, clear, and easily understood.

Client Screening

One building block in the adoption of defensive practices is an effective technique for identifying and then managing or screening out clients who are most likely to present claims. Simply put, some personality and character types are far more likely to present claims than are most clients. In the author’s experience, a clear majority of accountants who have been sued for malpractice say that they knew or had a feeling that the client who sued them “was trouble.”

Of course, the difficulty lies in knowing which clients to watch more closely or, at the extreme, to terminate from one’s client list. The burden of this decision is compounded by the economic pressures faced by most practitioners. Here are some indicia of a dangerous client:

- Aggressive.
- Extraordinarily demanding of attention, including demands for instant access, immediate turnaround of services.
- Angry at “the system,” or those perceived to be more powerful in society.
- Invariably shifts blame for adversity onto external causes or other persons.
- Chronic complainer.
- Dishonest in business practices.
- Has history of frequent changes in professional relationships.
- Has record of participating in litigation.

- Represents a disproportionately large volume of the CPA's work.
- Disreputable.
- Demands "low-ball" fees.
- Financially weak.
- Will not accept bad or negative news.
- Has unrealistic expectations or goals.
- Wants a "favor" or billing discount in return for a promise to refer significant other clients to the CPA.
- Has poor payment record or haggles over bills to an extreme.
- Present or impending financial or organizational difficulty.*
- Involvement in suspicious transactions.*
- Refusal to sign engagement and representation letters.*
- A need for an auditor close to year-end.*
- Weakness or lack of internal controls.*
- Poor organization.*
- Poorly maintained records and collection problems.*
- Failure to file income tax returns.*

*Pascarella, "Client Screening: How to Reduce Malpractice Exposure," *The Tax Advisor*, Mar., 1996, at 179.

Business organizations also have traits which may portend litigation for an accountant. These telltale features include:

- Fighting between management or owners.
- Weak accounting department.
- Poor employee morale.
- Large number of claims or complaints against the entity by outsiders.
- Domination by one or two personalities.

- Management compensation tied closely to immediate financial results.
- Poorly trained or under qualified personnel (especially in a startup or fast growth company).

Yellow Flag Checklist

What follows is an extensive, but not exhaustive, checklist of potential yellow flags. While very legitimate clients might display one or more of these characteristics, the following warning signs can nonetheless point to potential trouble.

I. The client's history and character

- Individuals and companies that have recently, or frequently, changed lawyers, accountants, or auditors, especially if they have changed professionals in the middle of the pending case or transaction. This warning sign becomes a red flag if the client will not consent to your talking to the predecessors to discuss reasons for the change
- Companies where an important executive has recently resigned unexpectedly and without adequate explanation
- Companies with unusually rapid revenue growth, especially through acquisitions
- Individuals and companies that have dramatically changed their business strategy
- Individuals and companies with business plans or objectives that call for experience, personnel, capital, or other resources that seem to be beyond their reach
- Individuals and companies that are changing their line of work or activity, e.g., from real estate developer/promoter, to purchaser/creator (owner/operator) of unrelated businesses (investment funds, banking, manufacturing companies)
- Individuals who are making large, conspicuous purchases - airplanes, yachts, or large homes and/or are living extravagantly or beyond their apparent means
- Companies that want to avoid registration as a U.S. investment without appropriate reasons
- Off-shore companies
- Individuals and companies that have sued other lawyers
- Individuals and companies that provide inconsistent or incomplete information or stories, or engage in other unexplained or unexplainable behavior
- Individuals and companies that have been convicted of or found civilly liable for financial malfeasance (or that have entered into consent decrees regarding such allegations)

II. The proposed representation

A. Other people's money

- Individuals and companies that seek to raise money from third parties, including those who plan to seek investments from or manage investments for foreign (non-U.S.) residents
- Start-up companies that seek to finance operations by means of an initial public or private offering

B. Dubious deals

- Individuals and companies that present deals and transactions that have no apparent business purpose
- Individuals and companies that promise high returns, low risks, and/or little or no taxes
- Individuals and companies that promote exotic investments, such as gold bullion, liquor futures, foreign currencies, or off-shore investments

