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TAX

Concerns About CPA Letters to Third Parties

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A CPA receives a request from a client to provide a letter to the client's mortgage broker, lender, adoption agency, or other third party. The request seems simple enough and harmless. All the client asks is that the CPA verify that this is her client, that she has been preparing the client's income tax returns, and that the client is employed by a particular employer or is self-employed. Is there any harm in the CPA signing the client's suggested letter or writing one of her own?

CPAs should remember that they prepare tax returns based on information provided by the taxpayer. It is very likely that they did not audit or otherwise verify the information used in the preparation of the returns. In fact, Circular 230 affirms that the CPA, in preparing a tax form, "may rely in good faith without verification upon information furnished by the client" but "may not ignore the implications of [other] information ... actually known" by the CPA, and he or she must make reasonable inquiries if the information provided "appears to be incorrect, inconsistent ... or incomplete" (Circular 230 §10.34(d)).

Professional standards prescribe what CPAs can and cannot do in these circumstances, and there are professional risks to signing these "comfort" letters. The third parties requesting these letters are not the CPA's clients. Tax preparers therefore should not convey any information to anyone without their clients' written permission. This is a requirement under professional ethics standards, the Gramm-Leach-Bliley Act, the Internal Revenue Code, and other federal and state privacy statutes and regulations.

Purpose of Comfort Letters

There are various reasons a client may request a comfort letter. Mortgage brokers may be collecting information needed for a loan approval, or other third parties may be trying to verify that clients applying for a particular service are who they say they are and have the resources and ability to pay for the service or items involved. (As used in this discussion, the term "comfort letter" does not refer to the letter a CPA issues in relation to a bond or stock offering.)

Verification of Source Income

Lenders do not normally need a comfort letter from a CPA unless there is some difficulty in qualifying the borrower using conventional information sources. This is usually the case in "stated income" loans, which qualify the borrower using the income the borrower states on the application form. This is not necessarily income the borrower can document.

This type of loan is designed for prospective borrowers who have the ability to make loan payments but do not meet traditional underwriting standards, which generally require borrowers to present W-2s or tax returns for the prior two years. Self-employed borrowers or those in professions with cyclical income may have difficulty meeting these traditional requirements. Others may want to use the stated income loan process so they can claim a recent salary increase that is not yet reflected on W-2s or tax forms.

On a stated income loan, lenders agree not to attempt to verify the borrower's stated income, but they will try to verify its source. They also use reasonableness tests in comparing the borrower's income from the stated profession with industry income averages. Applicants may be truthful about the total income amount because it

can be verified by looking at income tax forms, but they may sometimes embellish the income source to make the loan more likely to be approved.

Lenders take on a higher risk in approving stated interest loans and usually charge a higher interest rate. In the process of reviewing the application and approving the loan, they might ask for a comfort letter from the borrower's CPA. Most lenders will simply ask the CPA to write a letter indicating that the prospective borrower is self-employed or is employed in a certain profession. Others may attempt to shift the burden of responsibility for due diligence onto the borrower's CPA and provide a script of what they want the letter to say (see Exhibit 1, below). This letter provides third-party verification of details in the application and could transfer some of the potential liability to the CPA in the event of default on the loan; it is not recommended that CPAs sign such a letter.

Cautions for CPAs

There are a few issues with this type of letter that should concern CPAs. First, the proposed letter asks the CPA to attest, when the CPA has not specifically been engaged for that purpose. The report would be issued to a third party that has not contracted with the preparer for that specific purpose.

According to Auditing Standards Board Statement on Standards for Attestation Engagements no. 10, *Attest Engagements*, an attestation engagement is called for if the client wants a written report providing assurance about a specific subject. Of course, performing an attestation engagement is not prohibited in the case of a lender's comfort letter request, but CPAs must follow the procedures required in an attestation engagement. The client will likely not want to incur the expense of a formal attestation engagement.

It is also important to know what is not permitted under the standards. AT section 9101, *Attest Engagements: Attest Engagements Interpretations of Section 101, No. 2*, paragraph 25 states that practitioners should not provide any form of assurance that an entity is not insolvent or would not be rendered insolvent upon a proposed condition, or that an entity has the ability to pay debts as they mature. A lender may want the CPA to make an assurance that the applicant's withdrawal of the funds for a down payment or other purposes would not put a financial strain on the applicant's self-employment business. Any representation to that effect could be construed to be a comment on solvency and would thus be prohibited under the standards.

The types of services permitted in a CPA attest report include an audit, a review, or a compilation of the applicant's personal financial statements. The CPA may also report on pro forma financial information or perform an agreed-upon procedures report, as long as those procedures do not provide any assurance on matters of solvency. The important thing to consider is that this type of engagement requires many procedural steps, which take time and result in significant fees to the client.

