1991

Accountant's Liability Newsletter, Number 23, First Quarter 1991

American Institute of Certified Public Accountants. Professional Liability Insurance Plan Committee

Number 23

Accountants' Liability Newsletter

First Quarter 1991

The AICPA Professional Liability Plan and You

Many of the articles presented in this publication describe the vast liability exposures faced by accountants on a daily basis – and the devastating effect these exposures pose to the accountant's bottom line – especially those without liability insurance. As most of the recipients of this newsletter are AICPA Plan insureds, perhaps you can share this information with your colleagues in the profession, who, for whatever reason, have elected not to purchase professional liability protection.

Surveys conducted by RBH have revealed that in some states up to 50% of accounting firms do not have professional liability insurance!

The risks assumed by not purchasing professional liability insurance are as great as the awards rendered by our courts when claims do occur. Legal expenses alone can completely erode the total equity of a small to mid-size practice.

The AICPA Plan covers over 50% of insured accounting firms in the United States. As a member of the largest, longest continuously run, and only nationally sponsored accountants liability insurance plan, please share your knowledge with your uninsured

continued on next page

A Defensive Practice Checklist

Michael J. Chovancak
Assistant Vice President
Rollins Burdick Hunter

Much is said (and written) about the severity and frequency of liability losses incurred by accountants. In fact, this publication discusses claims as a regular feature. A key element missing from these discussions is that many of these losses could be eliminated or the severity significantly reduced if the firm followed some fundamental defensive practices.

The following checklist provides specific areas that the accountant should concentrate on to take a defensive stance against liability claims. It should be pointed out that the list has been assembled based upon elements that have led to actual claims against insureds in the AICPA Professional Liability Insurance Plan.

continued on next page

AICPA Professional Liability Insurance Plan

IN THIS ISSUE

ROUTE TO

☐ ____________________
☐ ____________________
☐ ____________________
☐ ____________________
☐ ____________________
☐ ____________________

Insurance *continued*

peers, as well as some of the current features of the Plan which make purchasing this protection easier than ever:

- Up to a 20% rate decrease in 1991 over 1990 rates.
- A new Basic Policy, designed for small firms with a corresponding lower premium.
- Premium financing at an 8.80% A.P.R.

Defensive Practice, *continued*

• Do not sue for fees. Countersuits are almost always filed against the firm in such situations, prompting legal expenses as a certainty and potentially huge claim payments. Choose an alternative collection vehicle whenever possible.

• Do be particular in client selection. Pre-qualify their financial stability to conduct business - and to pay your fee. Refuse engagements for clients exhibiting poor moral character or clients that frequently change accountants, as both are key indicators of potential problem accounts.

•Do use engagement letters on all engagements (including tax return preparation). Lack of engagement letters is the single-most common characteristic of almost every claim studied. You and your client should know what is to be done, when, by whom and the appropriate fee.

•Do establish a reasonable fee. An unreasonably low fee encourages dangerous "short cuts" or requires the embarrassment of approaching the client for additional fees to cover expenses.

•Do maintain high standards of quality control. The firm should maintain (and keep up-to-date) written procedural/ operational and training manuals. Internal reviews of work by independent members of the firm is encouraged.

•Do not accept engagements for which your firm is not qualified. This means not only type of engagement (i.e. tax preparation versus certified audit), but also industry (i.e. retail store versus financial institution). Additionally, do not perform activities which may be deemed to be legal services - have your client contact an attorney.

•Do not allow a client bill to get excessively past due. Recognize the problem as soon as possible and attempt to work with your client to resolve the situation - such as a revised payment schedule.

•Do preserve your integrity in all cases. Never suggest non compliance with applicable laws or regulations. Completely document any legal issues or controversial points in your work papers and fully discuss these with your client.

•Do communicate all problems to your client in writing.

•Do exercise extra care when performing high risk engagements, such as audits of financial institutions, grain elevators, or contractors or giving tax advice, or working with clients in financial difficulty.

