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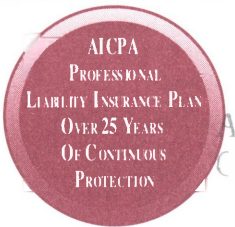
Accountant's Liability Newsletter, Number 33, Third Quarter 1993

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

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Accountants' Liability Newsletter

Number 33

1211 AVENUE OF THE AMERICAS

Third Quarter 1993

DEFENSE! DEFENSE!

by
Francis A. Corcell
Partner, Restuccia & Co.

A recent AICPA survey of 5,000 local and regional firms reveals that 41% of the respondents do not carry professional liability insurance, mostly because it is too expensive; 20% plan to discontinue offering certain services to limit their exposure; and 54% believe their exposure will increase over the next five years.

The cost of mounting a defense, beginning with a preliminary investigation, the filing of a lawsuit and continuing through discovery and trial or settlement, averages \$44,000, a figure that would be even higher if the unquantifiable losses were included.

That's a lot of money. If you don't think so, consider that the average billing rate for a sole practitioner in Massachusetts in 1991 was \$58 per hour. That's almost 759 hours in chargeable time to pay for the average defense. How much chargeable time do you have in a year?

Remember these figures reflect what it will cost you if you win! If you lose, you're going to have to pay a judgment. The median claim in 1991 was \$155,000. A year's work down the drain. And, if that isn't enough, there's always the possibility of punitive damages. These can be very expensive. An article in the July 1992 issue of the Journal of Accountancy cited the following:

"A 1987 study by the Institute of Civil Justice examined 24,000 jury trials in Cook County, Illinois, and found the average punitive damage award increased, in inflation-adjusted dollars, from \$43,000 in 1965-69 to \$729,000 in 1980-84, a jump of 1600%."

Is there a safe harbor? Some practitioners seem to think so. The trend is toward tax work and away from audits. Only 58% of California CPA firms did audit work in 1991, down from 61% in 1988. Audit services do not generate a high percentage of fees. However, they do generate a high percentage of claims and losses. Hence, the desire to discontinue offering such services.

When firms withdraw from attest services, such as audit, reviews and compilations, they try to replace the lost revenue by increasing revenue from tax services. What they want to do is shift from high-risk work to low- or no-risk work. Sounds good in theory. There's only one problem. It doesn't work that way.

Loss data from one regional liability insurer indicates that the majority of their claims (51.5%) and losses (40.8%) are a result of tax services.

These figures are not peculiar to any one region of the country. The most common causes of claims in the national AICPA plan for 1990 revealed that tax engagements represented the highest percentage for frequency of claims. However, audit engagements

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AICPA Professional Liability Insurance Plan

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Defense

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still represented the highest dollar amount for severity of claims.

Tax claims arise for a number of reasons. These may include:

- Late filing of returns
- Underpayment of estimated taxes because of alleged negligence of the accountant (resulting in penalties, interest, and other serious harm to the client)
- Disallowance of the treatment of items reported on the tax return prepared by the accountant.

You probably think this couldn't happen to you. After all, you always file returns on time and never have clients underpay taxes. You may be right. But, how about these situations:

1. A CPA was engaged to help his client design a pension plan. The IRS disallowed the plan, and assessed for taxes, penalties and interest. The tax assessment alone was \$100,000. In addition, the CPA believes that penalties and interest will be at least \$100,000. Thus, the total claim will be for \$200,000, plus defense costs.
2. A client received 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, 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 CPA failed to consider alternative minimum taxes of approximately \$350,000.

I didn't invent these examples. They are actual claims filed in the AICPA Plan.

So, what's the answer? In one word, defense! You've got to learn to protect yourself. Where do you start? Try your current client base. Professional liability insurance underwriters understand that a large percentage of claims result from clients who are either in severe financial difficulty or who lack basic integrity.

It's true. People react differently when under stress or pressure. And, financial pressure is the worst kind. It affects survival. Solution? Review your clients every year. Business conditions change. So do people. You may come to the conclusion that you have a problematic client. What are you going to do about it? Is the risk too great to continue the relationship? Maybe, maybe not. It's a hard decision to make. No one wants to give up clients. So, you may decide to keep the client. But, if you do, you'll have one advantage. You'll be aware that you should take additional measures to protect the firm against liability.

