CPA Malpractice Claims: CPA Responsible to Detect Fraud

By Craig L. Greene

In my last article on CPA malpractice, I discussed the CPA's responsibility to detect fraud. The views taken on fraud detection will vary greatly depending on who is asked. It is very common for the auditor to be convinced that fraud is not their primary duty. On the other hand, the general public often assumes that if a company's financial statements have been audited, then they can be relied upon and are free of fraud. These opposing views are commonly referred to as the expectations gap. When a fraud is discovered whether it is the CFO overstating revenues or the bookkeeper embezzling from a small business, the victims often assert a malpractice claim against the CPA firm.

Malpractice claims against CPA firms are widespread which is why they carry large professional liability insurance. The fact of the matter is that signing a report carries a large burden that requires a CPA to strictly adhere to the professional standards that are set forth by various governing bodies.

Craig L. Greene is a founding partner of McGovern & Greene LLP a forensic accounting and litigation services consulting firm. He is a CPA, certified in fraud examination, financial forensics, corporate compliance and ethics and a master analyst in financial forensics. He works as a consultant and expert witness on complex financial matters including allegations of financial fraud, CPA malpractice, shareholder and partner disputes and many other forensic accounting related matters. Craig is the former regional governor and president of the Greater Chicago chapter of the Association of Certified Fraud Examiners and an internationally recognized speaker on fraud and fraud examination. For more information, please visit www.mcgoverngreene.com.

As previously discussed last month, there are two governing boards that oversee auditors and set standards for CPA professionals. The PCAOB oversees the audits of public companies and the AICPA serves all other engagements. Both boards use the term Statements on Auditing Standards (SASs) as the actual standards number. The AICPA uses "AU-C" as the section indicator while the PCAOB uses the "AU" indicator. The AICPA also governs any review, compilation or tax engagements, which are represented by sections "AR" and "TS."

The standards that determine the auditor's responsibility in fraud detection are AU Section 316 (PCAOB) and AU-C Section 240 (AICPA), *Consideration of Fraud in a Financial Statement Audit*. In this article, I will discuss both of those standards, as well as the responsibility of the CPA in performing services in taxation and review and compilation engagements.

Fraud Detection in Financial Statement Audits

The PCAOB and AICPA state that the auditor's responsibility is "to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." While this statement would insinuate that detecting fraud is the responsibility of the CPA, it is not possible for an auditor to obtain absolute assurance that the financial statements are not misstated. Therefore, even an audit that is performed in accordance with standards set forth by the AICPA and PCAOB may not uncover fraud or even material fraud despite complying with generally accepted auditing standards (GAAS) due to unreliable evidence and false source documents that have been covered up through layers of collusion.

GAAS addresses the importance of maintaining professional skepticism throughout the engagement. It is easy for a CPA to trust the integrity and honesty of a company that they have been engaged with for a long time. The AICPA acknowledges that an auditor cannot literally question each piece of evidence that is presented and therefore, the auditor may "accept records and documents as genuine" if there is no evidence to the contrary.

Both sets of fraud standards characterize fraud into two categories: (1) misstatements arising from fraudulent financial reporting and (2) misstatement arising from misappropriation of assets. A misstatement from financial reporting is intentional and may be done by manipulating, falsifying, misrepresenting or omitting and intentionally misapplying accounting principles. Misappropriation of assets is also known as theft or defalcation that are material enough to cause the financial statements to not be presented in conformity with generally accepted accounting principles (GAAP).

Secondly, the auditor is required to discuss the issue with an engagement team. The AICPA requires that a partner be included in the discussion as well any key engagement team members. There is no limitation as to which team members are included but it is essential that even those members not included are filled in on the discussions highlights. The discussion should focus on where the entity is susceptible to fraud. This brainstorming session "should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity."

In order to further address fraud risk, the next step the auditor will need to take, is to perform a risk assessment of the entity. The first step in establishing an assessment of risk is making inquiries of management. The inquiry should also include any others who are charged with governance including the internal control department if there is one.

After the management inquiries, the auditor is required to identify and assess the risks of material misstatement due to fraud just as they would for every account on the trial balance. These are considered the analytical procedures.