•Do use checklists on all engagements to avoid omissions. If something appears on your checklist, ensure that the item has been completed or have the file reflect why the task has not been accomplished.

•Do document telephone conversations, workpapers, etc. This simple rule cannot be over emphasized. Should problems arise, whether legal or otherwise, written documentation protects your interests much better than a "he said - she said" verbal argument.

By faithfully using a checklist of this type, accountants could better defend themselves against costly claim situations. Such defensive measures can help the accountant minimize claim losses (and the resulting increase in insurance premiums) as well as reduce the lost time the accountant devotes to defending his or her practice should a claim be asserted.

Documentation – The Importance and the Care

The following two articles provide the reader with two informative messages relative to the goal of concise written documentation.

In the article, "The Importance of Documentation" you will be presented with the technical view of documentation in the accounting profession, while in the second article, "Accountants — Be Careful What You Write," you will be presented with the notion of measuring your words carefully in your documentation.

Both articles are rich with information on the art of solid documentation and its importance to the accounting profession.

The Importance of Documentation

Guy M. Hohmann
Norton & Blair

Mr. Guy M. Hohmann is a practicing attorney as well as a C.P.A. with the Houston firm of Norton & Blair.

Although most experienced commercial trial lawyers will say that many significant issues during the course of a trial will often boil down to a traditional "swearing match" between the adverse parties, this is particularly true in the context of professional liability litigation, and perhaps even more so with accountants' professional liability claims. Professionals are often paid to "give advice to their clients," and understandably clients often rely upon that advice in making future business decisions. When those decisions do not result in favorable outcomes, often times the question in ensuing litigation is, "what exactly was that advice?" However, very few professions have the voluminous pronouncements, guides, and other literature as does the accounting profession, which apparently were designed to provide the practitioner with guidance in performing those professional services. Indeed, in defending almost any accountants' professional liability case, it is rare that there is not some "yardstick" to measure the professional performance of the accountant. The sources in this respect may include Generally Accepted Auditing Standards ("GAAS"), Generally Accepted Accounting Principles, Audit Guides issued by the AICPA, APB opinions, and, in some instances, exposure drafts and private letter rulings. In many instances, GAAS will specifically mandate the type of documentation which is to be obtained in performing an audit engagement. In addition, the Statements for Standards of Accounting and Review Services will speak to similar documentation requirements in the context of reviews and compilations of financial statements. Obviously, when these pronouncements either require, or otherwise suggest, the utilization of engagement letters, management letters, representation letters and other documentation, the practitioner should obviously comply. However, as will be more fully set forth below, it also makes abundant sense to confirm, through correspondence or other documentation, other matters which current accounting pronouncements do not necessarily require or otherwise suggest.

In the context of audited financial statements, one must keep in mind the third standard of field work:

"Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."

(Auditing Standard § 326, Source: SAS No. 31; SAS No. 48).

Other auditing standards also speak directly to the concept of documentation. In numerous instances, the accountant will be asked to describe for the jury the main purpose in preparing audit work papers. Often times the accountant will respond that, "The audit workpapers are designed to evidence the work performed by the accountant in performing an audit

continued on next page

of the financial statements at issue." There certainly appears to be nothing wrong with this particular response. However, the accountant will traditionally be later cross-examined as follows: "Keeping in mind the purpose of the workpapers which you just described for this jury, show where in your workpapers there is any evidence of your having evaluated the internal control environment at XYZ Corporation."

Auditing Standard No. 1, Section 339 states that:

"The information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions that he has reached concerning significant matters."

In addition, Section 339 also footnotes those other sections which actually mandate particular documentation which should be obtained and form a part of the audit workpaper files. (Section 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments; Section 333, Client Representations; Section 325, Communication of Internal Control Structure Related Matters Noted in an Audit; Section 311, Planning and Supervision; Sections 319.26 and 319.39, Consideration of Internal Control Issues; and various other audit sections listed in Footnote 2 of Paragraph .01 of Section 339.)

