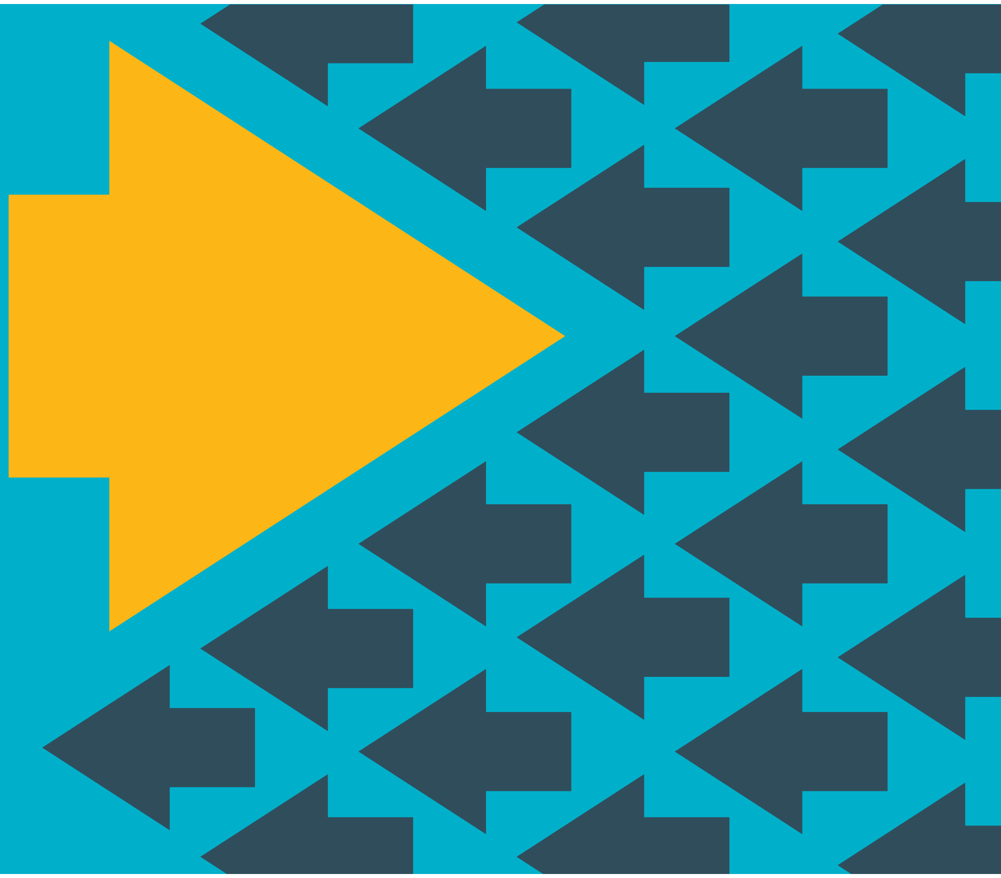
Managing Engagement Creep:

Boundaries Can Be a Good Thing



By Sarah Beckett Ference, CPA

We are taught at an early age that order, routines and standardization are good. We are encouraged to color within the lines, follow instructions, execute tasks in a specified manner and even follow specified color schemes. (Remember paint by number?) However, in today's world, individuality and uniqueness are embraced and even encouraged. After all, great thinking and great innovation generally do not arise without challenging the status quo.

Encouraging innovation and finding new ways to deliver services more efficiently and effectively is certainly part of a CPA's responsibilities. The commitment to continuous improvement and continuous learning is how we as a profession continue to deliver superior client service. That said, there is an area of a CPA firm's responsibilities that benefits from order, routine and standardization: the management of engagement scope. Done properly, effective scope management can not only result in financial rewards for the firm, but also help mitigate professional liability risk.

Expanding or modifying the scope of an engagement to respond to the needs of the client and to meet the engagement objectives is a good thing and is expected of the CPA. When such modifications are not properly managed, defending a professional liability claim related to the underlying services can be challenging. Consider these examples based on real claims reported to the American Institute of CPAs (AICPA) Professional Liability Insurance Program.

