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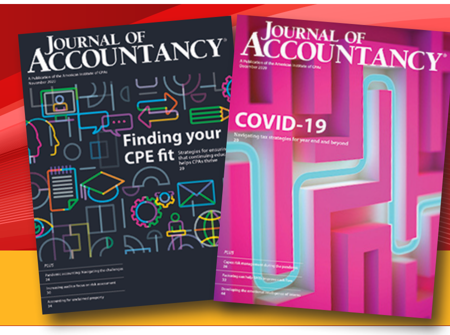

PROFESSIONAL LIABILITY SPOTLIGHT

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Client acceptance: A liability gatekeeper

By Sarah Beckett Ference, CPA

It is often said that engagement letters are one of the best tools in the defense of a professional liability claim. That said, few CPAs would prefer to test the strength of their engagement letters through the claim process and would rather avoid the claim altogether. Even a successfully defended claim is stressful and takes time away from revenue-generating activities, not to mention the defense costs associated with the claim.

What is one of the best ways to help prevent a claim? Employing strong client acceptance procedures — the process by which a prospective client is evaluated before undertaking any services. While client acceptance is no crystal ball, sound client acceptance procedures can help CPA firms identify potential problem clients before they cause trouble. Armed with this information, a CPA firm may avoid the risk and decline the prospective opportunity or begin the client relationship fully aware of the risks presented by the new client and implement risk mitigation tools to manage them.

WHAT TO EVALUATE

While there are many factors a CPA firm may evaluate when deciding to take on a new client, there are three that can make a significant difference to the firm's professional liability risk.

Integrity

Client integrity is critical. A CPA must be able to rely upon the client's representations and information provided. For many services — like tax return preparation, for example — a client's representations are the only thing that the CPA relies upon. A client's tone at the top speaks of its attitude toward risk. If a client lacks integrity, irrespective of how well the service is performed, a problem may still arise. Bad people do bad things ... and sometimes the CPA gets wrapped up in the wake of their misdeeds.

Financial strength

Another critical consideration is the client's financial stability and creditworthiness. CPA firms providing attest services are often sued when clients lose money or go bankrupt. A financially desperate client may be more likely to take unreasonable positions on a tax return, employ creative measures to prop up their financial statements, or treat their business's bank account as a rainy-day piggy bank. Any of these can lead to a claim against the CPA firm.

There's also a financial risk to the firm. Outstanding receivables create distractions. Many firms find it difficult to walk away from clients with past-due balances and continue to provide services, hoping that the client will pay, thus exacerbating the issue. Large, delinquent balances may tempt a firm to sue or send a client to collection for outstanding fees. However, this often leads to a counterclaim for professional negligence.

Culture

An often overlooked part of the prospective client evaluation is the alignment of cultures between the firm and client. Simply put, is the client someone with whom the firm would enjoy doing business? Is there mutual professional respect and courtesy? A lack of cultural alignment can manifest itself in many ways, including the client's treatment of CPA firm staff; willingness to meet deadlines, pay bills, or provide timely information; as well as the client's understanding and acceptance of each party's roles and responsibilities. Any of these items can lead to a dispute or misunderstanding regarding expectations that, in turn, may lead to a professional liability claim.

HOW TO EVALUATE

The AICPA Statements on Quality Control Standards (SQCS) require firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. While the SQCS apply to a CPA firm's accounting and auditing practice, these standards can be adapted to any service. Every firm, regardless of size, should have some sort of acceptance process. The formality and depth of such may vary from firm to firm. Solo practitioners may talk through a new opportunity with a trusted peer. Midsize firms may discuss prospective clients as a partner group. Larger firms may use a client acceptance committee. Firms of all sizes may leverage a checklist to guide their process.

Professional liability risk is borne by the entire firm, not solely by the partner that accepts and services the client. Consistency between offices, areas of practice, or individual partners in how prospective clients are evaluated and accepted is critical to ensure the firm's level of risk tolerance is maintained. To support consistency, document the firm's client acceptance criteria and evaluation process, including additional approvals required.

Specific client acceptance evaluation steps may include:

- Obtaining background information, including an internet search, on the client and key members of client management;
- Making inquiries of the referral source and/or the client's other professional advisers;
- Understanding why the client left its prior CPA and its history of changing service providers;
- Requesting to speak with the prior CPA. If the prospective client hesitates or declines, it could signal an issue;
- Assessing management's experience, financial knowledge, credentials, appreciation of internal control, and acceptance of their responsibilities that are applicable to the service to be rendered;

Continued.

- Understanding any changes in ownership, management, and those charged with governance;
- Performing a credit check to assess the client's ability or willingness to pay invoices on time;
- Personally meeting with prospective clients;
- Through inquiries, internet searches, and review of public records for pending or past lawsuits, understanding the client's propensity to sue its professional advisers;
- Reviewing the client's public records, including financial ratings;
- Reviewing prior financial statements and gaining an understanding of the reasons for any delays in issuance or restatements;
- Reviewing previous tax returns, recent tax return audit results, and other pending tax issues; and
- Taking a gut check. Instinct can play a key role in identifying and assessing client risk.

RESPONDING TO IDENTIFIED RISKS

Identifying risks during the client acceptance evaluation does not necessarily result in a declined opportunity but does require the firm to implement risk management practices to help reduce the risk to a level acceptable to the firm. Risk management practices to consider, among others, include:

- Obtaining a retainer prior to providing services and including billing and payment terms in the engagement letter;
- Where permissible, including risk allocation provisions, such as dispute resolution, limitation of liability and damages, and indemnification, in engagement letters;
- Assigning a more experienced engagement team to deliver the service;
- Including a secondary senior-level reviewer on the engagement team;
- Reviewing the contents of the engagement letter with the client, specifically discussing their responsibilities and your expectations of their role in the engagement; and
- Performing continuance evaluations more frequently to monitor client risk and ensure that it does not exceed the level of risk initially accepted.

Importantly, if integrity concerns are noted during the acceptance evaluation, strongly consider declining the client opportunity. It is difficult to identify a risk management practice, or combination thereof, that could mitigate the risk of a client that lacks integrity.

ECONOMIC CONSIDERATIONS

In tough economic times, CPA firms may be more willing to accept risk they might not have otherwise. This can manifest itself in accepting an engagement that stretches the boundaries or is outside of the firm's expertise. Or a firm may take on a client that doesn't quite meet the firm's acceptance criteria. Both of these practices result in additional risk to the firm.

CLIENT CONTINUANCE

A client's level of risk may change over time. A firm's level of risk tolerance may change as well. Performance of client continuance evaluations is just as important as client acceptance. The fundamental question to ask in any continuance evaluation is this: "If this client walked through my door today as a new client prospect, would they pass my acceptance criteria?" If the answer is "no," it may be time to part ways.

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