WILLIAM I. ESKIN, CPA

Presentation to :
Southeastern Accounting Show

"CPA MALPRACTICE"

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Before We Get Started

Before we get started folks, let remind everyone that I am NOT an attorney and nothing presented here today should be considered legal advice

Before We Get Started

It is highly recommended that if you have *any* questions or issues raised during this presentation, be sure to discuss them with your legal counsel

Are We Safe?

Hey Bill, some of us here today work in industry as controllers or CFOs. Are we safe from your evil outstretched arms?

"NO"

2 things could shoot you in the foot and could potentially hit your pocketbook and your license:

Reason # 1

Who is responsible for the fair presentation of the financial statements?

“MANAGEMENT”

Reason # 2

“SARBANES-OXLEY”

Financial Statement Warning Signals

When my clients forward to me financial statements they relied upon when making credit decisions, how do I decide which presentation of financial statements could be an indication of possible CPA malpractice?

I look for what I refer to as:

“FINANCIAL STATEMENT WARNING SIGNALS”

Items that upon a quick look-at would make it appear the CPA did not possess the proper knowledge of GAAP, GAAS, etc.

Financial Statement Warning Signals

- **Numerical errors**
- **Grammatical errors**
- **Improper name of the entity presented on the statements**
- **Lack of going concern disclosure**

Financial Statement Warning Signals

- **Opinion dates unreasonably close to the balance sheet date**
- **Omissions of common disclosures related to all financial statements**
- **Absurd disclosures**

Financial Statement Warning Signals

Examples of boiler plate disclosures:

1) **No disclosure describing the Nature of Operations - this is a boiler plate disclosure which virtually every entity needs to disclose**

2) **No disclosure concerning Use of Estimates - another boiler plate disclosure which every entity needs to disclose**

Financial Statement Warning Signals

3) No disclosure concerning concentrations (as required by SOP 94-6) which is also virtually a boiler plate disclosure

4) No disclosure concerning the definition of cash equivalents - boiler plate disclosure

Financial Statement Warning Signals

5) When I see rent expense on the books, no disclosure concerning operating lease arrangements - although not boiler plate, applies to many entities

6) Incomplete disclosure concerning long-term debt (lacking interest rates, collateral)

Financial Statement Warning Signals

An example of an "Absurd Disclosure"?

<u>PREPAID EXPENSES</u>

"Prepaid expenses represent expenses prepaid by the company"

Financial Statement Warning Signals

Now folks, I am not trying to represent that these items by themselves equates to CPA malpractice.

However, my experience in this field has led me to strongly believe that:

"<u>BAD FORMAT = BAD NUMBERS</u>"

Your Key Areas of Exposure

What are your key areas of exposure where I have been able to collect BIG bucks for my clients by proving CPA malpractice?

Well, let a friend of mine assist me in pointing these areas

Conclusion

Every business venture undertaken requires the assumption of a certain amount of risk

The key is to take steps to reduce this risk.

How do we as CPAs reduce this risk on our audits and reviews? That will be the focus of the Conclusion of this presentation

Conclusion

The first way which involves both your reviews and your audits is:

"PROPER WORKPAPER DOCUMENTATION"

Conclusion

Consider EVERY workpaper you touch as if it will eventually be going before:

"The Judge"

THEY ARE IN FACT LEGAL DOCUMENTS

Conclusion

Workpaper documentation is a 2-way street. It can "protect" you by providing "proof" that your audit or review was prepared in compliance with the various Standards.

It can also go the other way if your documentation is not appropriate or otherwise "stupid"

Conclusion

These comments are applicable for every compilation, review, and audit you perform and is a great way to keep Bill Eskin out of your pocketbook:

- **Be sure to toss all superceded workpapers and financial statements**
- **Be sure to toss review comments**

Conclusion

In order to pursue and collect on CPA malpractice, the bank or surety must be able to prove the following:

a) **<u>Reliance</u> - the bank must prove it relied upon your audited or reviewed financial statements when deciding to provide your client bank credit**

b) **<u>Damages</u> - the bank must prove it incurred losses as the result of relying upon your statements**

c) **<u>Malpractice</u> - the bank must prove you did not follow GAAS in the performance of the audit or SSARS with the review**

d) **<u>Errors</u> - the bank must prove that your malpractice caused the errors in the financial statements causing them not to be in compliance with GAAP**

e) **<u>Applicable state law</u> - statute of limitations, privity, etc.**

Conclusion

- **The burden of proof of proving CPA malpractice rests on the plaintiff (bank).**
- **The CPA is innocent of any malpractice until it can be proven by the bank.**

The bank must prove one of three wrongdoings:

Conclusion

1) <u>Negligence</u> - bank must prove CPA violated the duty of due care to the client and/or the third party (e.g. the bank)

2) <u>Gross Negligence</u> - Wrongful misconduct bordering on recklessness.

3) <u>Fraud</u> - bank must prove CPA knowingly and intentionally misstated the financial statements.

<u>We almost always try to prove only NEGLIGENCE since this is all the bank has to prove in order to recover for losses incurred.</u>

Conclusion

The key to keep Bill Eskin away from you is a simple 4 part process:

1) First, thoroughly GAAP, GAAS and the SSARS in general and how they relate to your client in particular
2) Next, thoroughly DOCUMENT your workpapers
3) Thoroughly DOCUMENT your workpapers
4) Thoroughly DOCUMENT your workpapers

Conclusion

Obviously you want to be careful with every client when we discuss workpaper documentation. But you all should be "extra careful" when it comes to those clients who are considered (IMHO) higher risk clients

Higher Risk Clients

Characteristics of clients who are considered higher risk of triggering a malpractice lawsuit include:

- ✓ **Personnel turnover, especially at the CFO level**
- ✓ **A sales type person with authority over the "check book"**
- ✓ **Pattern of failing to provide information requested**
- ✓ **Lacks even reasonable internal controls**

Higher Risk Clients

- ✓ Heavy use of the financial statements by 3rd parties (Bank, surety, etc.)
- ✓ Absentee owner who lives beyond his/her means
- ✓ Always involved in various types of litigation
- ✓ Owner involved in “recreational” activities

Conclusion

Please understand that I am not trying to scare the living day lights out of everyone.

Again, please keep in mind that the public is trusting us to produce a quality product and my services are just one way of keeping the public’s trust.

Conclusion

Folks, we are living in some very uncertain economic times today. With a very volatile stock market and the financial sector getting clobbered, we all must be aware that both banks and sureties are currently much more sensitive to their “bottom line” than in recent history

Conclusion

Accordingly, they may be more apt to consider litigation against a party that they conceive as causing them losses than before this current financial crisis

Conclusion

If corporate and personal indemnity is not enough to cover losses, they will look to alternative sources to help recover for losses incurred and there is no better source available to them than you folks;

The CPA

Conclusion

How do you prevent this action?

- ✓ **Don’t “sell yourself out” for any client. They are not worth it and will turn on you in a heart-beat. Many times, the bank will release the owner of the company from any personal indemnity in order to obtain his/her cooperation in pursuing CPA malpractice. Remember, the bank does not care who repays it for its losses incurred. Also, your golfing buddy for the past 20 years will turn on you in a heart-beat in order to save his house & company.**

Conclusion

- <u>Be careful how you treat your employees.</u> One of the procedures we perform when suing CPAs is to depose all members of the audit team. This includes the partner, technical reviewer, manager, senior, and junior

Conclusion

It is also CRITICAL when performing your audit or review, that you ask yourself this question:

Am I prepared to discuss how my audit or review was planned, performed, and supervised to the JUDGE?

Conclusion

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And Finally

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billeskin@juno.com