A CPA firm provided investment advisory services and was engaged to advise a client on whether to make a debt or equity investment in an entity. The potential investment was an internet start-up company with a good business plan, but little in the way of past performance. The CPA recommended a debt investment and made such recommendation in writing to the client, indicating that the investment decision was ultimately their responsibility. During a conversation with the client, the CPA was asked about the company's financial performance. The CPA calculated some financial statement ratios and provided these as well as some verbal comments on the company's financial statements to the client. The client ultimately made an equity investment and the company went bankrupt a few years thereafter. The client lost its entire investment and brought a claim against the CPA for failing to provide sound investment advice.

Despite the fact that the CPA had written evidence of the advice provided, which included telling the client that the final decision rested with them, the client asserted he had relied upon the additional financial statement analysis performed by the CPA in arriving at the investment decision. This additional work proved problematic in defense of the claim and the firm's defense that the written advice was the sole deliverable was disregarded.

A large accounting firm performed audit and non-audit services for a publicly traded client. As required by professional standards and Securities and Exchange Commission (SEC) regulations, the scope of the nonaudit services was reviewed by the lead audit partner to ensure they did not violate independence rules and were approved by the client's audit committee prior to proceeding with the nonaudit services. During the course of engagement performance, the once permissible nonaudit service was found to have deviated from its intended and approved scope and caused the firm's independence to be impaired. The firm had to resign from the audit engagement and the client terminated the nonaudit services. The client then brought a claim against the CPA firm to recover fees previously paid to the firm for both engagements and additional fees incurred to select and hire a new auditor. Not surprisingly, the firm's reputation was also damaged.

A CPA firm provided tax return preparation to a small business client for many years. An engagement letter was executed at the beginning of the client relationship, but not updated annually. Every year, the client's books and records were messy and unorganized. The firm routinely made adjusting journal entries, reconciled bank accounts and performed other activities to "clean up" the client's financial records in order to prepare the tax return. Several years into the relationship, the client discovered that one of its employees had embezzled funds. The client brought a claim against the CPA firm, alleging the CPA should have detected the theft. The client's claim was, in large part, based on the CPA firm's involvement with the client's books and records. During trial, the plaintiff attorney argued that, because of the CPA's familiarity and long-standing relationship with the client, its bank reconciliation and "clean up" activities, the firm should have identified red flags and unusual bank account activity and alerted the client.

A high net worth couple hired a midsize CPA firm to prepare their tax return. The couple had numerous investments, making for a very complicated annual tax return. To help facilitate the work performed by the firm and because the clients were very busy and did not attend to details like "paperwork," the client had all of their investment statements sent directly to the CPA firm. As a result of the housing bubble burst and the subsequent financial crisis, the couple lost millions. Turns out, they were heavily invested in residential mortgage-backed securities and commercial real estate investment trusts that invested in once "can't lose" real estate markets like Arizona and Florida. The client brought suit against the firm in an attempt to mitigate some of their losses. They asserted that, by receiving their investment statements, the CPA firm should have advised against the concentration in the real estate industry and brought the investment losses to their attention in a timely manner so the client would have had the opportunity to minimize their losses.

In defense, the CPA firm pointed to their engagement letter, which limited the firm's responsibilities to tax return preparation only and noted that receipt of the statements was to facilitate tax services only. However, the couple felt personally wronged and had the financial wherewithal to pursue the matter to trial. While the claim was ultimately dismissed, the CPA firm spent significant time and money defending the matter.

In each of these scenarios, proper management of the engagement scope could have limited the likelihood of a claim. Regardless of whether it is termed scope creep or engagement creep, as noted by the scenarios above, staying within the boundaries of an agreed-upon scope is not always easy when delivering client services.

What's the Big Deal?

Professional liability concerns. A significant number of claims asserted against CPA firms in the AICPA Professional Liability Insurance Program include allegations related to a disputed engagement scope. Even if a scope dispute is not expressly alleged, defending a claim can be challenging if the firm's activities were not in line with the scope described in the engagement letter (if an engagement letter even existed).

Often, the scope of service is inadvertently expanded by a well-intentioned CPA trying to deliver good client service. Perhaps the client asked the CPA to "quickly look into something" or wanted to "bounce something off" the CPA. Or, during the performance of services, the CPA realized that additional services, such as bank reconciliation cleanup or the preparation of an additional state tax return, were needed. Acting on these good intentions may place additional obligations on the CPA, which may be challenged by a plaintiff attorney in the event of a professional liability claim.