Alternatives to Comfort Letters

If the CPA takes the time to explain to the lender what is involved in presenting a comfort letter similar to the one in Exhibit 1, in light of CPA professional standards and the related cost to the applicant of issuing any attestation letter, the lender may be convinced to withdraw its request.

Another option is to offer to send a copy (with the client's written authorization) of the client's tax forms directly to the lender with a simple cover page stating, "Please find attached the tax forms I prepared for the Client family for the past two years." Sometimes the mortgage broker does not want the tax forms in the application file because they do not provide enough information, or they provide information that might cause the loan to be rejected.

Some brokers can be very insistent on getting a letter from the CPA and may even encourage the client to switch to a different CPA who will issue such a letter. In terms of minimizing risk, it is best to avoid confirming any information to a third party. However, refusing to do so may offend your good client.

Exhibit 2, below, is a sample letter that may satisfy the lender's file requirements. It provides the lender with a CPA letter but basically makes no assurances and should limit the CPA's liability in the circumstance. The letter merely says that the CPA prepared the tax forms and that the lender should not construe the letter to be an audited CPA representation. In most cases, this should suffice. But CPAs should consult with their errors and omissions insurance company about the content of any such letter that they will be using in their practice.

CPAs may be tempted to just send off a quick letter to the lender "confirming" that the client is self-employed, or retired, or earning a living from the activities addressed on the tax return. But they should be careful about this. Do they really know everything that is occurring with that client? Does he or she have other activities on the side that the CPA is not aware of and that conflict with the information on the tax forms? When considering all the

possibilities, it is wiser to adhere to the comments in Exhibit 2. CPAs are certain about what they put on tax forms. Saying anything else in the letter advances the tax engagement to a new level.

Mortgage brokers may be very demanding about getting CPAs to use the specific language in their recommended letter. They may try to make the CPA the "villain" in the loan approval process, especially when the loan is difficult to approve. The most prudent course of action would be for CPAs to limit their response as outlined above, regardless of pressure from lenders or clients.

Exhibit 1: Lender's Preferred Wording for a CPA Comfort Letter

My clients, Mr. and Mrs. Tax Client, have asked me to write you concerning their [loan, adoption, etc.] application with your company. They have asked me to provide you with the following information.

I am John Accountant, CPA, State license #12345. I have been preparing the federal and state income tax forms for the Clients for the last two years. The Clients are self-employed in the field of [occupation]. The Clients' income has exceeded \$X for each of the past two years, and the income from their self-employment business has provided for the needs of the Client family for those two years. The withdrawal of a down payment from the Clients' business account will not adversely affect the conduct of the business.

Please feel free to contact me if you have further questions or concerns about this matter.

Exhibit 2: Suggested Wording for a CPA Comfort Letter

I am writing to you in response to a written request of my tax clients, Mr. and Mrs. Tax Client.

This letter confirms to you that I prepared the federal tax forms for 200X and 200Y for the Client family. These forms included Schedule C, *Profit or Loss From Business*. If the Clients authorize me to do so, I can send you a copy of these tax forms so that you can perform your due diligence. If you are making such a request, please send my firm an authorization form signed by the Client authorizing me to release this information to you.

I prepared the tax forms from information that was provided to me by the Clients. As is normal in this type of professional service by my office, I was not hired to perform and did not perform audit or other types of verification of the information provided to me. Thus, I cannot make any professional representation or assurance of the accuracy of this information or the sufficiency of the tax form for your credit decision-making purposes.

I prepared the Client tax forms in accordance with the applicable IRS rules and regulations solely for filing with the IRS. The tax forms thus do not represent any assessment on my part as to the creditworthiness of the Clients. The tax forms do not include any statement of financial position or income and expense for these years in accordance with generally accepted accounting principles (GAAP), and should not be construed to do so. I can provide a GAAP report, but it will require additional time and resources to prepare and will result in a significant fee to the Clients. The standards of my profession prohibit me from making assurances relating to solvency; however, I am permitted to present prospective or pro forma financial information. These, too, would require additional work and fees to the Clients.

As you know, a credit-granting decision should be based on a lender's exercise of due diligence in considering many factors. Your use of this letter from me, and the tax forms, in the exercise of your due diligence is solely a matter of your responsibility and judgment. This letter is not intended to establish a client relationship with you but is a response to a request from my clients, the Clients.

This letter gives you all the information I can provide to you according to my professional standards. If you need additional information relating specifically to the tax forms prepared by me, please let me know.

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