C. Troublesome transfers

- Individuals and companies that want to divert or transfer funds or other assets between related entities that they control other than in the ordinary course of business
- Individuals and companies that want you to “protect their assets” by transferring them to foreign trusts or other remote entities

D. Problematic Investigations

- Long-term clients that ask you to undertake an internal investigation of a matter that is arguably within the scope of your prior representation of the client

III. The client's relationship with the Firm

- Individuals and companies that seek to use the Firm's escrow or other accounts, rather than a bank, to transfer or hold money or other valuables
- Individuals and companies that want you to make statements (representations) to others about their financial substance, creditworthiness, or reliability

IV. The client's relationship with other professionals

- Companies that seek to make a public offering using a small, undistinguished, or otherwise weak underwriting firm
- Issuers of securities in a transaction in which no underwriter or other financial intermediary is present
- Individuals and companies that want to use lesser known law firms to give opinions relative to a transaction

The accounting firm might consider having business systems in place to screen clients along these lines before they are initially accepted by the firm. When feasible, at least one uninvolved firm partner should be asked to screen the potential engagement before a new client can be accepted. Business references, financial and credit checks are also advisable. Reduced to its most basic element, client screening involves heavy reliance on the savvy professional's instinctual feelings about a new client.

Although some might argue that every accounting firm ought to eliminate relations with a specific percentage of its clients each year, such a rigid approach is inconsistent with the economics of the practice of accounting. Rather, the CPA should manage difficult clients more assiduously than other clients and reserve terminating professional relations to just those clients who pose intolerable risk. Certainly, clients who are disreputable or prone to unethical or dishonest conduct should be at the top of the list for outright rejection. Financially weak clients, those who do not pay their bills, or clients who are extraordinarily difficult from a collection standpoint, should also be prime candidates for termination.

Management techniques for other clients are:

- Reduce all advice to written communications to the client.
- Document all verbal communications in writing, even if the writing is no more than an informal set of notes retained in a file for all such calls.
- Pay particularly close attention to the condition of the client and the client's industry; when these deteriorate, use even more caution.
- Involve other professionals in the process of assisting the client in making key decisions, particularly the client's lawyer.
- Require the client to make timely payments on account, even if the payments are in installments. Obtain a promissory note and security interest.

Proper client management and screening will go a long way toward reducing exposure to malpractice claims.

Documentation

It is difficult to overstate the importance of written documentation in the claims process. A clear written engagement agreement and a well-written and easily understood letter containing advice and outlining optional courses of action can be invaluable in minimizing the risk of a claim. In addition, the existence of a solid written record can dissuade plaintiff's counsel from pursuing a marginal case. When a claim is presented, the outcome of any resulting litigation is often closely tied to the quality of the written record.

All of this follows from the fact that our culture is visually oriented. As the saying goes, "seeing is believing." Because most of what an accountant does for a client is intangible, the only way to show someone that an event occurred, professional judgments were rendered, or advice was given on a particular subject, is to memorialize it in writing. For some unknown reason, accountants are often loath to write letters, prepare memoranda describing key events and decisions, or take notes concerning meetings or conferences with clients.

Documentation can, needless to say, be a double-edged sword. That is, incomplete or inartfully prepared writings can become the "smoking gun" that scuttles the accountant's defense. As a result, documents prepared for the purpose of preserving the context in which an engagement was performed, judgments analyzed, opinions rendered, and decisions made, should be prepared so that they carefully explain the context in which they were prepared (including all operative facts and assumptions), review the options considered and discussed, note the risks explained, and identify all persons responsible for making any necessary decisions. In short, written materials should be self-serving, so that they will be accurately interpreted by a third party called upon to stand in judgment upon the accountant's work, with perfect hindsight, in the context of a claim.

Because any written material can be used against the accountant, in a subsequent litigation, there is some debate about whether accountants should adopt a file retention policy mandating destruction of files after a relatively short interval, following the completion of each engagement. (See "Document Retention.") Although there are valid business reasons for adopting such a document retention policy, including important considerations of space and storage costs, an unduly truncated retention period may itself jeopardize the defense of the accounting firm, by making it appear as though the policy is intended to bury mistakes and avoid liability. Just as importantly, it is the author's opinion that it is impossible to predict when a document will be harmful. The total absence of documentation will often be just as harmful to a successful defense as would the existence of a file on a particular engagement.

