Client Acceptance Procedures
Best Practices Among Accounting Firms
By Kevin Prendergast

The accounting profession is under increasing scrutiny by state and federal regulators, requiring firms to become more selective with the entities and people with whom they do business. More and more leading firms are conducting investigations into the backgrounds of their prospective clients, employees and business partners. While once the province of only the largest firms, conducting prospective client investigations is now becoming more common among regional and local firms. A large firm can typically survive the negative fallout from a poor client choice while a smaller firm could face devastating consequences from just one bad association. Rather than viewing an investigation as a luxury for only the big players, progressive firm leaders now view prospective client due diligence as a necessary step for reducing risk.

The return on investment from a sound client assurance program is clear. Simply put, problem companies are more expensive to do business with than companies with excellent track records and operating results.

The Two Objectives of a Client Acceptance Program

While client acceptance procedures may differ among firms, the common objective is to gain insight into the prospective client's past business practices, the integrity of the management team and to identify any issues that may create a breach of the accounting firm's professional obligations. This boils down to two key elements:

1. *What is the relationship between the prospective client and current and former lawyers, bankers and with the predecessor accountant*? A firm should establish how the management team interacts with other professionals and the reasons why the firm is now seeking a new or different accounting firm. While the prospect may be changing firms for purely legitimate reasons, it is advisable to verify that the reasons are not due to a fee dispute or because the prospective client is opinion shopping. Some questions that should be answered are:

    - What was relationship with prior accounting firm?
    - Can the business provide legitimate business references?
    - Is there a history of professional liability claims?
    - Does the prospect pay their professional service providers in a timely manner?

2. *Does the prospective client's management team meet your firm's standards of integrity?* As an integral part of most engagements, the CPA will be relying on the management of the prospective client to provide meaningful disclosures and representations. Especially for tax and audit engagements, ask yourself these questions:

    - Does the business/leadership team have a history of enforcement/criminal actions?
    - Does the prospect pay its bills/honor its agreements?
    - Does the prospective client have a litigious nature, either as a plaintiff or defendant?
    - What is the reputation of the firm and its leadership team?

While it is not uncommon for a company to have been involved in litigation, a history showing multiple lawsuits as a defendant may reveal a company that does not or cannot perform its agreements. This could be a sign of poor management practices or a management team lacking character. In either case, it is a red flag that should be investigated.

Similarly, a history as a frequent plaintiff may reveal a client with unrealistic expectations or one who uses the courts to gain an economic advantage. You should review the litigation history for professional liability claims and determine whether the engagement is worth the risk of being associated with a client that has asserted those types of claims in the past.

Legal Reasons for Implementing a Client Assurance Program

The passage of Sarbanes-Oxley heightened the importance of client acceptance procedures in every CPA firm. In speaking on the requirements imposed by Sarbanes-Oxley, former SEC chief accountant Donald Nicolaisen stated:

> *"OCA encourages firms to approach client acceptance and retention with selectivity, retaining those companies as audit clients that are consistent with their ethical expectations. Senior management at the firms sets the standards and values of their respective organizations. If a firm doesn't support audit partners making tough calls and replaces them with partners who are more accommodating, that practice will damage this profession and the firm along with it. The director of the Enforcement Division has made it clear that the SEC considers individual as well as firm accountability."*

The message from the SEC is clear. A firm that fails to take a selective approach to client acceptance will face exposure as will the individual partners of that firm. However, the legal issues surrounding client acceptance go well-beyond public audit engagements.

The U.S. Patriot Act requires businesses to "know their clients." In handling a transaction involving the transfer of funds to or from offshore entities, all businesses have an obligation to verify the identity of the parties involved. More and more transactions include a foreign element, either through a party having a non-U.S. business operation or principal. It is imperative that those foreign connections be verified.

Beyond the exposure created by these and other state and federal laws, a thorough client assurance investigation reduces the risk of a poor client decision. With the possible exception of technical competency, a thorough client assurance investigation is the single most important factor for avoiding professional liability claims. A thorough litigation review is essential due diligence for client acceptance and may provide a basis to discount a firm's professional liability and E&O policy premiums.