What about accepting new clients? Use common sense. Everybody wants to grow. But, does the risk outweigh the reward? Charles A. Werner, CPA, JD, gave examples of the following types

of clients to avoid in Accountants' Liability, Second Quarter 1992:

1. Clients with known or alleged connections to organized crime or other illegal activities. Even if the connection is merely alleged, you don't want to find out if it's true.
2. Clients with transactions that are difficult or impossible to verify under generally accepted auditing standards. If such transactions are material, even a highly qualified report may be risky.
3. Clients that are so unstable financially, it is doubtful you could collect your fees. Bankrupt clients often sue CPAs who are perceived as having "deep pockets".
4. Clients where the risk is clearly out of proportion to the fees you might receive.

What else can you do? Develop a sound risk-management program. Here's a list of some of the things that you can do to implement a risk-management program:

1. Use engagement letters. This is especially important when you are doing any "special" type work. The engagement letter should cover such items as:
 - Professional services to be performed by the accountant
 - Responsibilities assumed by the client
 - Extent of the accountant's liability
 - Timing of the engagement
 - Limitations of the engagement
 - Type of report expected to be issued
 - Accountant's billing procedure

Engagement letters will not prevent malpractice claims. However, they do help in reducing exposure to liability. They also improve the chances of a successful defense.

2. Acknowledge your professional limitations. You can't know everything. Admit it. There are certain types of engagements that you're better off not taking. Think long and hard about the risk/reward factor. For example, the area of pension and profit sharing plans is extremely complex. Do you really have the expertise to draw up a qualified plan for a client?
3. Adhere to defensive billing practices. Clarify your billing and collection policy

up front. Also, be very specific as to when you will withdraw from an engagement because of unpaid fees. This means, put it into the engagement letter.

Another piece of advice. Think twice before you sue for unpaid fees. Why? Simple. Clients often initiate counterclaims for malpractice when they are sued for unpaid fees.

Another thing to bear in mind is that clients don't like surprises. This is especially true where unexpected large fees are concerned. It might become a question of what is a reasonable fee. You may have to consult an expert witness. And you may have a possible lawsuit on your hands.

4. Comply with continuing professional education requirements. Tax laws change almost daily. The same holds true for accounting theory, auditing techniques, and procedures. You must stay on top of them. The only way to do it is through CPE. Also, try and structure your courses to get a reasonable cross section. Don't take 95% of your CPE credits in taxation and 5% in accounting and auditing.
5. Implement a system of quality control — and adhere to it!

Recently, I talked to an attorney who does malpractice work for CPA firms. I asked him what were the three biggest shortcomings in malpractice cases. His answer:

- Lack of engagement letters
- Financial reports that should have qualified opinions, but do not, and
- Lack of documentation.

Engagement letters have been elaborated upon elsewhere. Issuing "clean" opinions that should really be qualified is another matter. Accounting literature is fairly explicit in respect to qualified opinions. There are only two circumstances when a qualified opinion is required. In addition, the circumstances must have a material impact on the financial statements. What are these circumstances?

1. Sufficient evidential matter cannot be collected because of engagement circumstances or restrictions imposed by the client. (A scope restriction.)
2. Generally accepted accounting principles, which include adequate disclosures, have not been observed by the client in the presentation of the financial statements. (A GAAP departure.)

What is a scope restriction? An auditing problem. What is a GAAP departure? An accounting problem. Conclusion: You really shouldn't concentrate all your CPE in the tax area.

Lack of documentation is a bit more problematic. Most accountants are fairly responsible. They know their clients and their clients' problems. After all, they've been doing this job for years. They know what's material and what are the areas of risk. They probably know more about the company than the owner. So, why bother writing it down? It takes time and the client won't pay for it.

As a result of this mind set, their work papers end up with certain deficiencies. Like what? Here are some of the most prevalent ones:

1. Failure to use standardized or tailored audit programs, checklists or questionnaires.
2. Inadequate documentation of material and audit risk considerations.
3. Failure to indicate the audit work performed.
4. Inadequate documentation of:
 - Preliminary evaluation of internal control
 - Flow of transactions
 - Control environment
5. Inadequate documentation of analytical review procedures
6. Inadequate evidence of pre-engagement planning
7. Failure to obtain management-representation letters.
8. Inadequate documentation of consultation performed
9. Using tax-accounting principles rather than GAAP accounting principles, yet reporting on a GAAP basis
10. Failure to include all required report disclosures.

