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Issues in Representing Smaller Accounting Firms

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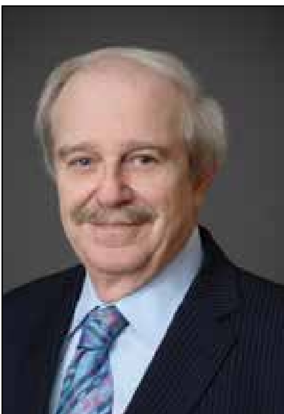

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Reducing the exposure of a smaller accounting firm is a challenge, but it is easier if you know some of the recurring issues.

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.

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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.

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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.

Regardless of form, the quality of workpapers is often an issue in smaller firms, where there tends to be less rigor about completion of all workpapers, especially planning and program forms. Attorneys working with these firms should stress the importance of maintaining high-quality documentation. One method for improving the quality of documentation is the use of contemporaneous memos discussing how key audit issues were addressed and resolved. Another is to assure the completion of workpaper lock-down within the prescribed period under applicable law or regulation. Counsel should stress the importance of assuring timely clean-up and lock-down of workpapers and that that message must be communicated throughout the firm. Equally important, any supplementation after lock-down must be properly dated and explained.

Record Retention

A related and equally important area is record retention. Written record retention policies are generally required by federal and/or state law/regulation. Yet in many cases, smaller firms fail to create and maintain such policies. Counsel should discuss these issues with their accounting firm clients and assist in the development of proper written record retention policies where necessary.

Once a written policy is in place, it must be consistently applied and compliance should be contemporaneously documented. Personnel should be specifically designated as responsible for assuring that the retention and disposal provisions of the policy are carried out and documented. In the event of a potential claim, it is important to implement a litigation hold as soon as possible that overrides the firm's general document retention policies. Since smaller firms with little litigation experience generally do not have a thorough understanding of the present state of the law on litigation holds—and the often serious consequences that can arise from not complying with that law—counsel should act as quickly as possible to ensure that proper litigation holds are established, communicated and documented.

At some firms, the partners are reluctant to inform staff accountants of potential or threatened claims. However, those partners must be advised that every staff person who was involved with the engagement that is the subject of the actual or threatened claim must be informed so that an effective litigation hold can be implemented. This is particularly important given the many different devices on which potentially discoverable material can now be stored.

In addition to workpapers, personnel evaluations should be conducted at periodic intervals and documented as performed and compliance with federal and state employment laws must also be documented.

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Quality Control

While larger firms have quality control departments, or at least a quality control partner, in very small firms, there may be no one designated to oversee quality control. As a result, best practices and/or firm procedures and policies may not be enforced. Counseling small firm clients to adopt quality control policies and to designate one partner to be responsible for quality control can significantly reduce the firm's risk exposure. The costs that may result from these steps will likely be more than offset in the long run by savings on insurance premiums and on time lost due to errors in performing professional services.

Even if firms do not wish to establish internal quality control policies, they should be encouraged to develop relationships with other CPAs with whom they can consult on technical matters or unusual situations, or at a minimum avail themselves of hotlines or other resources from which they can seek assistance.

Economic Pressures

Small firms are often excessively dependent on one client or a small group of related clients. This dependence makes the firm particularly vulnerable to client loss due to acquisitions, economic downturn, etc. This can lead to undue pressure to take positions desired by the client. Even in engagements where professional independence is not required, the smaller firm may not be sufficiently independent to avoid actions that may not be fully in accord with professional standards. Even if such actions do not result in liability actions, they may result in exposure to disciplinary proceedings and licensing difficulties. In worst-case scenarios, client cost sensitivity can lead to insufficient audit or other attest work, which of course can result in liability to a client or a nonparty.

Smaller firms also find that they face difficulties in competing for clients. As a result, the smaller firm may find that, in order to generate sufficient revenue to keep the firm going, it must settle for having a clientele that is of lower quality. Revenue needs can thus lead to poor client intake procedures, lowering the bar for the firm to accept a client engagement. The firm can become less rigorous in investigating potential clients' history, resulting in engagements for clients who lack the integrity the firm might otherwise require or who have a history of legal or regulatory violations, frequent accounting firm changes or other issues that adequate due diligence might uncover.

Even if the client has an unblemished record, the firm may nonetheless be taking on an engagement for which it lacks experience, staffing or other capacity. Small firms should be advised to consider carefully whether they are capable of handling a potential engagement before agreeing to take it. Often, smaller firms with experience in a limited range of industries believe they can handle engagements in other industries or that their experience in one industry is sufficient to enable them to handle engagements in other industries that may seem analogous on the surface, but in fact are not. The firm must satisfy itself not only as to its knowledge of the industry but also knowledge of applicable accounting principles and how they are applied as a practical matter by companies in that industry.

One particularly difficult source of economic pressure is unfunded retirement obligations to senior partners and/or significant rainmakers who are approaching retirement but still have significant influence with important clients. The buy-out expectations of senior partners can lead to problems in retaining younger partners, who feel they are being undercompensated and burdened by these obligations, particularly if they generally work on matters for their own clients, rather than clients of the partners who are approaching retirement. These economic pressures can lead to difficulties in retaining potential future rainmakers, which of course can significantly hinder the firm's growth, or even survival, prospects. Internal divisions over these issues can also result in conflict within firm, which in turn can distract from client service and make it harder to enforce quality control.

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Management Issues

In some firms, management control is held by a single partner or very small group of partners. In such cases, successful firm management depends on the managers' ability to be aware of all aspects of firm operations and to enforce adherence to firm policies and consistency in performance of firm engagements. This is, of course, a difficult task and requires an almost superhuman attention to the detailed operations of the firm. At some point, the firm may grow to a size where such a management style is simply inappropriate and/or ineffective. However, often that fact is not recognized until it is too late and potentially serious problems have occurred and created threats to the firm. Counsel with experience advising small accounting firms should provide their growing small firm clients with the benefit of their experience, though this can be

a sensitive situation where the firm managers have been in control for a long time and are reluctant to cede some of that control in the name of promoting future growth by creating a larger infrastructure and delegating some level of authority to others within the firm. Problems can also arise when those in control of a small firm deviate from firm policies/procedures without knowledge of others within the firm and without any effective check on their ability to make such deviations.

Other smaller firms lack centralized management, with partners essentially running their own separate practices under one umbrella, sharing space and costs but not truly operating as a firm should. This can result in an absence of firm-wide policies and procedures or an inability to enforce such practices and procedures if they do exist. This can lead to a lack of consistency and increased risk of deviations from professional standards and non-compliance with regulatory requirements. Once again, advice regarding changing a firm culture may not always be welcome, but sometimes it is necessary for counsel to provide advice that initially is distasteful but may necessary for the firm to prosper, or even to survive, in this difficult and highly competitive economic environment.

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