Although the Auditing Standards require that "competent evidential matter be obtained," there may often be instances where that evidence not only should be obtained but also retained in the workpapers as well.

Example: A small accounting firm located in the Southern United States was sued by its corporate client after the Internal Revenue Service (the "IRS") appeared at its corporate headquarters with padlocks claiming that the corporation had failed to deposit payroll taxes for the previous 18 months. The company took the position that the particular employee who was charged with preparing and filing the payroll tax returns and making the related deposits had, purportedly unbeknownst to management, failed to perform these duties. Resulting litigation sought to recover the penalties and interest from not only the particular ex-employee involved, but also from the company's independent auditors. As the evidence in the case developed, it appeared as though the ex-employee had actually prepared the payroll tax returns at issue, which had been reviewed by the accountants during the course of the audit examination. However, these returns were apparently never filed and were subsequently discarded. While the accountants maintained that they had reviewed them during the course of their examination, their subsequent disappearance raised an issue on this point. Again, although possibly better evidence than simply a copy of the tax return should have been obtained, a copy of the returns actually reviewed by the accountants, if copied and maintained in the working papers, would have served as better evidence than none at all.

The need for obtaining adequate documentation is perhaps even more important in areas outside the context of audited financial statements and other financial statement oriented engagements. Although somewhat subjective, it is this author's opinion that, in many instances, had better documentation been obtained or other "understandings" or "recommendations" been documented in correspondence or an engagement letter, the suit in question would have never been filed. Certainly, in other instances, the particular claims would have been much easier to defend.

By way of example, although "tax shelter" cases appear to be on the decline, in the early 1980's, these suits were prevalent. Typically, the accountant would be approached by a tax client, usually sometime between December 26th and December 31st, and would be asked whether the accountant was aware of any tax advantaged investments which would allow the client to shelter taxable income. While many accountants have refused to counsel clients over these matters, others have, on occasion, provided clients with various private placement memorandums received throughout the course of the year and allowed their clients to review these materials. After having invested in one or more of these failed tax shelters, the client will often times sue the accountant for not only the principal amount of the investment, but also substantial penalties and interest which have accrued to the investor after the IRS has disallowed the deductions and other tax credits. Invariably, the client will be claiming that the accountant had "guaranteed" (or words to that effect) that the investment would "produce substantial income and also provide substantial tax benefits." Despite the numerous disclaimers contained within a typical private placement memorandum concerning the riskiness of the investment and its tax benefits, the client would normally state that he didn't rely upon the private placement materials — rather, he relied upon his accountant's advice. This type of litigation is, of course, the classic "swearing match." This area, perhaps more so than any other, is the best example of where an engagement letter or other documented correspondence to the client should be considered. This documentation should set forth the limitations on the accountant's investigation into the factual accuracy of the representations in the private placement memorandum, as well as the uncertainty concerning any of the potential tax benefits. Although the IRS's crackdown on tax shelters of the early 1980's and other revisions to the Internal Revenue Code have resulted in fewer tax shelter investments, similar recommendations insofar as documentation is concerned apply equally to any other type of investment as to which a client seeks his accountant's input. This author would also advise against ever recommending to a client, or even suggesting that a client consider, an investment in a company which also happens to be a client of the accountant or an entity in which the accountant also owns an interest. Should a practitioner nonetheless wish to consider such a recommendation, extreme care should be taken to document those recommendations, with attention being paid to possible independence issues as well as the duty of confidentiality which may exist as to that particular client's financial affairs.

