Accountant's Liability Newsletter, Number 34, Fourth Quarter 1993

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

AICPA Insurance Plan Over 25 Years of Continuous Protection

Accountants' Liability Newsletter

Number 34 Fourth Quarter 1993

"I CAN'T AFFORD THE TIME ..."

— Engagement Letters

"The engagement is only a tax return... Why should I use engagement letters... Engagement letters are good, but I can't afford the time and expense to do them..."

Think again. We all know society is continuously becoming more litigious, jury awards are astronomical, and accounting malpractice claims are on the rise. So, is it worth the risk to leave anything in your practice open to interpretation?

An accountant has more exposure than meets the eye. A properly worded engagement letter, combined with routine documentation, can eliminate any interpretation of the nature or breadth of the engagement. While insurance may provide a backstop beyond the deductible—which often is substantial—consider the hours that must be spent processing and reviewing the claim or lawsuit in-house, with the insurance company, defense counsel, or with a personal attorney, when there are allegations of potentially uncovered (by the insurance policy) acts, errors, or omissions. Time that could be spent servicing clients is lost to answering interrogatories, reviewing allegations, damages, and expert testimony to prepare for appropriate responses and depositions.

"The estate's attorney requested I only prepare Form 706...I was not engaged for the state returns."

This quotation comes from an accountant involved in a case where an attorney for a doctor's estate asked the accountant to prepare estate returns. Whether the state return was to be included in that engagement was disputed. Since the state return was never filed, the state requested over $152,000 in interest.

In addition, a second accountant was engaged solely for the appraisal of stock ownership and partnership interest. While his engagement was much more specific, and the issue centered on the state return, the second accountant was also placed on notice of the claim.

Normally, responsibilities are easily understood. In this case a letter to the attorney and client specifying what returns were being prepared (and not prepared) should have alerted the estate's attorney, likely preventing the assessment and subsequent claim. However, the terms of engagement were not so confirmed, resulting in each party blaming the other.

"Once the attorney came into the picture, my responsibilities were over...the attorney was handling the matter from that point on."

Similar disputes can arise in cases where an accountant is engaged to handle an IRS audit and appeal, either for an existing client, or as a separate engagement.

An accountant was called in to handle the IRS' disallowance of the method the accountant used in reporting the sale of certain properties. The accountant suggested that a tax attorney intervene to protest the

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AICPA Professional Liability Insurance Plan

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assessment and, if denied, pursue an appeal to the United States Tax Court. This was done. However, the 90 day deadline was missed, and the client sued the accountant and the attorney. Among the allegations against the accountant were: failing to refer to a competent tax attorney; failing to advise the client of the imposed deadlines; failing to represent the client at the protest, or file with the USTC.

At stake was $100,000 in taxes plus $95,000 in interest and penalties. Eventually, the IRS concurred with the accountant's position, granted a full refund and abated other damages. While this sounds successful, the case continues while the client pursues a claim for "loss of profits" and attorney's fees.

Consider, too, that $38,000 has been spent to date on defense. In this instance, since the accountant believed his services were no longer needed once the attorney was hired, a termination letter or other brief confirmation to the parties would have been appropriate, leaving no doubt regarding any continuing responsibility, and the forthcoming 90 day deadline.

While we could review numerous examples, think of your own practice, and consider whether an engagement letter could likely eliminate a claim being presented:

— An engagement for corporate returns when the client is supposedly filing the payroll or sales tax estimates;

— A new tax client may have a refund owed from prior years, or an amended return may be appropriate, and there is no access to prior returns;

— A corporate client doing business in more than one state, requiring multiple state returns; and

— An individual client where residency may be an issue requiring multiple state returns.

