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## Accountant's Liability Newsletter, Number 27, First Quarter 1992

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

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# Loss Prevention for The Tax Practitioner

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By Michael J. Chovancak  
Vice President  
Rollins Burdick Hunter

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**L**iability claims involving taxes continue to be the fastest growing source of claims under the AICPA Accountants Professional Liability Insurance Plan.

Although one can take comfort in the fact that liability insurance can and will protect you in the event of a covered claim, one should recognize the unprotected personal exposures not covered under this insurance. Beyond the applicable deductible on your insurance policy, your firm must also consider:

1. The loss of billable hours which will be necessary to research/review workpapers, interview staff, hold discussions with counsel, participate in depositions, and ultimately appear in court. These all represent a loss of income to the firm.
2. The negative public relations that will certainly circulate and potentially cost you the loss of some of your valued clients.
3. The stress and other adverse human behavior experienced by your staff which can have a dramatic effect on your firm's productivity.

The simple solution, of course, is to not have a claim. However, in today's litigious world this is not always under your control - even if you do not make an error or omission on your work. The following provides several loss prevention tips that can assist you in your efforts to control the occurrence of a claim.

1. Investigate fully before giving advice. Research the client's file completely, explain the pros and cons

of advice to the client and confirm the client's understanding of your advice—in writing.

2. Maintain written records. Written documentation of telephone conversations via a follow-up letter, for example, greatly reduces the possibility of diverse perceptions of what was said by both you and your client. This type of documentation is invaluable to support your position if you are sued.
3. Assure that you meet your deadlines. The means to do this is to have an automatic docket system that flags a file well in advance of applicable due dates - including adequate time to solicit, obtain, and review necessary information from the client.
4. Practice quality control. If you have a staff of more than one, the preparer of the document should have his/her work reviewed by another staff member using a reviewer checklist - before the work is signed off. Sole practitioners should make reciprocal arrangements with other firms for this vital function.
5. Conduct proper research. Know your firm's limitations and consult with others and/or research unclear facets of an engagement. This is especially true when one is involved with engagements that are subject to multi-state tax laws, which may vary drastically.
6. Avoid conflicts of interest. Never represent both sides of a transaction, such as a divorce or the sale of property.

Other defensive practices, such as the use of a good engagement letter for all engagements, have previously appeared (and will continue to appear) in this Newsletter to assist you. □



reveal why the trend is not likely to be soon reversed. Among the more significant reasons for the trend is the current growing comfort with which the American public has come to accept claims against independent certified public accountants. Accountants have long, and deservedly, had a reputation for integrity and honesty; and twenty years ago most clients would have been loath to assert claims against their trusted advisers. Due to increased financial pressures, this initial reluctance to assert claims against accountants has dissipated, with the result that such claims have become common. This, in turn, has detracted from the image of accountants as being professional and reliable and has encouraged even further suits.

**Liability,**  
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Another major factor is the growth in the size and quality of the plaintiffs' bar. As most recently pointed out by Vice President Quayle, the number of lawyers in the United States is considerably larger on a per capita basis than in any other country and the law schools show no signs of decreasing the number of students which they are accepting into their programs. As a result, the total number of lawyers is increasing faster than the population; and those lawyers must seek ways of developing a livelihood from their practice. In large measure, this has meant increased litigation and suits against accountants have proven to be a very lucrative area of litigation for the plaintiffs' bar. Not only have the

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## TAX TIPS

### 1. Loss Prevention Course On Tax Malpractice Claims Available

Completed by Crum & Forster Managers Corp. (Ill.) in cooperation with the Professional Liability Insurance Plan Committee, "Tax Malpractice Claims and How to Prevent Them", is a 39-minute videotape that alerts CPA's to danger signals, typical tax situations that can lead to claims and how to prevent them, and six specific steps that can protect tax accountants from lawsuits. The price of the tape (118600), including workbook, is \$69.00 with additional workbooks (118610) at \$34.50 each. Recommended CPE credit, requiring completion of the accompanying examination, is 4 hours.

To order, simply call the Order Department of the AICPA at 1-800-334-6961. In New York State, call 1-800-248-0445.

### 2. Basic Accountants Professional Liability Policy for the Tax Practitioner and More.

The AICPA unveiled the Basic Accountants Professional Liability Policy in 1990 in an effort to afford professional liability insurance protection to smaller firms (such as tax preparers) that had historically gone without insurance because of cost.

The Basic Policy was designed:

- For firms of 1 to 5 people and with billings less than \$250,000.
- With a sole limit of liability of \$100,000 and a deductible of \$500.
- To provide coverage for firms engaged in: tax preparation; bookkeeping; write-ups; compilation; and M.A.S. consultation only.

Although broader in scope than the so-called "tax preparers policies" on the market today, the "Basic" Plan is narrower in scope of coverage than the "Standard" AICPA Plan.