Importance of Documentation *continued*

Other areas which generally present similar risks to a practitioner, where documentation in the form of correspondence to the client is advisable, include recommendations for particular computers or other software, and personnel hiring. Often times practitioners, being familiar with a client's data processing needs and its business environment, are asked to recommend particular computers or other software options. Litigation has resulted against practitioners when the particular program did not perform, or otherwise was not serviced by the manufacturer, to the satisfaction of the client. Similarly, an outside accounting firm will often be asked to interview and ultimately recommend in-house accounting personnel for the firm's client. In some instances, these recommendations have resulted in claims against the practitioners when an employee either failed to competently handle his accounting functions or, in other circumstances, ended up embezzling company funds. Again, the practitioner would be well served to document the limitations imposed upon him in terms of his ability to perform any type of background check into the prospective employee's moral integrity or previous employment experience. (There is only so much that can be gleaned from a 30-minute interview.) Some practitioners refrain from providing any recommendations such as these particularly since claims resulting therefrom may not be covered under their liability insurance policy.

Lastly, another area that has seemed to spawn litigation results from tax return preparation engagements. Invariably, many clients desire to take somewhat aggressive positions in their tax returns. (Aggressive positions are of course distinguished in this context from positions clearly in violation of the Internal Revenue Code or other Treasury Regulations.) While the practitioner may orally discuss the risk associated with the potential disallowance of such a position, including penalties and interest, invariably the client will seem to have forgotten that those risks were disclosed to them when three years later the IRS seeks to impose

continued next page

those same penalties and interest previously discussed.

In conclusion, it was not the intention of this presentation to single out the accounting profession in this area. In fact, after having defended a number of lawyers and law firms in professional liability claims who, one would think, would be more concerned about potential litigation, lawyers have at least an equal number of failings when it comes to documentation. While there may perhaps be a school of thought that documenting certain matters in your workpapers or in other correspondence may often prove to be more damaging than helpful, if this task is undertaken with a view towards possible litigation, practitioners will be well served by their efforts in this respect and will be less susceptible to confrontations with individuals who have either faulty or selective memories.

Accountants — Be Careful What You Write

John R. Gerstein
Ross, Dixon & Masback

Mr. Gerstein is a senior partner in the Washington, D.C. law firm of Ross, Dixon & Masback. He represents accountants and other professionals in major litigation throughout the United States

Sometimes, what an accountant puts in writing can cause him more problems in litigation than what he fails to put in writing. For years, accountants have been cautioned to be sure to put their retainer agreements in writing (engagement letters), so that there is a clear record of the scope and limitations of any engagement. However, what has not always been stressed is the need for accountants to think carefully about what else they put in writing. Everything from a joking phrase, to an exaggeration, to an inartful expression of a concern written on a workpaper, a handwritten note, a letter, or an internal memorandum may be fodder for substantial cross-examination and later jury argument if the accountant becomes embroiled in litigation in the future.

When accountants are working on an engagement, or otherwise are interacting with clients, they rarely think about the prospect that sometime in the future, for reasons that cannot be anticipated now, the work that they are performing will be scrutinized by an adversary. Frequently, in litigation involving accountants, handwritten notes in the files, memoranda, "buckslips," or phone message slips end up providing juicy cross-examination for the opponent. Where the accountant finds himself defending notes in his own handwriting with responses such as "I don't agree with that characterization," or "I was exaggerating — I was mad at the time," or "I didn't literally mean that" — even if these responses are totally true — somehow the answers sound contrived when an adversary is suggesting that the note is in fact a "damning admission."

The lesson is simple. Every time an accountant puts anything in writing, he or she should learn to visualize it being turned over years later to an adversary in a lawsuit against the accountant. The accountant should further picture being asked to explain or justify what he or she meant by the writing. Once you get in the habit of "monitoring" what you write, the task becomes easy. If anything, you become a better writer, because you are very careful to say precisely what you mean, and you become a more prudent writer because you do not put reckless, careless, or inflammatory expressions of thought onto paper. In modern times, litigation provides little respect for privacy. Love letters exchanged between auditors working on the same engagement may later be used by an adversary to suggest that the auditors were more interested in each other than in the audit engagement. There is an old saying that an ounce of prevention is worth a pound of cure. In the modern business world the "ounce of prevention" is to think carefully about what you put in writing.