In the area of taxation, you also have to adopt a defensive posture. Some possible measures to consider are:

- A. Use engagement letters.
- B. Don't shoot from the hip! Do your research. Then, document your research. Make sure you investigate before you give any advice.
- C. Put it in writing. Whenever you give someone advice by phone, follow up with a letter. Memory is not infallible. Too often you get into a shouting contest if there is no written documentation.

Apparently, there are a lot of practitioners who do not have malpractice insurance. I wish them well. Regardless of whether or not your firm has insurance, there are a number of defensive measures you can adopt to help reduce your exposure.

- Review your existing clients. Determine if any relationships should be terminated.
- Screen all potential clients very carefully.
- Know your limitations. Don't take on engagements you lack the expertise to perform properly.

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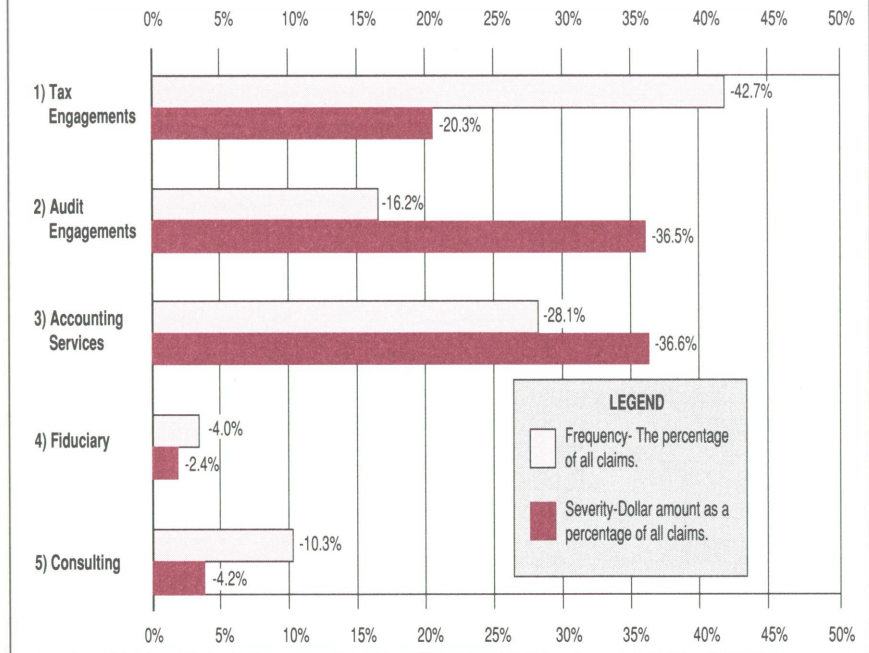
Defense

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- Make sure you get adequate CPE
- Adopt defensive billing practices. Think twice before you sue for fees or bill substantial contract overruns.
- Adopt and adhere to a system of quality control that ensures compliance with generally accepted auditing standards and standards for compilation and review procedures.
- When doing tax work, remember:
 1. Use engagement letters
 2. Do your research
 3. Put it in writing

If you do these things you may be able to sleep a bit better at night.

Most Common Cause of Claims in AICPA Plan During 1992



This article is reprinted from *Massachusetts CPA Review*, courtesy of the *Massachusetts Society of CPAs*.

Client Evaluation

CHECKLIST

Formal evaluation of clients by an accounting firm often reveals whether mutual benefits are being derived from the professional relationship and determines where the major portion of client problems occur. By using an objective method to determine which clients do not measure up to firm standards, such as allocating points to responses to the categories listed below, the firm may be encouraged to take steps to correct problem areas. Generally, each client's evaluation should be done by the partner or manager with the most knowledge of, and exposure to, the client.

