

Professional Liability

L I T I G A T I O N R E P O R T E R

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Commentary:

Surety, Fidelity and Accountant Liability: When Do You Have a Case?

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Contract surety bonds and traditional fidelity bonds have more in common than being three-party contracts. The underwriting and losses associated with both types of bonds often involve the work product of certified public accountants. All of the “three C’s” of contract surety credit evaluation — character, capacity and capital — require the review of and reliance on the CPA’s work product, typically either an audited or reviewed financial statement.

Similarly, financial statement analysis and management controls, related to the CPA’s work product, are important factors in the underwriting of fidelity bonds and the discovery of a fidelity loss in progress.

When losses on either surety or fidelity bonds are incurred and there are hints or suspicions that the CPA’s work product may have fallen short of applicable standards, the possibility of recovery from the CPA or firm may be considered as part of the claim management process. However, actions against CPAs can be expensive to pursue with opponents like “deep-pocket” professional-liability carriers and the CPA with a large deductible and reputation to protect.

These cases are document-intensive and almost always require the extensive use of other CPAs as experts. Although not addressed in this article, the evaluation of privity or standing to bring a suit and choice of jurisdiction must also be addressed early in the process.

Given these hurdles, how should the decision to initiate an action against a CPA be approached? There are three key questions to address while making this decision:

- Was there a violation of professional standards, indicating motive or opportunity for error?

- Is there a “smoking gun” indicator of a clearly defined error in the financial statements audited or reviewed by the CPA? and
- Are there actual damages that can be associated with this error?

The CPA’s Professional Standards

In general, the standard to which a certified public accountant is held is the Code of Professional Conduct promulgated by the American Institute of Certified Public Accountants. The code encompasses both general principles relating to the conduct of a CPA and general rules that apply to most engagements.

The principles contain general statements relating to CPAs’ general responsibilities, their obligations to the public interest, maintenance of their integrity, maintenance of their objectivity and independence, a general commitment to exercise due care and a commitment to exercise these principles in connection with the services provided.

The AICPA rules provide more specific requirements relating to independence, integrity and objectivity; general standards, which incorporate the more specific Generally Accepted Auditing Standards¹ and Generally Accepted Accounting Principles²; and responsibilities to clients. The rules also detail other responsibilities and practices relating to acts discreditable to the profession, advertising, commissions and the form of practice. Although recent events may indicate that these standards are not always followed by certain renegades of the profession, causing disastrous results to shareholders and the public, they do exist in all their complex and voluminous glory.

The Underwriting Process and the CPA's Work Product for Construction Surety Bonds

The financial statements of a construction contractor are critical to the evaluation of the contractor's capacity and capital, providing hints to character. The financial statements of a contractor are also different from those of other businesses. In addition to the typical information contained in financial statements, the contractor's financial statements and supplemental schedules also include information on the profitability of completed contracts, the status of ongoing projects and the remaining contract backlog.

It is in the financial information specific to construction accounting that the accountant's adherence to professional standards will most often go awry. Because of the long-term nature of many construction projects, the revenue and costs related to the projects will be earned and incurred over a period of years. In general, the contractor will not know precisely what the profit will be on a project until it is completed.

Unfortunately, it is a fact of construction accounting life that the preferred method of accounting for long-term construction projects, the "percentage-of-completion" method, relies to a large extent on the estimates of costs and profit by the contractor. The contractor's estimates of profit on the work in progress affect both the revenue reflected for the year in the income statement and the assets and liabilities reflected on the balance sheet.

Given the financial statements' dependence on the estimates of the contractor, reliance on those financial statements may seem imprudent. However, the underwriter or other experienced reader of the contractor's financial statements is not without the tools to evaluate and analyze the statements. It does require comprehensive disclosure through notes to the financial statements, backlog information and supplemental schedules, which — at a minimum — should include contract status schedules for both completed contracts and contracts in progress.³

Two accounts, found only on the balance sheet of contractors, are key to the analysis of the financial statements: costs and estimated earnings in excess of billings on uncompleted contracts — an asset; and billings in excess of costs and estimated earnings on uncompleted contracts — liabilities commonly referred to as "under-billings" and "over-billings," respectively.

