FORENSIC ACCOUNTING

CPA Malpractice – Claims and Professional Standards

By Craig L. Greene

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Litigation claims against accountants are brought on a variety of legal theories, and most of these matters include multiple causes of actions based on the facts and circumstances of the particular case. The following is a listing of claims the plaintiffs will assert we often see in these cases.

Negligence claims are the most common and require the plaintiff to prove that the accountant (1) owed a duty of care to the claimant; (2) failed to conduct their work in accordance with applicable professional standards; and (3) that the failure resulted in the claimant's damages.

Breach of contract claims are often used due to the longer statute of limitations in most states. Often issues with the CPA may not come to light until years later, for example, erroneous tax advice that the IRS challenges years after a tax return is filed. A breach of contract claim is based on the failure to perform a specific service the CPA has contracted to perform or breach of a specific promise or undertaking made in the contract. It should be noted that not all states allow for a breach of contract claim against CPAs.

Fraud claims are generally asserted by third parties. A fraud claim requires the plaintiff to prove that the CPA either knowingly misled the plaintiff or acted so recklessly as to be indifferent to the damage caused to the plaintiff.

Breach of fiduciary duty claims are often asserted by clients that have engaged the CPA for tax advice, tax preparation and management consulting services. CPAs who audit a client's financial statements are required to be independent and do not have a fiduciary relationship with the CPA. Plaintiffs in these cases must show that a fiduciary relationship existed and that the CPA acted in a manner that disregarded the client's best interest in favor of their own and/or the interest of another party.

In addition to the type of claims listed above, other claims may be based on state and federal securities laws and RICO.

Since the majority of these cases have a negligence claim, these cases generally require proof that the CPA did not comply with professional standards.

Professional Standards of Practice applicable to CPAs are generally promulgated by the American Institute of Certified Public Accountants (AICPA) and the Public Company Accounting Oversight Board (PCAOB). Standards issued by the PCAOB apply primarily to auditors of publicly traded corporations, whereas AICPA standards apply to all CPAs. Finally, state governments and/or state public accounting boards also issue laws and regulations concerning the practice of CPAs, often incorporating the AICPA professional standards, but may have other rules and regulations that need to be reviewed for the case.

One of the first assignments is to review the applicable professional standards that are relevant to the facts and circumstances of the case. For the purposes of this article I am going to only address the standards issued by the AICPA. If the matter concerns auditors of publicly traded companies then the reader is directed to the similar standards issued by the PCAOB which can be downloaded from their website: www.pcaob.org.

AICPA Code of Professional Conduct provides guidance and rules to all members in the performance of their professional responsibilities. The code consists of principles and rules as well as interpretations and other guidance. The principles provide the framework for the rules that govern the performance of CPA's professional responsibilities.

The AICPA bylaws require that members adhere to the rules of the code. Compliance with the rules depends primarily on members' understanding and voluntary actions; secondarily on reinforcement by peers and public opinion; and ultimately on disciplinary proceedings, when necessary, against members who fail to comply with the rules. Members must be prepared to justify departures from these rules.

Statements on Auditing Standards (SAS) are applicable to engagements wherein the CPA was retained to perform an audit of the entity's financial statements. An audit of financial statements is the gold standard of the practitioner's services and requires the CPA to express their professional opinion as to the fair presenta-

tion of the financial statements with U.S. Generally Accepted Accounting Principles (GAAP). In essence, it is an examination and verification of an entity's financial and accounting records. Thus, SAS address such things as the objectives of an audit; audit planning; procedures to be performed; quality control considerations; audit documentation; sufficiency of audit evidence; types of reports and communications required as part of an audit; responsibility of the auditor to detect fraud during the audit; and other guidance for CPAs performing an audit.

Statements on Standards for Accounting and Review Services (SSARS) are applicable to engagements wherein the CPA is retained to provide accounting and/or review services on unaudited financial statements and/or other financial information for a non-public entity. There are basically two different types of services that fall under SSARS: review of financial statements and compilation of financial statements. In a review of financial statements, the CPA performs some limited due diligence on the financial statements consisting primarily of inquiry and analytical review. While a compilation of financial statements entails the CPA simply compiling financial information for the purposes of presenting that information in a set of financial statements. Although, SSARS engagements are performed on unaudited financial statements, the CPA still has to perform certain specified procedures, document their work and do have a responsibility to report fraud when they become aware of it.

Statements on Standards for Attestation Engagements (SSAE) are applicable to engagements wherein the CPA is retained to attest to certain financial representations. These engagements include: agreed upon procedures; financial forecasts and projections; reporting on pro-forma financial statements; compliance attestation; and management's discussion and analysis. Like the standards above, SSAE provide guidance, documentation requirements and procedures to be performed.

Statements on Quality Control Standards (SQCS) addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. It is required for firms that are enrolled in a practice monitoring program. As a practical matter, most, if not all, states' boards of accountancy require firms to be enrolled in a practice monitoring program to be licensed to practice public accountancy, so therefore it is likely that the subject CPA firm would be required to have a system of quality control and adhere to SQCS.

Statements on Standards for Tax Services (SSTS) are enforceable tax practice standards for members of the AICPA. The SSTS apply to all members regardless of the jurisdictions in which they practice and the types of taxes with respect to which they are providing services. The SSTS and interpretations delineate members' responsibilities to taxpayers, the public, the government and the profession. They are intended to be part of an ongoing process of articulating standards of tax practice for members.

Statements on Consulting Services apply to CPAs that provide consulting and management advisory services to clients. The AICPA define these services to include:

- Consultations with clients such as reviewing and commenting on a client prepared business plan and suggesting computer software.
- Advisory services such as an operational review and improvement study, analysis of an accounting system, assisting with strategic planning, and defining requirements for an information system.
- Implementation services such as providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.
- Transaction services such as insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.
- Product services such as the sale and delivery of packaged training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

Finally, should the issue concern an improper accounting for a specific transaction, then the expert will want to refer to U.S. Generally Accepted Accounting Principles (GAAP). Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting (GAAP) that govern the preparation of financial reports by nongovernmental entities. Those standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants.

In the next article, on the subject of CPA malpractice, I will discuss the documents that should be obtained, reviewed and what to look for when representing plaintiffs or defendants in these cases.