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AICPA® Professional Liability SPOTLIGHT

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The Dangers of Dabbling

Ensure that firm staff have the proper experience and training to take on the engagement.

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To meet evolving marketplace needs, CPAs often look to diversify their service offerings. However, undertaking a new service or providing service to a client in an industry with which the CPA is unfamiliar, frequently referred to as "dabbling," can elevate the risk of errors and professional liability claims. Why? Reasons include inexperience and inadequate training, which may limit the CPA's ability to identify and address issues.

THE NEED FOR COMPETENCE

One of the fundamental principles of the CPA profession is the standard of due care. Section 0.300.060, Due Care, of the AICPA Code of Professional Conduct indicates that due care requires the CPA to conduct his or her activities "with competence and diligence." This section also states that the CPA should "undertake to achieve a level of competence that will assure that the quality of the [CPA's] services meets the high level of professionalism required" by the professional standards. Further, a CPA's level of competence establishes "the limitations of a member's capabilities." Thus, understanding the CPA firm's strengths and being cognizant of its limitations constitute not only a good risk management practice, but also are required under the professional standards.

DEFENSE COUNSEL PERSPECTIVE

Dianne Wainwright, Esq., a partner with Margolis Edelstein in Pittsburgh; Thomas Falkenberg, Esq., a partner with Williams, Montgomery & John Ltd. in Chicago; and Kevin Murphy, Esq., managing attorney for Carr Maloney PC in Washington, all specialize in the defense of accountants' professional liability claims. They shared their insights about the relevance of professional competence in defending CPAs, in the following Q&A.

Can you share a story in which "dabbling" created a professional liability issue?

Wainwright: I defended a CPA firm in a lawsuit filed by a bank. The firm's client was an online retailer. The bank provided asset-based lending to the client and required an audit. The CPA firm performed the engagement despite having no prior experience working with web-based businesses. The client got the loan but later defaulted, and the bank sued them as well as the CPA firm.

An issue that arose during the audit was the capitalization of expenses incurred in setting up the company website. CPA firm staff had not encountered this issue before. They performed some research and concluded that the client's percentage of expenses capitalized was appropriate, but did not document their research or rationale for this conclusion. Some of these expenses could not be capitalized in accordance with generally accepted accounting principles. Given the firm's inexperience in the industry and lack of documentation, defending the work would have been difficult, and the case was settled.

How often does the subject of competence come up in defending accountants?

Falkenberg: I would estimate this issue plays a role in 25% of the lawsuits I defend, at least in part.

Murphy: Competence is often implicated in defending tax engagements, especially those performed for clients in niche industries or in niche services, such as estate or gift tax, where the rules are complex and frequently changing.

Wainwright: Competence is one of the areas where the plaintiff's attorney will seek extensive discovery on all engagement personnel to determine if the team had the right background, training, and expertise to perform the work.

To enter a new practice area, there must be a "first time" that service is rendered. What insights have you gained from defending lawsuits involving CPA firms rendering a "first time" service?

Murphy: The professional competence of the firm to perform the engagement will be challenged. Robust documentation of research performed regarding the service and the client's industry, as well as applicable professional guidance and standards are important. It is also helpful to have documentation evidencing that members of the engagement team completed directly relevant continuing professional education.

Does the need for specialized industry knowledge come up in professional liability claims? How can CPAs mitigate risks when undertaking engagements requiring such knowledge?

Falkenberg: A common line of questioning by plaintiff attorneys in professional liability lawsuits related to audits is the number of audits the CPA firm previously performed for other clients in the same industry. Engaging an expert with related industry experience to assist with the audit can help mitigate this risk, but the firm must have sufficient knowledge to evaluate the work of the expert.

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Murphy: This issue frequently arises in cases involving highly regulated industries, such as banking, insurance, or health care. Industries with unique financial reporting and audit considerations, such as governmental and not-for-profit entities, are also ripe for such allegations. If the CPA firm lacks relevant experience, the plaintiff attorney may argue that the CPA firm "went out on a limb" to secure a new client or hold onto an existing one that was entering a new industry.

What about competence at the firm level versus that at the team-member level? How does that factor in?

Falkenberg: At the firm level, efforts should be made to ensure that each engagement is properly staffed. If an engagement requires the use of personnel with limited experience, additional monitoring is warranted to ensure that the work is competently performed.

Murphy: If a firm has only one member with relevant industry expertise in an engagement, the adequacy of firm quality-control practices may be subject to challenge.

Wainwright: Working papers should be sufficiently documented to reflect that the engagement partner, manager, and team members were competent to render the services they were tasked with performing.

In view of these comments, do you have any recommendations for CPA firms regarding professional development and training plans?

Murphy: CPA firms may benefit from routine review of firm engagements by a partner who is not part of the engagement team, applying the critical eye of a would-be challenger of the firm's competence. Recommendations for additional training should be documented and communicated, when necessary, to the engagement partner.

Falkenberg: Do not take classes simply to meet CPE licensing requirements. Consider the services you perform, and complete coursework that will help improve your competence. You need to get the CPE credit, so make the training worthwhile.

Wainwright: Management should encourage CPAs who complete coursework specific to an industry or service to share that knowledge with others in the firm who can benefit from the training. This internal training should be documented for peer reviewers and others who may examine firm quality-control practices.

RISK MANAGEMENT CONSIDERATIONS

CPA firms can mitigate the risk of experiencing competency-related professional liability claims by implementing these basic steps:

- Avoid "dabbling" and one-off engagements performed as an accommodation to existing clients.
- Ensure that the engagement team has completed sufficient CPE relevant to the service and client industry.
- Consider engaging an industry expert to assist with engagements, when appropriate.
- When using an expert, firm management should have sufficient expertise to monitor the expert's work.
- Consider the need for second partner review in engagements where the firm has limited experience.
- Document all research performed and conclusions reached in the working paper file.
- Send written communications to clients documenting research findings on tax and accounting positions.

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