As with any risk avoidance procedure, a firm should document, document and then document the process! Every firm should have procedures to clearly show and acknowledge when a prospective client first made contact regarding professional services. If the firm decides not to move forward, a letter to the company documenting that decision is essential, especially for time-sensitive engagements such as tax, audit and wealth planning. Without a written letter documenting the decision to decline the engagement, a professional liability claim may boil down to the risk management nightmare of "he said-she said."

Investigative Red Flags

1. Frequent changes of professional service providers. Could mean a firm is opinion shopping.
2. Poor financial history. Prior failed business or bankruptcy could indicate a person who takes unjustifiable risks.
3. Work/ Business History. Unstable address, employment or professional history.
4. Overly litigious as a plaintiff or defendant. Signals a party who is not afraid to sue, presents a risk of non-payment or who may not honor their agreements.

5. High turnover in upper management. Often indicates lack of internal stability.
6. Short operating history. Where were the principals before they were at the current firm?
7. Foreign operations or plants. Hoping you won't check whether there is a plant in Tunisia.
8. Reluctance to provide references. If they are reluctant to disclose information now, how will they be once they are a client?
9. Pressure to get deal quickly. Often a sign that they don't want you looking into their background.
10. Regulatory Actions. Often indicates poor internal controls or a management team ignoring internal controls.

Establishing a Character Assurance Program

Establish a written protocol for client acceptance and draft client acceptance forms. Typically, the process of handling client acceptance varies with the size of the firm. Larger firms use their risk management/security office to oversee the assurance process. Decisions to accept or reject a client are made with consultation from their General Counsel. Regional firms generally take one of two approaches. Some have client acceptance committees composed of high level members of the firm, while firms streamline the process by having a system of approvals which must be obtained prior to the rendition of services. These approvals usually consist of the CEO, Managing Partner of the particular office, chief audit partner and the partner in charge of internal assurance.

Decide whether the prospective client will be informed of the investigation. Once the approval/rejection process is established, you need to decide whether you will inform the prospective client that it is being investigated. Some firms have a formal application process in which prospective clients complete a form for client acceptance. These firms make an up front disclosure that a full investigation will be performed as part of the client acceptance process. Other clients prefer to perform the investigations without the prospective client's knowledge. Because they are considered commercial investigations, client assurance matters can be handled without disclosure or authorization from the subjects and without leaving a trace. Some firms prefer to use this approach since they fear offending their prospects by the thought of being investigated.

Common Client Acceptance Documents

- Client acceptance checklist. All of the elements of the acceptance process are listed. Internal controls prevent the firm from rendering services until "the boxes are checked" and the partner with final authority signs off.

- Client acceptance information form. A form completed and attested to by prospective client containing basic information including the names of officers, directors and key employees, names of prior CPA's and professionals and a list of professional references.

- Rejection Letter. A formal letter which is vital to document the time of the initial contact and rejection, especially for prospective clients seeking tax or other time-sensitive services.

Identify which prospects will be subject to an investigation. Here, the firm is asked to identify where the largest risk of exposure exists and begin screening prospects in those areas. The criteria used for screening a particular prospect are typically based upon the following factors: (1) size of the engagement in terms of dollar volume; (2) whether the company is publicly traded; (3) whether the company operates in the firm's niche markets; (4) whether the company operates in certain high risk industries (construction, trash hauling, scrap, gaming); and (5) the familiarity of the company to the key members of the firm. Here are some categories of clients that are candidates for investigation:

- Publicly traded companies
- Audit clients
- Tax clients
- Clients in highly regulated industries
- Clients in traditionally questionable industries(e.g., construction, labor, scrap dealers, gaming, etc.)

Identify the parties who will be investigated. Determining the parties to be investigated will often hinge on the type of business entity under consideration. As part of the initial documentation process, you might require a disclosure and certification listing all officers, directors, partners and owners of more than 10% of stock for larger companies and all equity holders for closely held businesses. Those individuals might fall into this category as well.