In simple terms, both reflect the difference between what the contractor estimates was earned to date and what the contractor has actually been able to bill the owner of the project to date. In the income statement,

under-billings and over-billings increase and decrease "billed revenue" so that it becomes "earned revenue." On the balance sheet, under-billings (an asset) are, in effect, an increase to contract receivables, while over-billings (a liability) are an offset, in effect, reducing contract receivables.

Most deficiencies and errors in the financial statements of contractors affect these two accounts. When these two accounts are correctly computed and reflected in the financial statements, they provide insight, or at least clues, to help identify on which projects the contractor may have been overly optimistic in estimating profits.

The causes of under-billings and over-billings are somewhat counterintuitive. Naturally, it would be expected that an asset, or under-billings, would be a good thing, while a liability, the over-billings, would be a deficit. Usually, the opposite is true. Significant under-billings are usually an indication of an underlying difference of opinion between the contractor and owner regarding either the value of the work completed to date or the ultimate value of the contract, or an underestimation by the contractor of what the final cost of the construction project will be.

Over-billings, while an indication that the contractor has already billed a disproportionate amount of the contract, are also an indication that the owner has been happy enough with the progress of the project to either permit or not detect the over-billing.

The Underwriting Process and the CPA's Work Product for Fidelity Bonds

The underwriter's need to rely on components of the accountant's work product is much more specific and direct with regard to contract surety bonds than in the fidelity bond underwriting process.

There are two primary pieces of an accountant's work product that are relied upon by the fidelity bond underwriter: the accountant's evaluation and consideration of the principal's internal control structure prior to a loss, and the accountant's audit and review procedures performed after a loss has been incurred but before it has been discovered.

While a principal's management is responsible for establishing and maintaining an internal control structure, the auditor/accountant must obtain an understanding of the control environment, system and procedures and whether they are being utilized and followed. In general, when the auditor finds "material" weaknesses, these

weaknesses or deficiencies should be communicated to the principal's management.

Audit procedures are not specifically intended to discover fraud, but to enable the accountant to render an opinion on the financial statements.⁴ However, when an audit is performed after a fidelity loss has occurred but *before* it has been discovered, questions may arise as to whether it should have been discovered during the performance of the required audit procedures.

Deficiencies in the Accountant's Work Product

Not all surety losses are caused, nor are all fidelity losses left undetected, by some lapse of the principal's accountant or auditor. Contractors default and have financial difficulties for many reasons. Creative thieves can often find ways to circumvent the best internal control systems.

An action against the accountant in a surety or fidelity loss is warranted and likely to be successful when three components of deficiency in the accountant's work product can be explained to a jury of people who do not have doctorates in accounting:

- A clearly defined error or omission by the accountant;
- A clearly defined, significant error or misstatement in the financial statements (or embezzlement in the case of a fidelity loss) caused or facilitated by the accountant's error or omission; and
- Damages caused by reliance either on the flawed financial statements or the accountants' failure to detect weaknesses in the internal control structure or detect the fraud itself.

Cases based only on an alleged misjudgment or a question as to the degree that a procedure was performed tend to be weak. A strong case will have a complete omission of a certain critical procedure (*e.g.*, allowing the client to control or decide what accounts receivable will be confirmed). Reliance on the cost estimates of a contractor with a history of profit fade can often appear reasonable when justified by project management and documented in the accountants' work papers.

However, the shifting of costs between projects or unreasonable allocations to projects would be much harder to defend. An overly optimistic profit estimate on a project with significant under-billings identified in the supplemental information alone makes for a weak case. Add an attempt to disguise those same

under-billings by overstating the actual billings on a contract and you have a much stronger case.

Missed weaknesses in the internal control structure that may have facilitated a fidelity loss will need to be significant. By itself, the circumvention of an adequate internal control structure by a thief will likely not be enough justification to bring suit against the accountant.

An astute accountant, who is aware of the soft spots in both his own procedures and in the presentation of the financial statement, will sometimes attempt to mitigate any potential liability. This is sometimes done by way of often obtuse disclosures buried in the footnotes to the financial statements. Even if the disclosure relates to an inappropriate departure from Generally Accepted Accounting Principles, it makes for a difficult argument that the underwriter's reliance on the accountant's work product was misplaced. Underwriters, in general, are expected to be sophisticated readers of financial statements and financial information.

Linking Deficient Standards With a Financial Statement Error

The mere fact that the accountant omitted or failed to properly perform certain procedures is only the first hurdle. There must be a link with a significant financial statement error or misstatement. If the financial statements are accurate, the procedures performed or not performed are largely immaterial.