The auditing standards require an auditor to presume that fraud exists in revenue recognition and therefore has the obligation to evaluate the revenue activities, transactions and assertions of the entity. Audit documentation must be kept if the auditor concludes that the presumption of fraud is not applicable to the engagement and therefore revenue recognition is not considered as a risk of material misstatement due to fraud. If there are risks that are assessed, they should be considered significant and the internal controls of the entity should be scrutinized.

Fraud Detection for Performing Review Services

A review engagement is when the CPA is engaged to provide the user with some level of comfort that the accountant is not aware of any material modifications that need to be made to the financial statements of a privately held company. In a review, the accountant will provide the client with limited or negative assurance that material misstatement due to fraud or errors do not exist. Limited assurance indicates that nothing has come to the CPA's attention, whereas during an audit, the CPA will provide reasonable assurance that the financial statements are in conformity in all material respects.

Fraud is addressed in AR Section 90 of the AICPA standards. The first thing that an accountant should understand is that management is the one responsible for fraud prevention and detection. It is also true that a review engagement cannot be relied upon in detecting fraud or errors. Actual performance standards of the AICPA require the accountant to start with inquiries of management specifically related to fraud, including their knowledge of fraud or suspected fraud involving management or other persons.

A CPA is required to receive a written representation letter from management that shows "management's acknowledgement of its responsibility to prevent and detect fraud" as well as any "knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees or others."

The accountant will need to document any responses to inquiries of management as well as all analytical procedures performed including, in this case, those that are related to fraud.

Fraud Detection for Performing Compilation Services

During an engagement in which the CPA is compiling financial statements of a privately held business there is almost no concern of fraud. The accountant is not required to perform any analytical procedures or inquiries as it would in a review engagement. There is a requirement to gain an understanding of the industry and that the financial statements are clear of any obvious errors. No opinion is rendered or assurance as to the fair presentation of the compiled statements is given.

In the case that fraud is discovered or that documentation is incomplete or unreliable due to fraudulent activity, the CPA should consult with management about the effects of the issues. If there is a suspicion of materially misstated items due to fraud, then the CPA should request additional information. If the entity refuses, it is the accountant's duty to withdraw from the engagement and document the decision.

Fraud Detection for Providing Services in Taxation

Claims brought against CPAs for malpractice occur most frequently when the engagement was for tax services. While the lawsuits are not always as lucrative, in terms of dollar amounts, the total number of cases brought against tax preparers is high. The easiest claim a taxpayer can make against a CPA is when the preparer makes an error or fails to inform the taxpayer of a past mistake. The AICPA is one governing body that sets standards for CPAs who perform tax services. Specifically, the Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings,* (SSTS No. 6) is the written standard that will guide the tax preparer as to what steps should be taken when there is an error on the tax return.

SSTS No. 6 defines the three types of situations that the standard addresses. They are as follows:

- An error in a taxpayer's previously filed tax return.
- An error in a return that is the subject of an administrative proceeding, such as an examination by a taxing authority or an appeals conference.
- A taxpayer's failure to file a required tax return.

Once a tax preparer finds an error, it is important that they inform the client of the error. Paragraph 7 of SSTS No. 6 requires the tax preparer to give notice as well as recommend the appropriate steps taken to correct an error. The tax preparer may give such advice over the phone or in person, but I recommend it be made in writing. When facing malpractice lawsuits, it is important to prove that there was no negligence and that is was essentially the taxpayer's decision to forego correcting the error. A memo sent to the client regarding the error, as well as their response should be sufficient to document the requirement to inform the taxpayer.

In the end, it is the taxpayer who is responsible for deciding whether or not to fix an error and amend a return, not the tax preparer. Therefore, if the taxpayer goes the route of not correcting an error, the tax preparer should consider withdrawing from the engagement. Keep in mind that it is not required that the CPA withdraw from the engagement. Tax standards require the tax preparer to confirm that if they do not withdraw from an engagement in which an error does not get amended, then they must confirm that it will not carry forward to the next year. Tax standards also require the preparer to disclose any "erroneous" accounting methods that are used by the taxpayer.

Conclusion

The idea that a CPA malpractice claim can happen to any firm that engages in accounting is not a false one. The CPA profession has a high exposure to lawsuits and liability for a multitude of reasons.