Qualifying firms will find the Basic Plan priced competitively with the tax preparers policies. For additional information, please contact Rollins Burdick Hunter at 1-800-221-3023 or your State Society.

### 3. Toll-Free Claims Line Available

Crum & Forster Managers Corp. (Ill.), the underwriter for the AICPA Professional Liability Insurance Plan, has a nationwide toll-free telephone system to encourage insureds to call at any time with information or questions about their claims.

Please note that claims cannot be reported to Crum & Forster via the telephone. The insurance policy specifically states that reports of claims must be written. However, if you are presented with a claim, or potential claim, and want to discuss reporting or other aspects, please feel free to use the toll-free number. Of course, insureds with existing claims are encourage to call the claims technician handling their case at any time.

The Crum & Forster Managers Corp. (Ill.) claims toll-free number is 1-800-879-4272.

### 4. Engagement Letter Assistance Available

An important loss control technique that all firms can employ is an engagement letter. Firms interested in samples and/or guidance in structuring engagement letters should contact the AICPA Technical Information Division at 1-800-223-4158. In New York State, call 1-800-552-5430. □



number of lawyers pursuing accountants' liability claims grown, but they have also become far more expert in this rather specialized area enabling them to achieve greater success and thereby draw other attorneys into this field.

Adding to the growth in liability claims against accountants since the 1970's is the growing number of accounting firms which engage in litigation support services. In the early 1970's, it was very difficult to find an accountant willing to testify regarding the indiscretions or blatant negligence of other accountants. In fact, one frequently had to look hard and long in order to find an accountant willing to testify for a plaintiff in an accountants' liability case. This is certainly no longer true, as virtually every major (and most middle-sized) accounting firms now actively solicit litigation support services in which accountants not only assist attorneys in bringing accountants' liability cases but also assist in the analysis of damages and in the organization and retrieval of the myriad of documents that are involved in complex financial litigations.

The accounting profession itself, attributes much of the increase in litigation to the "deep pocket" syndrome, pursuant to which accountants, lawyers and directors and officers are sued, not because of their own particular wrongdoing, but because of their professional liability insurance which guarantees the plaintiff a lucrative award if victory is achieved in court.

To some extent, the courts themselves are to blame for the increased number of civil liability claims. During the 1960's and the early part of the 1970's, the courts embarked on a campaign of greatly expanding the theories of law under which civil liability claims could be asserted. Among the more significant theories adopted by the courts during this period was the "fraud on the market" theory pursuant to which a person who did not actually read the alleged erroneous financial statements might nevertheless claim that he relied upon them. Similarly, the courts adopted the "aiding and abetting" theory under which an accountant or other professional could be deemed

### **Coverage** *continued*

liable, on a joint and several basis, for statutory violations perpetrated by their clients. In addition, in the 1980's, at least four state courts abandoned the privity doctrine in favor of the "foreseeability standard" allowing accountants in those states to be sued on a negligence standard by persons other than their clients whose reliance upon their financial statements report was reasonably foreseeable. This relaxation in the scope of persons who could sue accountants on a negligence standard makes accountants far more vulnerable to civil liability.

The greater notoriety given to accountants' liability claims in the financial press has also helped create what the accounting profession has dubbed as the "expectation gap." This expression refers the differential between the level of assurance which the public believes is provided by an auditors' opinion and the level of assurance which the auditors themselves believe they are providing the financial statement users. As a result of the accounting profession's perception of an expectation gap, the Auditing Standards Board, the auditing standard setting body within the accounting profession, published in 1988, nine new auditing standards designed to raise the level of audit practice and thereby close the "expectation gap." There are some questions as to whether those audit standards will actually raise the level of practice or simply make "substandard practice" a more common phenomenon. In any event, many critics of these standards believe that the Auditing Standards Board simply gave further and unnecessary credence to those who felt that the public's expectation of audit performance was realistic.

The problem, of course, is further complicated by the fact that to the extent that an "expectation gap" exists, it is not static. There is no question that the level of audit performance has increased enormously over the past twenty years; however, one could hardly discern this from reading the financial press which is constantly featuring articles concerning "shoddy practices" at the nation's leading accounting firms. The moral of the story is that, no matter what improve-

ments in the quality of audit practice the accounting profession may be able to achieve, public expectations of auditors' ability to uncover fraud and reveal their clients' illegal acts and other indiscretions is always likely to outstrip the profession's ability to satisfy these expectations.

There are, however, some signs that the current trend in the claims against accountants may be nearing an end. Some of the signs are already present in the changing accounting profession. For almost fifty years, the accounting profession was dominated by eight large accounting firms who were generally referred to as the "Big Eight." In 1989, there were two mergers of these accounting giants, reducing their number to six and giving rise to the new name "Big Six." In addition, there have been a number of second tier firms to also become history. Finally, hundreds of small accounting firms have been forced to merge in order to survive or else face extinction. This contraction in the accounting profession is perhaps best seen in the number of firms that continue to audit the financial statements of public companies. Whereas in the beginning of the 1980's, there may have been as many as two thousand firms which audited the financial statements of public companies; today there are only slightly over six hundred such firms.