A well drafted engagement letter defines what an accountant is specifically responsible for and also provides limits on the scope of the engagement. Sample engagement letters are available from the AICPA and some state societies. For loss prevention, a tax return only engagement letter should, where appropriate, include the following:

1. A preamble that the engagement letter confirms the terms of the tax engagement understanding between the CPA and the client;
2. A listing of specific returns (and their frequency) that the CPA firm will prepare (the CPA should name the state and federal returns rather than using phrases such as "all state and federal tax returns");
3. Identification of organizer, worksheets or schedules that the client should use in providing information to the CPA;

3a. A list of documents to be sent to the CPA;

4. An assertion that the client will provide true, correct and complete information;
5. A declaration that the CPA will not verify the client's information, and that the CPA may require clarification or additional information;
6. Warnings that: a) taxing authorities may examine returns; b) documentation should be retained to support the information provided to the CPA, especially travel and entertainment expenses, use of vehicles and other "listed property" and barter transactions; and c) penalties can be imposed on tax returns that are late, underpaid or inaccurate;
7. Statements describing how fees and other charges will be calculated, when payment is due, and that additional fees will be charged if the CPA is asked to assist or represent the client in a tax examination or inquiry;
8. Notification if the CPA will use an outside computer service. This can affect the degree of confidentiality of the client's information;
9. An assertion that the client is responsible for timely payment of quarterly payment vouchers;
10. An alert that a copy of joint tax return will be provided once requested by either spouse;

10a. A warning that spouses filing a joint return cannot later amend if they wish to file as married filing separately, but married filing separately status can be amended to allow a joint return

(10 and 10a apply when there is strain between spouses or they are separated)

11. A statement that the CPA will contact the client if new information that affects a tax return is discovered by the CPA and that the client has a similar responsibility to alert the CPA of any information that would lead to a change in a tax return;
12. A statement that the CPA is not responsible for a disallowance of deductions, or inclusion of additional income, or any resulting taxes, interest and penalties;
13. The duration of the agreement;
14. An indication of extension procedures and the date preferred for providing information to the CPA;
15. A signature block for the CPA; and
16. An acceptance of the engagement letter terms and a signature block for the client.

" In My Opinion ... "

— Lessons from the Courts

by
Lawrence A. Wojcik

Documentation, documentation, documentation. Tired of hearing about it? Don't have the time to do it? It's just not in the budget? Several recent court decisions provide new incentives for practitioners to pick up that pencil and become the historians of their relationships with their clients.

Although large-scale securities frauds make the news, it's the garden variety embezzlement cases which continue to haunt most firms. Whether it be audit, review, compilation or monthly book-keeping services, CPA's continue to face claims from their clients when defalcations are uncovered.

Last year, Maryland's highest court dealt with a typical embezzlement situation. The case involved a claim of malpractice brought by a jeweler against its CPA for failure to detect embezzlements by the store's cashier in a non-audit engagement. The jury found that the plaintiff was contributorily negligent in causing the loss and the accountant prevailed. However, on appeal, the jeweler convinced the appellate court that it justifiably relied upon the CPA. In reversing the trial court, the appellate court stated:

The difficulty with (the accountant's) position is that the facts surrounding the contributory negligence issue are such that those upon which (the accountant) relies to prove (the client's) failure properly to supervise its employee could also support (the client's) position that it was relying on (the accountant's) skill and advice in determining how it supervised its employees. Indeed, at oral argument, it was conceded that, when (the client's wife) began to suspect the cashier of stealing, that fact was brought to (the accountant's) attention and at least (the client's wife) followed through on the advice he gave her, i.e., to keep an eye on her.

The CPA appealed to Maryland's court of appeals, the state's equivalent of a supreme court. Maryland's highest court reversed the appellate court's decision and reinstated the jury verdict in favor of the CPA. In doing so, the court specifically pointed out that although in some cases accountants may be employed for the very purpose of detecting possible defalcations, there were other cases in which the accountant's employment was more limited and did not necessarily include searching for misappropriations. The court observed that the scope of the accountant's undertaking had a direct bearing on how much reliance a client could place upon the advice of a CPA. In discussing this proposition, the court stated:

The client, however, should not be permitted an absolute and unqualified right to rely on the accountant's advice and thereby be completely insulated from responsibility for his or her own shortcomings. For example, we do not believe that an accountant's negligent failure to report shortages completely insulated the client who consistently leaves the company's cash unattended and fully accessible to all employees and customers. The fact finder should consider the client's reliance on its accountant as an integral part of the determination of whether the client took reasonable actions to protect its interest. That is quite a different prospect from requiring the fact finder to absolve the client from responsibility for its losses if it has relied on its client.