Of course, a key part of any document retention policy is to be sure that only records accurately reflecting the final outcome of an engagement are retained. This means that all interim drafts should be filtered from files before they are stored, along with any checklists that show work not fully completed. It also does little good to retain audit workpapers to show that work was performed, unless they have been prepared accurately and completely, with appropriate notations of authorship and review.

Practice Pointers

On the theory that actions are better than words, here is a list of specific and concrete steps that each accountant can take (or avoid) to control the risk of a malpractice claim:

- Never start a lawsuit. Do not serve legal process to recover a fee.
- Never apologize or admit an error. Clients construe such concessions to be admissions of liability and, all too often, an invitation to commence suit.
- Avoid low-ball fee engagements.
- Every engagement with each client should be memorialized in some form of writing.
- When terminating a client engagement, follow the golden rule and remember that a little professional benevolence can go a long way toward smoothing a client's ruffled feathers.
- Know your partners and employees. Personal financial, emotional, and marital problems are often associated with professional malfeasance.
- Know your client. Failure to identify who one's client is can lead to an infinite variety of conflict-of-interest situations.
- Consult with an objective and uninvolved person in your firm, or an experienced outside attorney, whenever you have a concern about a client or a difficult situation.
- When documenting advice, be sure to write clearly and simply, explaining the client's options and the risks of each option.
- As often as possible, follow up client communications with a memorializing "CYA" letter. This letter should make it clear that the *client* decided to act or to refrain from acting.
- Carefully ensure that billing statements and time entries correlate precisely with all work. Never describe compilation work as "audit procedures," for example.
- Discard all preliminary and working drafts of opinion letters and workpapers.
- Before closing a file, discard all informal or incomplete procedures checklists.
- Do not shy away from writing a strong management letter in an audit engagement, and be sure that it gets into the hands of all outside directors.
- Require clients to establish an audit committee of the board of directors.

By following these recommendations and adopting defensive accounting practices, the CPA will go a long way toward avoiding the difficulties, cost, and unpleasantness of responding to a malpractice claim.

A third reason blamed for the increase is the expansion of the scope of services CPAs provide. "As CPAs step off their traditional turf they create more exposure points." Matt Roush, "Liability Is No. 1 Issue for Accountants," 9 *Crain's Detroit Business* 8 (Jan. 25, 1993).

Documentation of Casual Client Interaction

Although it should be rather apparent that all professional client interaction should be documented, casual client advice should be documented as well. Social gatherings often serve as the impetus for clients to casually seek advice on the sale of an estate, an investment, or tax planning. If the advice is profitable, it is likely that the CPA may never hear about it again. However, if the advice results in a sizable loss, the CPA may face malpractice liability. By formally documenting even the most informal of client contacts, an accountant may prevent future liability.

Careful Documentation Will Aid Factfinder

Whether a CPA rendered advice to a client and whether a client reasonably relied upon the advice are questions of fact to be determined by the factfinder. *Lien v. McGladrey & Pullen*, 509 N.W.2d 421 (S.D. 1993) (corporation's only shareholder brought malpractice action against corporation's accountant, alleging professional negligence by accountant for adverse tax consequence allegedly incurred by following accountant's advice). Consequently, a clearly documented course of action may help sway the factfinder in the CPA's favor. Not only will careful documentation help a factfinder to "fill in the gaps," but it may also dissuade opposing counsel from bringing a claim in the first place.

CPAs should document client interactions that occur outside the office just as scrupulously as those that occur within the office. Subsequent to the interaction, the CPA should send a memo to the client summarizing the interaction. The memo should contain all issues discussed, their ensuing alternatives, and any additional information the accountant believes is necessary. Without sounding like a hungry salesperson, let clients know about any additional services your firm may offer to guide them in their decision. (Casual advice may often lead to a source of valuable revenue.) Richard Rosario, "Making Documentation Pay Off," *Journal of Accountancy* 70 (Feb. 1995).