While the threat of civil liability suits against accountants does not fully account for the contraction in the accounting profession, it is certainly a reason frequently cited by accounting practitioners for leaving the practice.

Another sign of change is the growing number of accounting firms that have sought to diversify their activities into other, less risky, areas of practice. For example, most medium and large accounting firms feature a wide variety of personal and business consulting services in addition to traditional financial statement and tax preparation services. The growth of these new types of services has been enormous during the 1980's and is likely to continue not only because of the lesser degree of liability exposure but also because of the generally greater profitability associated with these services.

There are already some signs that

### Coverage continued

the state and federal legislatures are becoming concerned with the growing number of liability claims and the burden which those claims are imposing upon the nation's economy. While most attention has been focused on medical and products' liability claims, there have nevertheless been some signs that legislatures are willing to deal with the liability crisis as it affects accountants. For example, four states have already adopted "privity" legislation permitting accountants to limit the person who might bring claims against them based on a negligence standard. In addition, Congress is now seriously considering amendments to the federal RICO statute which will virtually eliminate claims against accountants based upon this Draconian law which was originally aimed at curbing organized crime. Although the accounting profession has also targeted the elimination of joint and several liability in suits against accountants, no particular headway has been made in this campaign.

The courts, to some extent, have begun a process of curtailing professional liability claims. For example, the Supreme Court has recently ruled that claims based upon the antifraud provisions of the federal securities laws must be brought within the one/three-year limitations period contained in Section 13 of the Securities Act of 1933. This ruling, which is to be applied both retroactively as well as prospectively, should substantially reduce the number of large claims against accountants and other professionals. In addition, notwithstanding the movement toward a "foreseeability standard" replacing the "privity rule" that was so clear in the early 1980's, most state courts have refused to follow these rulings and have instead opted for either the Restatement of standard or the Credit Alliance standard. While many litigators have a sense that most judges are no longer willing to simply entertain novel theories of liability or to countenance unfocused or badly pleaded claims, there are still few, if any, signs that the courts are likely to abandon claims which they have previously countenanced.

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If a new perspective on accountants' liability is likely to come in the near future, it is likely to be prompted by a further contraction in the market for professional liability insurance. A strong argument can be made that the failure of most state courts to adopt the "reasonably foreseeable" rule can be traced to the insurance crisis of 1985 and 1986, when insurance premiums for accounting firms went up approximately 400% and many accounting firms were unable to secure professional liability insurance. This crisis not only seemed to prompt insurance reform legislation, but also seemed to scotch the notion that expanded liability claims could receive funding from private insurance.

There are currently a number of dark clouds on the horizon with respect to accountants' liability insurance which could give rise to a similar contraction in the liability insurance market in the next few years. First and foremost, is the current wave of claims being asserted by the FDIC and the RTC against accountants and other professionals arising out of the collapse of the savings and loan industry. These suits, while representing a relative small portion of all claims against accountants, are

### **Liability,** *continued*

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*Mr. Goldwasser is a Senior member of Solinger Grosz & Goldwasser, P.C. a New York City Law Firm, which represents the New York State Society of CPAs and approximately 110 CPA firms. Mr. Goldwasser is actively involved in the development of Defensive Loss Prevention Techniques/Practices for CPAs. This article is the second of a series of articles that Mr. Goldwasser has contributed to this newsletter, portions of which may have previously appeared in other periodicals or presentations by the author.*

seeking damages into the billions of dollars and, if successful, could significantly reduce the available professional liability insurance for both lawyers and accountants practicing in the United States much like the prior crisis of 1985/1986. Moreover, because of the political pressure to recover substantial sums and thereby reduce the taxpayers' burden, there is extreme concern among insurers of an increased volume of regulatory suits against accountants. Because of the dollars involved, the ultimate likelihood is that most of these suits will be settled for amounts which will be extremely large in comparison with prior claims against accounting firms. In addition, these settlements will come at the same time that the wave of new claims arising out of the 1990-1991 recession hit their peak (in or about 1994). In summation, these two movements could give rise to a new liability insurance crisis. On the negative side there would exist fewer sources of liability insurance to the professional accountant or lawyer with lower limits and increased policy restrictions and premiums. On the positive side, the crisis will make possible the tort reform which never really got off the ground in the mid-1980's. □

## **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 the publication, please address your questions to:

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

*I am a partner in a medium sized firm that specializes in tax related accounting services. During the tax season, we sub-contract some of our work to other CPA firms and independent contractors. By doing this, we expect to be able to better manage the increase in volume and provide our services in a timely manner. Do we have coverage for the work performed by our sub-contractors under our AICPA Accountants Liability Insurance?*

To answer your question, we must look to your policy's DEFINITIONS. Your Policy provides coverage for acts, errors or omissions for the Insured's per-

formance of professional accounting services for others. The term "Insured" is defined to include "(B) any accountant or accounting firm while performing professional accounting services, under contract with the Named Insured." Furthermore, professional accounting services are "services performed or advices given by the insured for fee or otherwise in the conduct of the Insured's practice as an accountant..."