In finding that the scope of the CPA's duties did not include the detection of fraud, Maryland's highest court cited the CPA's language in the engagement letter:

...(The CPA) sent (the client) an annual engagement letter which informed it that his services did not include an audit and would "not be designed and cannot be relied upon to disclose fraud, defalcation or other irregularities." The letter went on to state that he would inform the business "of any matters that come to our attention which cause us to believe that the information furnished us is not correct." Under these circumstances, a client may be less justified in relying on its accountant than in a situation where the accountant has been employed to protect against the risk of a specific harm, i.e., hired to do a fraud audit to protect against the possibility of an embezzlement. In addition to the engagement letter, the court cited the CPA's testimony that at yearly meetings in 1983 and 1984, the CPA pointed out his concern that employees might be stealing from the business. It was during these meetings that the CPA cautioned his clients to "keep your eyes open." Although the court acknowledged the CPA may have failed to report suspicious discrepancies in the books and records of the jewelry store, the court held this was not sufficient to excuse the owners from looking out for their own interests.

The court pointed out that the jury most likely concluded that under similar circumstances, a prudent person would have further investigated the activities of the cashier and that the jewelry store's loss was not the result of reasonable reliance on the CPA.

This decision teaches important lessons. It underscores the need for engagement letters. The reference to the language in the engagement letter demonstrates how a court can attach great legal significance to a CPA's disclaimer of any responsibility to detect fraud. Accordingly, the language indicating the CPA's services are not designed and cannot be relied upon to disclose fraud, defalcation or other irregularities should be inserted in most, if not all, engagement letters. However, such a disclaimer should not be watered down with any suggestion such as "if I see it, I'll let you know." The disclaimer should stand on its own terms. In

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In My Opinion ...
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regard to audit engagements, the auditor should indicate that although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities.

Such language is critical in engagements that do not involve the preparation of financial statements. For example, CPAs are routinely retained to prepare corporate tax returns for business entities on an annual basis. In such engagements a CPA is often required to first post the year's transactions to generate a general ledger and trial balance. In such a situation, it is clear that the CPA is doing more than just basic tax return preparation. However, the nature and scope of the accounting services provided are often subject to misinterpretation by the client. Without documentation of the scope of the engagement, it is virtually impossible for the CPA to protect himself against a claim down the road that more than tax preparation was involved. In Griffith Motors, Inc. v. Parker, such a situation existed. Griffith Motors sued its CPA for failing to detect that an employee was creating false and fictitious bookkeeping entries to cover the employee's theft and check-kiting scheme. Although the CPA contended he was doing only tax return preparation, the court pointed out that the client was under a different impression. After first noting that the CPA had provided all of the accounting services for the business, as well as the business' owner, the court stated "there was never any informal or written contract for the accounting services."

Nevertheless, the court went on to discuss whether the CPA would have any responsibility even if only tax return preparation was involved:

" But even should we accept the Defendant's contention that the contract was merely for preparation of income tax returns, there is disputed proof as to whether the accountant should have sought additional information at (the embezzler's) insistence that a year-end adjustment of $326,000 was proper, especially when this sum is compared to none or relatively modest ones in most of the prior years."

As one might expect, the plaintiff was able to employ an accounting expert to testify that under standard tax procedures he would not have made the adjustment without (1) verifying the reasons or basis for the adjusting journal entry, and (2) calling the overdraft situation in the bank and journal entry to the attention of the business owner.

Although not even a written disclaimer in the engagement letter might have protected the CPA, it certainly could have assisted his defense and his ability to place some of the blame upon the owner of the business. The court was faced with contradictory statements regarding the scope of the CPA's services, and expert testimony that professional standards required the CPA to speak up. The CPA lost.

Apart from the obvious lessons, one should note that if a situation arises requiring disclosure to the client of an event or condition which could result in an embezzlement or defalcation, such disclosure should be confirmed in writing. Once the management point is made, the accountant must continue to make that observation as long as the condition exists. Although repetition may be futile with some clients, it is vital to the accountant's protection.