Underwriter's Corner

The Underwriter's Corner was developed as a service to provide AICPA Plan insureds with answers to frequently asked questions. Should you have any questions which you would like answered in this publication, please address your questions to:

Michael J. Chovancak, Editor
AICPA Newsletter
c/o RBH Direct Group
4870 Street Road
Trevose, PA 19049

Financial Planning Activities

Q. Our firm offers a wide variety of accounting services, including financial planning. While most of our financial planning activity involves accounting services (for example, income and estate tax advice, the preparation of financial statements and cash flow projections), a small portion of our practice sometimes involves "investment advice" as this is a term broadly defined under the securities law. We do not recommend or sell specific investment securities, however, we may broadly suggest asset allocations to a type of security (i.e. tax free bonds, blue-chip stocks, etc). Would coverage under the AICPA Plan extend to these activities?

A. According to the policy wording (Exclusion J) which states "To any claim arising out of the promotion, solicitation or sale of specific securities...," the broad advice would be covered, however, one should always be cautious in the interpretation of "general advice."

Although not specifically excluded in the policy, any referral of clients to "specific" stock brokers, money mangers, etc. could result in a suit against your firm if the recommended stock broker, etc. does not meet the particular expectations of your client.

In general, our tip would be to keep it general and you should be covered under the policy wording.

Case Brief

Income Tax

The client retained an accounting firm to prepare federal income tax returns. According to facts related by the court, the firm recommended that the clients invest in a limited partnership. The clients incurred losses on that investment and the firm advised them to claim deductions for the losses on income tax returns for 1976 and 1977. In 1981 the IRS notified the clients that the deductions were not allowed. The accounting firm then advised the clients to challenge the IRS determination, and a challenge was filed with the tax court. In May 1983, the IRS and the clients settled the matter and an order was entered requiring the clients to pay a tax deficiency. In February 1985 the clients filed suit against the accounting firm alleging accounting malpractice and claiming damages for the tax deficiency. The trial court ruled that the cause of action arose when the IRS sent notice of deficiency in 1981. Because the suit was not filed within two years of that date as required by the Florida statute of limitations for professional malpractice, the suit was dismissed. The clients appealed, and the appellate court reversed.

The appellate court reinstated the suit, ruling that the cause of action did not arise until the tax court rendered judgement against the clients in May 1983.

The accounting firm appealed to the Florida Supreme Court which affirmed the decision of the appellate court allowing the claims for accounting malpractice to go forward. Florida's two-year statute of limitations applies to actions for professional malpractice, and runs from the time the injury occurs or the injured party either knows or should have known of the injury. The issue here was whether the clients' injury occurred when they were notified of the tax deficiency in 1981 or when the tax court judgement assessing the deficiency was entered in 1983.

The court compared the cause of action for accounting malpractice to a cause of action for legal malpractice. A majority of Florida courts have ruled that legal malpractice actions do not arise until appellate review is complete reasoning that any actionable error cannot be determined until the appellate process is complete.

continued next page

The accounting firm argued that this situation was distinguishable because here, the clients knew of the injury when the IRS notified them of the tax deficiency. The firm asserted that fact of the injury was determined by the IRS not by a court. The court rejected this argument, noting that the clients appealed the IRS determination on the advice of the accounting firm. Furthermore, if the clients had been required to file accounting malpractice case when they received the IRS notice of deficiency, that position would have been contrary to the clients' position in the appeal to the tax court. The court also noted that the clients' appeal to the tax court was in response to the firm's assertion that no tax deficiency was owing. The clients believed the accounting advice was correct and filed the appeal of the IRS determination based on the belief. Therefore, they did not know of their injury until the tax court judgement was entered, and the cause of action did not arise until that time.

AICPA Professional Liability Insurance Plan Committee
c/o Newsletter Editor
Rollins Burdick Hunter
4870 Street Road
Trevose, PA 19049

BULK RATE
U.S. POSTAGE
PAID
SEATTLE, WA
PERMIT
NO. 4250