CPAs often inquire as to whether documentation can be used to their *disadvantage*. In many cases, the answer is "no." More often than not, according to one authority, thorough documentation will strengthen a CPA's position in court. Richard Rosario, "Making Documentation Pay Off," *Journal of Accountancy* 70 (Feb. 1995). A CPA's testimony is bolstered by comprehensive documentation. Oral testimony is rarely as persuasive as the written document. Lawrence A. Wojcik, "Lessons Taught by the Courts," *Journal of Accountancy* 125 (Oct. 1993).

Lack of documentation may also increase the costs of litigation, because of the need to rely on other sources of evidence. Dale A. Oesterie, "A Private Litigant's Remedies for an Opponent's Inappropriate Destruction of Documents," 61 *Tex. L. Rev.* 1185, 1186 (1983).

Documentation Do's and Don'ts

- Do document all interactions, even the most perfunctory.
- Make documents as factually correct as possible.
- Send follow-up memos subsequent to all significant interactions.
- Follow a strict document retention schedule. Maida Odom, "For the Record, Throw Away that Old Notion that Storing Documents is a Routine Task. "With Growing Concerns About Lawsuits, Fancy Technology and Global Communications, Recordkeepers are Earning New Respect," *Philadelphia Inquirer*, Nov. 3, 1992, at F1.
- Do not include personal notations or ambiguous information on the document.

When Client Does Not Follow CPA's Advice

If the client does not follow up on the advice, the CPA may send a letter, reconfirming his or her advice. The clients may have simply misunderstood the advice, but if they have decided to take an alternative course of action, the CPA will want to let them know why the accountant does not recommend that alternative. Possibly, a better way to disagree would be to simply lay out why another option or alternative is the best choice and why the alternative solution may have some negative repercussions. The accountant should include a copy of this letter in his or her own files.

Disclaimer of Fiduciary Obligations

In light of the potentially grave consequences of a finding that a CPA is acting as a fiduciary to a client, it may be appropriate in certain situations for the CPA to insist upon a contractual disclaimer of fiduciary obligation. Here is an example of such a disclaimer:

(1) The parties to this contract specifically intend that neither this agreement nor any course of dealings between them shall create fiduciary obligations.

(2) Nothing contained in this agreement, and no course of dealings between the parties, shall be construed as establishing a partnership, joint venture or agency between the parties.

(3) The rights, duties and obligations of the parties are to be controlled exclusively by contract. Any obligation or covenant of good faith and fair dealing, whether express, implied-in-fact or implied-in-law, is intended to be contractual only.

(4) This contract was negotiated at arms' length. There is no "special relationship" between the parties. Neither party is or has been influenced or dominated by the other.

(5) Each party places in the other the trust and confidence that reasonable strangers dealing at arms' length in business relationships would place in one another. Neither party reposes special or extraordinary trust in the other.

(6) Each party to this agreement represents that it is an independent, experienced and sophisticated business entity. Each party conducts its own investigations and obtains its own information about business transactions. Each party relies wholly on its own counsel in making business decisions.

(7) The frequency, length or closeness of dealings between the parties shall not create fiduciary obligations. In particular, extended dealings over a lengthy period of time shall not create fiduciary duties.

(8) Any advice given by one party to the other is offered unilaterally and accepted indifferently. Neither party undertakes to act for the benefit of the other, and neither accepts any trust unilaterally reposed by the other.

(9) Any disclosure obligations contained in or arising from this agreement or the course of dealing between the parties are strictly contractual, and do not create fiduciary obligations.

(10) The parties intend that any disclosures of information, confidential or otherwise, during the course of business negotiations or dealings not be construed as creating additional disclosure obligations.

Avoid "Engagement Creep"

The phenomenon of "engagement creep" continues to plague the accounting profession. Simply stated, "engagement creep" occurs when accountants provide services beyond the scope of their written engagement agreement, thereby waiving or limiting protections built into those carefully crafted arrangements. CPAs may be able to minimize their exposure to this dilution of their engagement agreements by considering the use of the following language in their written agreements:

You agree that you will only rely on our written recommendation and reports. That is, you agree that you will not rely on any oral advice that you may receive from us. At the same time, you agree that we have no duty to give you any advice or to make any recommendation to you beyond anything that we put into our written recommendation or report to you.