

CPA “Comfort Letters” to Lenders and Third Parties May Be Traps for Violating Professional Standards and Creates Litigation Risk for Accountants

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Summary

In recent years, as lenders and other third parties attempt to shift transaction risks to other professionals, including accountants, CPAs have felt pressure to issue so-called “comfort letters” on behalf of their clients. Comfort letters are typically requested by banks, loan brokers, government agencies, and other third parties. CPAs should be aware of the ethical risks associated with preparing comfort letters, as well as potential disciplinary actions that may be initiated by various state accountancy boards as a result of preparing such letters. Not only are regulatory issues important, but the violation of professional standards in any engagement increases the accountants’ risk of litigation losses once a client has been sued.

This article provides the accountant with an overview of common types of comfort letters, ethical traps that may arise in preparing them, examples of how to minimize litigation risk and meet regulatory requirements, and additional technical resources to help the practitioner stay in compliance with professional standards surrounding comfort letters.

Common comfort letter requests summarized

According to the AICPA, some of the common types of comfort letters requested from CPAs from third-parties include:

1. Request from a lender to verify, certify or otherwise validate information contained in a tax return.

2. Request addressing the issue of whether a client withdrawing money from the business has an effect on the business going forward.
3. Request to verify self-employment or independent contractor status.
4. Request from a government agency for a "current auditor's certificate of employee's current wage rate" for a client who is submitting invoices to a local governmental agency for work performed.
5. Request to certify the length of time a borrower has been self-employed.
6. Request a statement that a client is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby.
7. Request confirmation that the client has the ability to pay debts as they mature.
8. Request to provide any of the following in connection with the client obtaining a business or personal loan: Signed cash flow analysis, year-to-date P&L signed and dated, or a financial forecast.

A 4-step process to address comfort letter requests

When confronted with requests for comfort letters, the accountant should consider the following 4 steps in order to reduce risk and meet professional standards:

Step 1 - Client confidentiality. The first rule in evaluating any comfort letter request is client confidentiality. Professional standards do not prohibit the disclosure of factual information as long as the client has authorized it (very important as you consider Step 4 below). Various federal and state laws, as well as AICPA Professional Standards (Ethics) require specific consent before a CPA can disclose confidential client information. Accordingly, this must be addressed before the CPA can proceed with any comfort letter response.

Step 2 - Determine whether the request may be considered an attest function and subject to AICPA AT professional standards. The use of words in a comfort letter such as “assert”, “attest”, “certify”, or “verify,” indicate that the opinions or representations made by the CPA may be subject to AICPA Attestation standards (AT), which in turn requires the CPA to be Independent (AT-C Section 105.24), may subject the CPA to Peer Review, and requires the CPA to perform and document specific procedures as the basis for the CPA’s attestation conclusions. Failure to consider and follow this step is a primary cause of comfort letter related disciplinary actions by various state accountancy boards. Moreover, failure to follow this step will likely subject the CPA to higher risk if litigation arises out of issues surrounding the comfort letter.

Step 3 - Determine whether professional standards prohibit the CPA from responding to the comfort letter request. Paragraph .03 of AT-C Section 9105, "Responding to requests for reports on matters relating to solvency" states, "... a practitioner should not provide any form of assurance, through an examination, review, or agreed-upon procedures engagement, that an entity

- is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby.
- does not have unreasonably small capital.
- has the ability to pay its debts as they mature.

Matters relating to solvency are not clearly defined in an accounting sense and are subject to various federal and state legal interpretations. Accordingly, these opinions are prohibited in the context of a CPA preparing comfort letters.