Management representation letters have also been viewed as significant by the courts. In Beiger v. Price Waterhouse, the trustee for a bankrupt client sought to hold the accounting firm liable for breach of contract in the performance of its audits. The accounting firm argued that the client provided false and misleading information as part of its massive fraudulent scheme to inflate the value of the corporation and hide the company's true financial position. In granting summary judgment to the CPA firm, the court held that the client had lied to the firm in its management representation letter. The court pointed out that the engagement letter between the parties required that the engagement would be performed in accordance with GAAS. The court determined that the client had, indeed, provided false and misleading financial information, therefore breaching a material provision of its contract with the firm.

The case is also significant because it held the trustee in bankruptcy bound by the acts of the corporate officers prior to bankruptcy.

Practitioners should incorporate into their engagement letters a statement that the auditor will not release its report until such time as it receives the management representation letter containing a specific acknowledgment by the company's management that it is responsible for the fair presentation of the financial statements and that it must affirm the truthfulness of the information it provides to the auditor. Thus, it is clear at the outset of the engagement that the management representation letter is, itself, a material element of the contract.

Decisions such as these clearly underscore the importance of documentation and disclosure in defending malpractice claims. CPAs, through their working papers and related engagement documentation, are afforded a unique opportunity to record history for courts to review in the future. This opportunity should not be missed. Practitioners must keep in mind that their own clients remain the most likely plaintiffs in a lawsuit. Although oral testimony is, at times, persuasive, it rarely rises to the level of reliability of a writing, especially a writing exchanged between parties at the time the discussions or events took place.

Make the time to document.

Mr. Wojcik is a CPA and a partner in the Chicago law firm of Keck, Mahin & Cate.

Confessions of a Bare Accountant

by
David L. Stevens

As we approach the upcoming busy season, I see and hear my tax preparing brethren hurriedly organizing their offices for the deluge: ordering forms, updating software, and studying the nuances of the latest tax law.

A few weeks ago I had lunch with a colleague who, in addition to all the above, is checking the fine print of his professional liability insurance. He is double checking the coverage for all the services his office will offer this year. During lunch he told me why he pays close attention to the details.

In the summer of 1987 he let his professional liability insurance lapse. The carrier had recently doubled the premium and then informed him they were no longer insuring firms of his modest size. He had dutifully paid the premiums for eight years without a hint of legal action. He had received a new quote for $5,000 annual premium to cover his write-up and tax-practice with a $5,000 deductible. He felt it wasn't worth it.

Later in 1987, a two-year business compilation client received notice of an audit from the IRS for his 1985 personal tax return. The client's prior accountant had prepared all of the personal returns. The audit went poorly. The IRS initially determined that the client had under-reported personal income by $15,000 in 1985, 1986 and 1987. The IRS assigned a special agent to pursue matters.

My friend referred his client to an attorney experienced in this type of case. Two weeks later my friend received a call from an attorney who was very abusive over the telephone. The client had hired the attorney to sue my friend.

The client and his attorney engaged a separate CPA to reconstruct the three years of records and meet with the IRS. A determination was made that the client owed $25,000 in taxes and $15,000 in penalties. A suit was filed against my friend for $75,000. My friend hired an attorney who stalled. He finally engaged a prominent litigator from a high profile firm. They then hired a Big 6 partner who concluded that all standards had been met or exceeded. A recognized ethics expert agreed with the partner. All involved on my friend's side were confident that he would win the case. At this point, the legal fees exceeded $20,000.

After discovery, the plaintiff dropped his claim to $45,000. My friend's attorney said that in order to go to court, it would cost an additional $20,000. Under Colorado law it would have been very difficult to win a claim for legal expenses. The attorneys negotiated a settlement of $12,000. The total cost to my friend was in excess of $32,000. The settlement occurred nearly a year ago. My friend still owes $12,000 to his attorney and the expert witnesses. It should be paid off next year.

Two years ago he found a new liability insurance carrier. The cost for a $5,000 deductible policy is $1,200 per year.

The moral to this story is that, had my friend had liability insurance, his cash outlay would have only been the $5,000 deductible. The insurance carrier would have hired the attorneys and managed my friend's defense. And, finally, the settlement would have been paid through insurance. My friend says he learned a valuable lesson through his experience. I could only nod my head and thank him for sharing.