As underwriters often have specific standards relating to levels of profitability, capital, net worth and backlog, the error in the financial statements should significantly affect those items that are being evaluated and considered by the underwriter. A little excessive optimism in the profit estimates will not usually be enough for a strong case. The booking of significant claims, shifting of costs to disguise a loss on a project or the systematic omission of particular cost types from all project estimates often will have a significant effect on items in the financial statements relied upon by an underwriter.

Identifying a significant error in the financial statements or other financial information is often the most difficult component in evaluating a potential claim against the accountant. Given the comprehensive and specific nature of accounting standards and procedures, it is usually less difficult to identify the weakness in an accountant's work product once the financial statement error is identified.

In a fidelity loss scenario, rather than identification of specific errors in the financial statements, the goal would be to identify internal control weakness not detected and communicated to management by the accountant. In the case of a loss spanning several years, the goal would also be to link procedures that should have been performed or deficient procedures actually performed that failed to identify the ongoing loss.

Damages Linking the Loss to Reliance On the CPA Work Product

When an action against the accountant is being considered, it is assumed that there is a loss. But is the loss somehow attributable to reliance on the financial statements with the error? Damages are the final link in the case-evaluation chain.

In general the sequence of events should be: first, the reliance of an underwriter in some manner on the deficient work product of the accountant; second, the issuance of bonds based, at least in part, on that reliance; and finally, losses incurred on the bonds issued based on the reliance.

This sequence is often not obvious, particularly with regard to surety bonds, as the cause of the loss will require thorough investigation of the principal's overall financial situation. Because construction contracts are long-term, contractors incur losses and cash flow from earlier projects that carry over and affect subsequent projects. As a result, contractors often "use Peter to pay Paul" and bank debt to delay their ultimate default or financial difficulties. The complex nature of inter-related financial issues can obscure the underlying cause of a loss.

It would seem that an accountant's failure to detect an attempt by a contractor to minimize the effect of bad projects by shifting costs on financial statements, resulting in a loss to the contractor's surety, would have the components of a strong case against the accountant. However, it is not these doctored financial statements that were relied upon when the bonds for those bad projects were issued. Most likely, it was some prior year's financial statements that were relied on in issuing the bonds for the bad projects. Without any errors in those earlier financial statements, the case against the accountant would be weak.

When there is a pattern of the same or similar deficiencies in financial statements over a period of years, linking the underwriter's reliance to the cause of the loss is easier and strengthens the case against the accountant.

Whether there is a link between the error of the accountant and the subsequent actions of the thief, resulting damages facilitated by the error are usually much easier to identify with a fidelity loss. The

transactions and accounting in an embezzlement loss tend to be far simpler with fairly direct connections.

For example, an internal control structure that permits one individual to write checks, sign checks and reconcile bank statements clearly could facilitate the misuse of funds by that individual. However, it becomes more difficult to design internal control procedures to prevent losses resulting from the actions of a group of individuals acting in collusion.

Conclusion

Merely incurring a loss and identifying deficiencies in the financial statements or internal control structure are not enough to start an action against an accountant with a reasonable chance of success. Before bringing an action against an accountant, consider the sequence of the accountant's error and clearly identify links between his or her deficient work product, reliance on the deficient work product and damages resulting from the reliance.

When taking a case to court, it is always best to be able to explain the accountant's and the financial statements' errors using concepts that would be understandable to the average jury, rather than theories based on cryptic accounting standards and practices understood only by the accounting professor who will be needed to opine on them.

Notes

¹ In general, Generally Accepted Auditing Standards relate to the manner in which audits are conducted. GAAS include both general standards applicable to all audits and specific standards relating to certain industries or certain types of transactions.

² In general, Generally Accepted Accounting Principles define the proper treatment and presentation of financial statement information. GAAP include both general rules applicable to financial statement presentation in general and rules related to specific transactions or situations.

³ GAAP require various disclosures of significant accounting policies either in the body of the financial statements or in notes to the financial statements. Supplemental information on backlog and schedules of completed contracts and contracts in progress is not required a component of the financial statements. However, financial statements that do not include this supplemental information should be subject to additional analysis.

⁴ Statement on Auditing Standards No. 99 requires an assessment of the risks of a material misstatement due to fraud in the planning and performance of an audit.

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