(Circle one in each group)

Usual condition of client's records

- 2 Unusable or always late
- 4 Scattered but workable

- 6 Client needs orientation
- 8 Good
- 10 Excellent

Client's potential growth

- 5 Terminating
- 10 Decreasing
- 15 Level
- 20 Growing
- 25 Unlimited

Client's attitude towards IRS

- 1 Apprehensive
- 2 Hostile
- 5 Apathetic
- 8 Cooperative

Work done for client

- 3 Bookkeeping
- 6 Reviews or compilations
- 9 Audits

- 12 Year-end work, special
- 15 Comprehensive services

How client pays fees

- 1 May never pay
- 2 Always pays 90 days late
- 5 Pays within 45 days
- 10 Pays when billed

Client's reaction to fees

- 1 Fees always challenged
- 5 Requires itemized bill
- 10 Usually accepts bill
- 15 Expects to pay for service
- 20 Pays premium—thinks we're superior

Total annual fee

- 3 To \$1,500
- 6 \$1,501-\$5,000
- 9 \$5,001-\$10,000
- 12 Above \$10,000

Accountants' Liability

Client's attitude toward recommending us

- 1 Would never do so
- 2 Might do so
- 12 Has not recently
- 16 Does at times
- 20 Does frequently

What client wants from us

- 1 Minimum service
- 2 Security regarding IRS
- 3 Counseling
- 4 Timely service
- 5 Direction, tax planning

Where client seeks information

- 1 Client's employees
- 2 News media
- 3 Client's competitors
- 4 Client's friends
- 5 Professionals (including us)

Client's attitude towards expenses

- 1 Spendthrift
- 2 Stingy
- 3 Economical
- 4 Liberal
- 5 Goes "First Class"

Exposure to legal action

- 1 High risk
- 2 Would consider suit
- 3 Low risk
- 4 Little risk
- 5 Would never sue

Client's attitude toward our staff

- 1 Critical, argumentative
- 2 Uncooperative
- 3 Usually cooperative
- 4 Businesslike
- 5 Friendly, appreciative

Client's financial strength

- 1 Insolvent
- 4 Solvent, undercapitalized
- 8 Adequate
- 10 Strong capital structure

TOTAL POINTS _____

Above conditions prevailed as of (month) _____

Evaluation by _____

SCORING

Maximum — 155 points

Minimum — 23 points

- 30 points and below = Drop client
- 31 to 50 points = Evaluate in 90 days (on trial)
- 51 to 70 points = Make an attempt to upgrade client
- 71 points and above = Retain client

Adapted from the American Institute of CPAs Management of an Accounting Practice Handbook

Two States Labor for Limiting Liability

Both the Massachusetts and Texas Society of CPA's have recently intensified their efforts to effect laws to limit liability.

Beyond actively supporting the national effort of the AICPA for tort reform to restore "justice" to the legal system, the Massachusetts Society has introduced tort reform on the state level. Targets for the Massachusetts Society's charge include: privity, several liability and proportionate liability versus the current joint and several liabilities, and limited liability organizations (form of practice).

The Texas Society has concentrated its efforts to: privity, proportionate liability, punitive damages, and limited liability organizations (form of practice).

Many of the reforms proposed by these two Societies (as well as other state Societies) and national movements include conditions to discourage frivolous suits by calling for the plaintiff to pay all of the defendant's legal costs if the plaintiff loses the case and/or the suit is deemed meritless by the court.

Accountants' Liability

Client Acceptance Procedures

by
Michael J. Chovancak
Vice President—Aon Direct Group

A key element in reducing the possibility of a liability claim is the establishment of sound client acceptance procedures. It follows that if the firm exercises good judgment from the beginning of client selection, then the remainder of the engagement should proceed smoothly.

These five points will prove helpful in creating solid client acceptance procedures and evaluating potential clients:

Client Integrity

Will/can client provide appropriate information, disclosures, and/or representations?

What is background/experience of client's management team?

Is management "controlled" by one individual?

Is management extremely aggressive in conducting business? Accepting high risks?

Has any member of management been convicted of a criminal offense? Suspended or sanctioned?

Is management committed to maintaining effective internal controls?

Do members of your staff know the potential client, or will you need to consult with outside sources for additional references?

Client Reputation

What was the relationship of the client with the former accountant? Did the accountant sever the relationship? If so, why?

What is relationship of the client with the business community? Bankers? Lawyers?

Your Reputation

Are you willing to reject a potential client if your screening process points in that direction, even if the potential client could make your firm a lot of money?

Is the potential client involved in any litigation? With whom? Why?

Is the litigation a result of a regulatory dispute with the

inherent poor publicity to both the client and the accountant?

What is the business of the client and is the firm comfortable with this?

Is the potential client's industry rather volatile?

Is the client "healthy" financially?

Your Skills

Does your firm possess the technical competence to adequately perform the engagement?

Is additional training of your staff necessary?

Can you afford the training (time and money)?