Step 4 - Play it safe and offer only factual information (if possible) while disclaiming specific representations or any other assurance. Remember, there are no professional standards that prohibit the communication of factual client information as long as the client has authorized the disclosure (see Step 1 above). In most instances, the accountant may be able to “play it safe” and simply provide factual information. The following responses to the common comfort letter requests identified above have been provided by the AICPA and should be considered by the accountant in preparing responses:

1. Request from a lender to verify, certify or otherwise validate information contained in a tax return – “At the request of my client, I have attached a copy of the tax return and related schedules provided to the IRS for filing for tax year XXXX. The attached tax return reports income from self-employment of \$XX,XXX. The return was prepared based on information provided by my client. This information was neither audited nor verified by me, and I make no representation nor do I provide any assurance regarding the accuracy of this information or the sufficiency of this tax return for your credit decision-making purposes.”
2. Request addressing the issue of whether a client withdrawing money from the business has an effect on the business going forward – Though this appears to be a request for solvency assurance, ascertain from the requester whether the CPA can perform another service such as an examination or compilation of a forecast showing the expected effect the withdrawal will have on the business given certain assumptions. If after speaking with the lender the lender

really wants a verification related to solvency, the response is as follows: "I am precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency. It is a violation of AICPA attestation standards and therefore an ethical violation."

Alternatively, "I can provide you with compilation or examination services. However, I cannot provide you with assurance that the use \$xxx will not impact the viability of the company. Doing so may be construed as providing a solvency assertion. I am precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency. It is a violation of AICPA attestation standards and therefore an ethical violation."

3. Request to verify self-employment or independent contractor status – "I prepared a tax return for filing with IRS reporting self-employment income on federal Form 1040 based on information provided by my client. At my client's request, I have attached a copy of the tax return and related schedules I provided for filing with IRS. This information was neither audited nor verified by me, and I make no representation nor do I provide any assurance regarding the accuracy of this information."
4. Request from a government agency for a "current auditor's certificate of employee's current wage rate" for a client who is submitting invoices to a local governmental agency for work performed – "Based on the company's monthly payroll reports I obtained from the client (or client's payroll servicer), the following were the reported wage rates: \$xx rate 1 and \$xx rate 2. Please note that this information was neither audited nor verified by me, and I make no representation nor do I provide any

assurance regarding the accuracy of this information."

5. Request to certify the length of time a borrower has been self-employed – "I have been engaged by the client since XXXX and have prepared tax returns for filing with IRS reporting self-employment income on federal Form 1040 based on information provided by my client for tax years XXXX, XXXX, and XXXX. The returns were prepared based on information provided by my client. This information was neither audited nor verified by me, and I make no representation nor do I provide any assurance regarding the accuracy of this information or the sufficiency of this tax return information for your credit decision-making purposes."
6. Request a statement that a client is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby – "I can provide you with various services to help you determine whether the client's assets exceed their liabilities after the debt has been incurred. However, I cannot opine on whether the client is insolvent or would be rendered insolvent as a result of entering into this debt. That could be construed as a solvency opinion. I am precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency. It is a violation of AICPA attestation standards and therefore an ethical violation."
7. Request confirmation that the client has the ability to pay debts as they mature – "I can provide you a report on a financial forecast or financial projection if so engaged. That information may give you the support you need to arrive at your own conclusions regarding the entity's ability to pay its debts. However, I cannot assert whether my client has the ability to pay debts as they mature. That could be construed as a solvency assertion. I am precluded from giving any

form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency. It is a violation of AICPA attestation standards and therefore an ethical violation.”

8. Request to provide any of the following in connection with the client obtaining a business or personal loan: Signed cash flow analysis, Year to date P&L signed and dated, or a financial forecast – “CPAs can substantiate financial information to third parties by performing procedures that can range from a rigorous audit (or examination) that results in a report about whether the CPA believes the information to be free of material misstatement to those less rigorous engagements, resulting in lower levels or no level of assurance. Such services may include a compilation, review or agreed upon procedure engagements. If engaged, I can render such services”. [Additional language may be added: “However, unless I am

engaged to perform those services I am prohibited from signing any such financial statements”].

Additional resources may be needed

Some comfort letter responses may be more complex, subject the accountant to higher risk and should be evaluated further. The AICPA has provided practitioner’s with a matrix for evaluating comfort letter requests as well as other analysis related to comfort letters and the accountants’ responsibilities. These materials can be found on the AICPA website.

However, since comfort letters may shift transaction risks to the accountant, it may be prudent for the accountant to obtain consultation from a qualified accounting malpractice attorney and/or an accounting “standard of care” expert. As Benjamin Franklin said, “An ounce of prevention is worth a pound of cure”. Nothing could be more true today than in the preparation of comfort letters.

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