Thus, should an act, error or omission be discovered and should such act, error or omission have been made by an independent contractor while performing professional accounting services on your firm's behalf (e.g. the work was performed on your firm's letterhead), coverage applies.

Of course, as with all "claims made" policies, any claim is subject to the terms and conditions of the policy in force at the time the claim is presented to the insurance company. Therefore it is important to review your policy wording for each new policy period. Please feel free to contact your Account Representative at 1-800-221-3023 with any coverage questions. □



# Tax Claim Reports

The following claims are taken from actual claims filed in the AICPA Plan. Even though many claims appear to have questionable merit, once filed, they become costly. Many times a little more care and business judgment can avoid practitioners being put in a position of being forced to defend unnecessary suits. The best defense against any suit is quality work. Considerable CARE and good DOCUMENTATION are key ingredients to performing quality work. A common thread present in the following claims is a failure to carefully research authoritative tax literature before giving advice. Anyone can make mistakes; but to give advice in a highly technical area without doing the necessary research is asking for trouble.

1. The insured was engaged to help his client design a pension plan. Erroneous advice from the accountant led to the IRS disallowing the plan and an assessment for taxes, penalties and interest. The CPA believes that penalties and interest will be at least \$100,000 in addition to a tax assessment of \$100,000 for a total claim of \$200,000 plus defense costs.
2. The client receives large distributions from both a pension plan and a profit sharing plan funded by his employer. The CPA gave erroneous advice about the treatment of these distributions. The CPA admits that IRS Code and Regulations

were not checked. The CPA states that had he consulted the Code, he believes that the error would not have occurred. The CPA is therefore liable for the tax deficiency, interest and penalty.

3. A CPA was asked to estimate the tax liability of a substantial transaction and the tax savings considering an option of a charitable contribution. The advice giver failed to consider alternative minimum taxes of approximately \$350,000. This problem is a common one where the CPA is asked "what if" questions. The lesson to be learned here is, research the questions carefully to avoid giving improper advice.

With the frequency of changes in our income tax laws and with the ever changing regulations, every practitioner must always be careful when furnishing advice. It is best to take the time to research the problem and document your file with the appropriate references to authoritative tax literature before giving advice.

The area of pension and profit sharing plans has become increasingly complex in recent years. Likewise numerous other areas of tax practice which used to be simple and easily dealt with, have become more complicated. Take the time to make sure that the advice you are giving is correct under the circumstances and supported by the tax literature. □

## TAX ENGAGEMENTS, MANAGING YOUR TIME AND YOUR BUSINESS

Recent surveys suggest that approximately 50 percent of billings of the average CPA firm are derived from tax work. Couple this staggering statistic with the fact that this volume of work is concentrated within approximately 70 business days at the on-set of the year, and one has an alarming time management headache.

To help relieve the pressures of this situation, there are a number of suggestions worth considering:

1. Read this newsletter after April 15th.
2. Structure non-tax engagements during the May-December months, which provides time constraint relief and spreads out your income stream/cash flow more equally.
3. Get a head start on the tax season by planning the necessary hours to interview, procure information, prepare, review, and approve each

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client's work. Here you can **determine** if you have enough "hours-in-the-day" to handle the volume projected with existing **resources** (including clerical staff) or need to **hire** part time/ temporary help.

**4. Have all the necessary forms ready, in advance of the tax rush.** This means **not only the tax forms**, but also your **internal contract forms** such as: **client interview forms, client evaluation forms, preparer's checklist, reviewer's checklist**

**5. Access/review client evaluation form each year. Determine if the needs of the client and those of the firm are consistent. If for whatever reason your evaluation points toward termination of the relationship, then do so. An unhappy cli-**

**ent is a red flag from not only time management (i.e. lost time to iron-out complaint), but could lead to a malpractice claim.**

**6. Assure that you are adequately compensated for planned hours to be spent on each engagement. Too often, cutting fees to attract or retain a client can lead to cutting corners on the preparation/review of the engagement and lead to complaints and/or costly malpractice claims.**

**Your time is limited during this part of the year, therefore, it is imperative to properly plan and price your work to assure your quality and profitability remain on an upward trend. □**

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*The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.*

#### AICPA Professional Liability Insurance Plan Committee

c/o Newsletter Editor

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