

CPA Malpractice Claims Part 2 – Document Examination

By Craig L. Greene

In my last article on the topic of CPA malpractice claims, I discussed the various legal theories used and the applicability of the various AICPA professional standards to these types of cases. In this article, I will discuss the documents that need to be obtained to successfully prosecute or defend these types of cases as well as the role of the accounting expert for both the plaintiff and the defendant.

Engagement Letters

Malpractice carriers and the profession see a well drafted engagement letter to be the first line of defense in claims against the CPA. The engagement letter is in essence the contract between the client and the CPA stating both parties' understanding of the professional relationship. The engagement letter addresses such items as:

- The purpose of the engagement, specifying the period to be covered and the records to be examined.
- A specific discussion of the scope of the engagement – what the CPA will do and will not do.

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- The professional standards the CPA will comply with while performing their services.
- Specific client instructions and a description of the client's responsibilities.
- Financial arrangements concerning billings and payments of invoices.
- Often, an arbitration clause requiring any related disputes be first arbitrated with the American Arbitration Association under its Rules for Professional Accounting and Related Services Disputes.

It is highly recommended – and obviously good practice – that the CPA issue engagement letters for all forms of professional services for which they are engaged. That being said, the professional standards for the profession only require engagement letters for attestation engagements such as audits and reviews of financial statements though the literature highly recommends that engagement letters be prepared for all

fore, it is imperative for the attorney to understand the proper vernacular when requesting these documents. When drafting the subpoena the plaintiffs should typically ask for the following files and documents for the type of engagement the CPA was engaged to perform:

- All audit working papers, including permanent working papers, for the audit of defendant's financial statements for the period ended December 31, 20XX.
- All review working papers, including permanent working papers, for the review of the defendant's financial statements for the period ended December 31, 20XX.
- All compilation working papers, including permanent working papers, for the compilation of the defendant's financial statements for the period ended December 31, 20XX.
- All financial statement files contain-

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other services provided by the CPA.

In examining document production in a CPA claim case, this is the first document the attorney and the accounting expert need to review. Although, the letter may include many limitations regarding their services in the letters, such defenses may be struck by a competent accounting expert when examining the underlying work product. Further, the plaintiff's expert may be able to demonstrate that the CPA breached the contract (engagement letter) by not performing the assignment with the applicable cited professional standards.

Working Paper Files

Accountants typically keep working paper files for all of their engagements that should be obtained early in the case by both the prosecution and defense. There-

ing financial statements, including drafts prepared by the CPA, as well as, documentation of quality control and partner reviews of such financial statements.

- All income tax returns and corresponding working papers, including permanent tax working papers, for the preparation of the defendant's federal and state income tax returns for the tax year ended December 31, 20XX.
- All correspondence and email files documenting correspondence and emails between the CPA and the client and correspondence and responses (written or by email) prepared by the CPA on behalf of the client to third parties.
- All billing files, including invoices and

detailed time records for all professionals that performed services.

Annual working papers produced by CPAs for their auditing, accounting review and compilation services will typically include the following documents:

- Index of the working papers, including descriptions of the documents and/or financial statement items showing page number references to those documents. The documents are often indexed through a system of both alpha and numerical entries.
- Working programs/plans consisting of a listing of objectives of the work and the procedures required to complete the objectives of the work.
- Review documentation and other practice aides such as checklists and forms required to be completed by professional standards.
- Account analyses often in a spreadsheet format which the accountant uses to analyze and verify transactions recorded in the client's accounting records.
- Memorandums discussing transactions, accounting systems, procedures, findings and other written evidence of the services performed by the CPA.
- Correspondence such as client representation letters, attorney's letters required by auditing standards, audit confirmations with customers and vendors and other relevant third-party documentation.
- Though not recommended by the profession, copies of client documents are often included such as invoices, insurance policies, bank statements and the like.

Permanent working papers produced by CPAs typically include the following documents:

- Entity formation documents such as articles of incorporation, bylaws, stockholder records, bank resolutions, board minutes.
- Accounting system documentation comprised of narratives and/or flow charts.
- Copies of significant employment agreements, leases, contracts, mortgages, bank notes, employee pension and benefit plans and the like.

Some CPAs may also maintain separate financial statement files that typically include the final financial statements produced as a result of their work, drafts of previous statements, written evidence

of the review of the financial statements consisting of work forms and perhaps marked-up drafts of the statements documenting their checking of the numbers.

In preparing the related income tax returns and/or other tax related engagements the CPA will typically have separate tax files that often contain:

- A copy of the final return filed, as well as, previous drafts.
- Tax working papers that include analyses of transactions that are reported differently for taxing authorities than shown in the financial statements.
- Memorandums documenting tax research, tax treatment of transactions and the like.
- Copies of tax law and regulations that may be pertinent to the returns.
- Like above written evidence of their review of the income tax returns consisting of work forms, checklists, and perhaps marked-up drafts of the returns documenting their checking of the numbers.

Other Accountant's Files

CPAs may have other files that should be obtained in the matter such as:

- Billing files including invoices for their services, as well as, detailed time entries for all staff working on the assignment.
- Correspondence files that contain any letters and/or memorandums written to/from the client.
- Electronic email files containing email communications sent by the accountant to the client and/or on behalf of the client.

Examination of Files

A competent accounting expert should be retained early on in the case to help guide document production and inspection. Once the documents are produced, the expert will review the files for compliance with applicable professional standards (see my previous article on this subject). A tool that is useful during the review is for the accounting expert to utilize the team and review captain checklists that are prepared and freely available to members of the American Institute of Certified Public Accountants on their website. These checklists are designed for practitioners who perform peer reviews of other firms' practices to test the firm's adherence to professional standards.

In examining the files the plaintiff's expert will scour the documents to find violations of professional standards to assist

in proving the plaintiff's case. In preparing the case, the plaintiff's attorney will want the expert to find as many violations of professional standards as possible, and other indicia that the CPA was not performing the engagement satisfactorily. The expert will also often look for potential conflicts of interest with the client and the CPA and a lack of perceived independence on the part of the CPA.

The defense expert is looking for evidence in the documents to disprove the plaintiff's case and by necessity will also focus on the CPA's compliance with professional standards. In a case where a large financial statement fraud or embezzlement has occurred the expert will be looking for evidence that the CPA was elaborately duped by the client and/or the actions of the CPA actually did not contribute to the harm sustained by the plaintiffs.

It is not unusual for the defense expert to point to issues with the client's accounting systems such as a lack or breakdown of internal controls when a large fraud is discovered. The responsibility of the CPA to test these areas fall primarily under the auditing standards, so often this is asserted when the CPA provides a lesser level of service such as a review or compilation of financial statements. Nevertheless, even in performing a lesser level of service the CPA has a responsibility to report known fraud to the client and be mindful of obvious indicators of fraud found during their work.

CPAs must often use their own professional judgment in their work and accordingly, two experts can and often have opposing viewpoints on the extent of professional judgment exercised by the CPA. Some examples wherein the CPA uses their professional judgment may involve the number of transactions to review and test; the applicability of a certain accounting standard to a transaction; the materiality of a transaction and or financial statement line item, the assignment of work to staff members, the quality of supporting evidence in an audit and the like.

In my next article on CPA malpractice claims, I will discuss choosing the right expert for these cases, preparation of a compelling and authoritative expert report; as well as, some practical pointers that I have learned over the years being retained as an accounting expert on behalf of both plaintiffs and defendants in CPA malpractice claims.