Determine which searches you want done. A business background investigation typically includes an inquiry into public record sources for the company and its principals. The goal is to verify the legitimacy of the company, the identity of the key officers and the integrity of those officers. Depending on the nature and scope of the investigation, the following records may be reviewed:

- Secretary of State Records
- Criminal Records Search (State and/or Federal Courts)
- Address History Verification
- Business Credit Review
- Bankruptcy Records and Tax Liens
- Education/Professional License Verification for Principals
- Civil Court Records (State and/or Federal Courts)
- National Proprietary Criminal Database Search
- National Newspaper Indices
- National Security Database Searches
- Related Company Reports
- Regulatory records, including records from the SEC, EPA, FTC, AICPA or other regulatory or professional body
- Specialized searches, including facilities and location verification.

Ensure the program meets the legal requirement of the relevant jurisdictions

Privacy laws and regulations are always a concern whenever investigating any individual. However, investigations for commercial purposes are generally unregulated, provided there is a legitimate business purpose.

All reports should be held in a confidential file and disbursed to only those with a legitimate need to know. The unauthorized disclosure of the information is still subject to common law privacy rules in every state.

CLIENT ASSURANCE INVESTIGATIONS—BEST PRACTICES

Level 1: Business/Principal Investigation

Level 1 investigations are designed to verify the legal existence of a business and its principals and typically reveal any major criminal or administrative actions. These investigations are most often used for prospective clients: that are well known to the firm; with low dollar volume and in low risk industries; or as a preliminary screening tool to disqualify prospective clients who will obviously not meet a firm's client acceptance standards.

- *Positive identification of business-Secretary of State.*
- *Address and social security verification of 2 individuals.*
- *National media search on company and 2 individuals.*
- *National financial reporting database search on company.*
- *National criminal database search on company and 2 individuals.*
- *OFAC list of Specially Designated Nationals and Blocked Persons.*
- *RAI Scan proprietary database.*
- *In-depth analysis and written report.*

Level 2: Standard Client Acceptance Investigation

The Level 2 investigation is the standard client assurance investigation used by many large accounting firms.. Some firms start with a Level 1 investigation, make an initial determination regarding acceptance, and then proceed to the Level 2 investigation for those prospects passing the Level 1 protocol.

- *All elements of a Level 1 investigation.*
- *County criminal records on company and 2 individuals.*
- *Federal criminal records on company and 2 individuals.*
- *Professional license/education review on 2 individuals.*
- *Affiliated Company review on 2 individuals.*
- *County court records (plaintiff and defendant) on company/ 2 individuals.*
- *Federal court records (plaintiff and defendant) on company and 2 individuals.*
- *Financial verification (reporting source, bankruptcy records & tax liens).*
- *SEC records (company and 2 individuals).*
- *Affiliated companies report on company and 2 individuals.*
- *In-depth analysis and written report.*

Level 3: Full Due Diligence

A Level 3 investigation is an in-depth inquiry designed to provide: a comprehensive view of the operating history of a business; the current status of key relationships with clients and suppliers; and the physical verification of claimed business operations. These investigations are used in the area of, for example, mergers and acquisitions or transactions where credit will be extended).

- *All elements of a Level 2 investigation.*
- *Applicable administrative agency search (FTC, EPA etc.) up to 3 agencies.*
- *Physical verification of facilities (2 US locations or 1 international location).*
- *Business reference interviews (up to 3 reference interviews with banks, accountants, attorneys or others).*
- *Development and interview of up to 3 additional sources (customers, vendors or others).*
- *In-depth analysis and written report.*

At one time, the expense associated with an investigation was cost prohibitive for mid-market firms. However, technological advances have made the availability of information far more cost effective. For example, a basic investigation which will verify the legal status and background of a company and its key officers can be conducted for less than $500. A standard prospective client investigation, which will uncover criminal, civil or administrative enforcement actions, can be completed for around $1,000. Oftentimes, the cost of an investigation is a small fraction of the value of the engagement and is increasingly being passed on to the prospective client as part of the initial retainer agreement. In today's business environment, it makes good business sense to consider these types of investigations.

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