Is your firm well versed as to the peculiarities of the client's industry?

Do you have the necessary, experienced personnel to devote to this client, while adequately staffing your firm's other engagements?

Payment

Is the fee reasonable as respects:

- The amount of time your firm will devote to the engagement?
- The amount of risk involved?
- The client's ability to pay?

Does the client owe a fee to the former accountant?

Does the client feel the fee is reasonable for the work to be performed? A follow-up question: Does the client know exactly the parameters of the engagement?

Is the fee fixed or can it be modified based upon a future event?

Is the fee for the engagement spelled-out, in detail—in writing and signed by both the client and the firm?

Client acceptance procedures can be a valuable tool in reducing the risk of taking on a client that is not a good fit for your firm as well as reducing the liability insurance exposure of an unsatisfied client.

MALPRACTICE DEFENSE CHECKLIST

CPA firms of any size have a 5 to 10% chance of being sued for malpractice in any one year. The best defenses are a high-quality practice, thorough client evaluations and adequate professional liability insurance. In addition, all firm members should be aware of some prudent steps to avoid malpractice exposure:

- Use engagement letters that explicitly define the nature and terms of the services to be provided, the purpose of the engagement and the distribution of the report.
 - Be selective when choosing clients and avoid those with high-risk characteristics. These include financial or organizational difficulty, involvement in illegal or possibly illegal activity, unreasonableness or uncooperativeness, fee pressures, frequent involvement in litigation, refusal to sign engagement and representation letters and weaknesses in or absence of internal controls.
 - Recognize particularly hazardous engagements requiring unusual care, training and expertise. Examples are those involving new financing and divorce proceedings (specifically valuations of community property) as well as financial institutions, Securities and Exchange Commission filings, regulated or high-risk industries and tax-shelters.
 - Accept only engagements the firm is qualified to perform or can perform using outside specialists.
 - Prepare and document all work papers as if they were to be presented in court.
 - Never sue for collection of fees unless the suit is based on a promissory note.
 - Use management letters to recommend corrections of deficiencies in clients' internal control systems. Repeat the recommendations if conditions aren't corrected.
- Deliver reports only to clients and limit discussion of the engagement with third parties.
 - Never represent or advise both parties in any transaction or even give the appearance of doing so.
 - Retain a firm attorney and consult him or her regularly.
 - Require clients to post fidelity bonds for client employees who have access to company funds.
 - Trust your professional instincts. If, despite all defensive measures, you continue to feel uneasy about a prospective client or engagement, reject it.

Adapted from the American Institute of CPAs Management of an Accounting Practice Handbook.

AICPA Vehicle and Home Insurance Program

The AICPA Vehicle and Home Insurance Programs, underwritten by National General Insurance Company (NGIC) of St. Louis, MO, was developed to provide AICPA members with safe-driving records high-quality, affordable vehicle and home protection.

NGIC, a General Motors Insurance Company, is committed to rewarding members of associations with the vehicle protection they need at the affordable rates they deserve. In addition to the vehicle program, a home protection package is also available to AICPA members.

If your current policy is due to expire soon, call one of the toll-free numbers below:

Vehicle Insurance: 1-800-847-2886
Home Insurance: 1-800-847-7233

We'll be there...

Do you have questions about your accountant's professional liability insurance? If so, members of the underwriting unit of the AICPA Plan are tentatively scheduled to be at the following AICPA and/or State CPA Society meetings to answer your questions. Please come over to our booth and visit!

SHOW	LOCATION	DATES
Northwest Tax Institute (Oregon/Washington)	Caesar's Hotel, Lake Tahoe, NV	October 25 - 27
New Jersey Mid-Year Accounting Conference	Hyatt Regency, New Brunswick, NJ	October 28 -29
Ohio Accounting Show	Cleveland Convention Center, Cleveland, OH	November 3 - 4
Minnesota Tax Conference	Minneapolis Convention Center, Minneapolis, MN	November 7 - 9

Rollins Burdick Hunter Direct Group is now Aon Direct Group

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Plan Administrator: Aon Direct Group, Inc.
C. J. Reid, Jr.; Robert M. Parker

Newsletter Publisher: Michael J. Chovancak

Newsletter Editor: David E. Hallstrom

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AICPA Professional Liability Insurance Plan Committee

c/o Newsletter Editor
Aon Direct Group, Inc.
4870 Street Road
Trevose, PA 19049

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