Financial concerns. Often a CPA completes an engagement, reviews the client's unbilled fee balance and wonders how the balance got so high. If this has ever happened to you, it is likely that additional work was performed in an effort to deliver superior service. The CPA profession has established a great service culture. However, this culture can become a double-edged sword and should not be to the financial detriment of the CPA firm. Time is money. If not managed appropriately, supplemental activities outside the original engagement's scope may not only increase professional liability risk, but may also result in write-offs if the client refuses to pay for the additional work.

Other "costs" firms often overlook when dealing with scope disputes include lost time spent debating with the client, the aggravation caused by these misunderstandings and potential reputational damage that may be caused by an unhappy client. These hidden costs exist even if a claim is not asserted.

Risk Management Tips

To help stay in bounds, consider the following tips.

Be mindful of the type of clients with whom you choose to do business. Perform a client acceptance evaluation on all new clients and all new engagements for existing clients. Take on only those clients and engagements that are a fit with the firm's capabilities, risk tolerance and strategy. Be sure to evaluate all potential new clients and engagements, including those who seek out the firm's services or are sourced from an acquired firm or practice.

continued on next page

“GREAT THINKING AND GREAT INNOVATION GENERALLY DO NOT ARISE WITHOUT CHALLENGING THE STATUS QUO.”

Have a plan. Use an engagement letter for all services. The scope section of an engagement letter is critical when a professional liability claim arises and lack of an engagement letter is problematic in the defense of a claim. Did you know that nearly half of all claims reported to the AICPA Professional Liability Insurance Program in 2016 did not have an engagement letter related to the underlying service in place? The scope of work outlined in the engagement letter should be clear and the boundaries of the service to be performed should be well defined.

Clarify any limitations of the services. Examples of limitations for a non-audit engagement would be that the firm is not auditing or verifying any information provided by the client or that the services to be provided are not intended to detect theft or fraud. Identify aspects that will not be included, if appropriate. Include a statement indicating that if additional services are needed, written client approval will be required and additional fees will be charged.

Ensure everyone understands the plan. Communicate the scope to all client service team members, particularly those who perform services on-site at the client's location, to ensure everyone knows the boundaries of the services. Consider providing a refresher to teams on long-term engagements. Encourage upward communication from every level of the engagement team relating to potential deviations from the engagement scope.

Mind the expectation gap. Clarify the client's understanding of what is included in the scope of services. Take the time to review the engagement letter with them. This is critical to help ensure expectations are aligned. Strengthening client communications will not only help build a sound client relationship, but also helps mitigate the risk of unintended scope creep.

Stick to the plan. Deliver services in accordance with the scope outlined in the engagement letter and document work performed in engagement workpapers. Well-documented workpapers provide evidence of services delivered and assist in the defense of claims related to scope disputes. In addition, billing records, particularly the narrative included on client invoices, should align with the services described in the engagement letter. Consider attaching a copy of the engagement letter to invoices.

Adjust the plan, if needed. Circumstances may change, additional work may be needed to proceed or the CPA may identify additional service opportunities. All of these items require the CPA firm to pause and consider a new course of action. Work with the client to adjust the engagement scope. Document the revised scope and fee impact in a communication with the client. Depending on the extent of the revision, the client communication could be a simple email, an engagement letter amendment or a new engagement letter.

Know when to say goodbye. While evaluating the risk of new clients and new engagements is important, scope creep is likely to happen more often with existing clients. A client who consistently asks for “quick favors,” balks at engagement letters or additional fees, or pushes the boundaries of the engagement's scope might be taking advantage of the firm's commitment to client service. Not only does this type of client increase the firm's professional liability risk, it is likely to result in poor realization for the firm. Consider terminating this client relationship.

Managing Engagements Appropriately

Imagine what would have happened if Jackson Pollock or Pablo Picasso always colored in the lines? Or where we would be if George Washington and the other Founding Fathers always followed Great Britain's rules? Would technology have evolved so rapidly if Steve Jobs or Bill Gates always completed their tasks in a specified manner? Deviating from established boundaries and norms is not always a bad thing. However, all these figures deviated from the norm in a managed and deliberate manner, which resulted not in chaos but greatness.

Take a lesson from these greats and manage the risk of engagement scope changes appropriately. Doing so may help you avoid the turmoil of a professional liability claim.

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