Issues in Representing Smaller Accounting Firms

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Reducing the exposure of a smaller accounting firm is a challenge, but it is easier if you know some of the recurring issues.

CERTAIN RECURRING ISSUES, some of which are avoidable and others of which can be mitigated, present themselves in representing smaller accounting firms. These firms generally, though by no means exclusively, tend to represent non-publicly held companies. Nonetheless, many of them provides services, including attest services, to entities that are subject to governmental oversight, such as employee benefit plans and not-for-profit and charitable organizations. Recognizing these issues and helping clients address them proactively can help reduce significantly the risk of liability claims as well as help foster long-term relationships that emphasize loss prevention and advice concerning issues that will give the firm a more solid and high-quality client base, rather than just defending liability claims.
Engagement Letters

Annual engagement letters should be sent for each representation, including those as potentially straightforward as income tax preparation services. As with any engagement, a proper engagement letter should prevent after-the-fact attempts to expand the scope of the actual services, claims that the client did not understand the nature and scope of the engagement or any limitation of the engagement or services that were being provided, assertions which are frequently raised in claims alleging the failure to detect defalcations. An annual engagement letter should also assist in defending against claims of continuous representation and other issues facing tax preparers, including FBAR violations.

In tax preparation and other situations where a stand-alone representation letter will not be obtained, the engagement letter should be countersigned by the client to confirm his understanding of the nature of the services to be provided and the client’s own responsibility, including to provide complete and accurate information. The firm should not release its work product prior to receipt of the counter-signed letter.

Lost Client Relationships

A client frequently has contact with one only member of a smaller accounting firm. This not only can create more of a personal rather than firm-wide relationship, which could be jeopardized by any separation at either the firm or client level, but also increases the chance of errors going undetected by being repeated in subsequent years due to the lack of any substantive review of the work being performed. The failure to expand the client relationship is a concern for both accountants who hope to sell their practice and firms that seek to grow by acquiring the practice of retiring practitioners, since such clients may be significantly more difficult to transition and retain than those who are familiar with several professionals who will be joining the acquiring firm.

Client Breakups

While the accountant will rarely have the same relationship with all the principals of a closely held business, it is advisable for the client partner and perhaps others to meet with each owner on a periodic basis. Such in person meetings should at a minimum take place in order to distribute the client’s tax returns, individual K-1’s and any financial statements that may be prepared, and to reinforce that the accountant represents the firm, rather than only certain of its owners. Regardless of the relationship the accountant may have with any of the client’s principals, if the accountant becomes aware of improprieties engaged in by one of the principals, or by a staff employee who works for one of the partners, the accountant must take steps to timely inform the other principals or immediately resign the account. Failure to do so could result in the accountant being included in any litigation, especially if it appears that the person accused of wrongdoing may lack the means to make restitution and, as is often the case with non-reporting companies, they do not have fidelity insurance.

Failure To Follow Up on Audit Recommendations

Accountants will frequently be asked to provide a separate report to management on internal controls and other financial compliance issues. If such a report is issued, the firm needs to take affirmative steps to assure that the recommendations have been adopted, or that changes in circumstances no longer require their implementation and then properly document its conclusions. The firm should not simply eliminate the recommendation in a subsequent year, as this could allow management to assert that the firm no longer thought this was a concern that required management’s attention.

Investments with Clients

Investments with clients, or even putting two clients together for a potential investment opportu-
nity, should be avoided, even on a fully disclosed basis, if the firm is providing ongoing accounting services of any level. An investment by an accountant with a current client can lead to claims that the accountant was more interested in protecting his investment (and/or those of any client), rather than acting as an accountant, regardless of the level of the engagement. In addition, it is generally far from clear whether any claim arising out of an investment recommendation or investment is covered by liability insurance.

**Not-for-Profit Organizations**

Many smaller, not-for-profit organizations have board members that rely heavily on the Executive Director. If the not-for-profit requires an annual audit, the accountant should take appropriate steps to make sure the Executive Director has kept the Board properly informed of all material financial decisions. At a minimum, the accountant should attend the meeting at which the NFP’s financial statements are discussed and interact throughout the year with the audit or finance committee.

**Failure to Timely Report Potential Claims**

Accountants frequently feel that a long-term client “would never sue me”, even if an error or omission by the firm results in actual damages to the client. Separate from the somewhat unrealistic attitude this all too frequently represents, failure to timely report a potential claim could jeopardize the firms’ professional liability coverage if the insurance company ultimately determines that a reasonable person would have reported the potential claim once the firm became aware of the error or omission (and certainly after the client indicates its awareness of the situation, notwithstanding any disclaimer concerning a potential suit), rather than wait for an actual claim, which may not be asserted for years. This is a particularly dangerous situation if the firm has switched insurance carriers between the time the incident allegedly should have been reported and the time suit is actually commenced. Accountants need to better understand that in virtually all situations their liability insurance rates will not increase dramatically nor will they be non-renewed simply for reporting a potential claim, and that on balance the better practice is to report any potential claim as promptly as possible. If the firm has any question whether an incident is reportable, it should promptly consult with counsel.

At many firms the partner in charge of insurance does not properly involve the other accountants in the renewal process. The recommended procedure is to circulate a firm-wide email asking each accountant whether they are aware of any potential claim that needs to be reported in connection with the renewal application, when with the same or a new carrier, and not to submit the renewal application until every professional in the firm (not just partners) has responded by email.

**Workpapers**

Over the past 10 to 15 years, most major accounting firms have adopted the use of electronic working papers. However, smaller firms have generally been slower to adopt the use of electronic workpapers and/or have done so inconsistently. Indeed, in some cases, there is a mix of electronic materials and physical workpapers even within the same engagement. Needless to say, this is not a good method of documenting an auditor’s work and makes it more difficult to establish and defend the accountant’s work in an after-the-fact litigation.

From a litigation perspective, electronic papers are often easier to follow because they force accountants to use a standard format and generally result in a more complete and higher quality set of workpapers. While physical workpapers usually have a standardized structure, electronic workpapers seem generally to result in fewer stray notes, a more complete disposal of items that do not belong in the final workpaper set.