Mr. Stevens is a member of the Colorado Society of CPAs Insurance Committee. This article is re-printed with permission of the Colorado Society of CPAs.

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 them to:

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

Q: My liability insurance plan is often referred to as "the AICPA Plan". I know the carrier is now CNA and the broker/administrator is Aon Direct Group. What exactly is the AICPA's role in my liability insurance?

A: The AICPA Accountant's Professional Liability Insurance Plan is referred to as such as the AICPA actively endorses the Plan and has done so since 1967. Specifically, the AICPA Plan is governed by an appointed committee of AICPA members "who are entrusted to assure the availability, at reasonable rates, of an insurance program to local and regional firms which would assist them in defending against claims of negligence in their practice and to underwrite the costs at any recovery where such claims are found to be valid." (Source: AICPA Committee Handbook)

The Committee meets at least quarterly with both the underwriter and the broker to review the AICPA Plan in detail. Service standards to AICPA insureds, loss statistics, premium rates, and individual complaints are some of the topics discussed at these meetings. Additionally, AICPA Plan insureds can contact Committee Members at any time for information or to voice a complaint.

More information on the AICPA's role in the professional liability plan can be found in the following article.

Your Professional Liability Insurance Plan Committee

by
Leonard A. Dopkins

The AICPA Committee Handbook sets forth the objective for the Professional Liability Insurance Plan Committee as follows: "To assure the availability, at reasonable rates, of an insurance program to local and regional firms which would assist them in defending against claims of negligence in their practice and to underwrite the costs at any recovery where such claims are found to be valid."

The Committee is currently made up of 7 members of the American Institute of Certified Public Accountants (including the Chairman). The Committee selection process for this group deliberately identifies a diversity of members in public practice (or retired from public practice) whose firms are of the size and character of the insureds in the program. Members of the Committee are sole practitioners, small local firms, large local firms, and regional firms with several offices. Members generally are or have been the managing partner of their firm.

These are CPA's who in their practice have coped with the problems of obtaining insurance at a reasonable cost with limits of coverage that make them comfortable. They have also faced the problem of escalating premiums and, in some cases, the problem of defending against claims—be they with or without merit.

The Committee views its mission as that of a watchdog looking out for the interests of the approximately 11,000 firms insured in the program. The Committee meets at least quarterly with the broker, Aon Direct Group, Inc., and the underwriter, CNA. We constantly monitor the service of both the broker and the underwriter in the issue of policies, as well as their response to inquiries from member firms. To this end, we receive statistical data as to the number of policies being currently issued, the delays in issuing certain policies, if any; surcharges over the standard premium rate and the reason therefore; etc. We have been very pleased with the continued improvements in limits being offered and can relate that to the reinsurance being purchased; and finally and very importantly, each year the Committee must approve the rate that will be charged to our insureds for the succeeding year. The Committee is pleased that rates have either remained constant or actually decreased for the past six years of the Plan.

Your Committee is continuously evaluating the professional liability insurance product being offered to our members as to cost, coverage and service levels in order to provide the best available program and we are available for your questions and input.

Mr. Dopkins is Chairman of the AICPA Professional Liability Insurance Committee

AICPA Introduces
New Automobile and Home Insurance Program

The AICPA is pleased to introduce the new AICPA Vehicle and Home Insurance Plans. This exclusive, members only program, underwritten by National General Insurance Company (NGIC) of St. Louis, Missouri, was developed to provide members with safe-driving records complete, affordable vehicle and home protection.

Intensive research and screening went into the selection of NGIC. Many important factors were looked at in comparing companies, and NGIC came out heads above the rest.

NGIC, a General Motors Insurance Company, is committed to rewarding members of associations with the complete vehicle protection they need and the affordable rates they deserve. Readers of a leading consumer reporting magazine ranked NGIC among the top five insurance companies in overall customer satisfaction. NGIC has earned an A+ (Superior) rating from A.M. Best Company, a leading analyst on the financial health of insurance companies.

One big difference you'll see with the AICPA Vehicle Insurance Plan is that you won't be lumped in with the careless drivers on the road when it comes to figuring rates. This members-only plan bases its rates on the safe-driving experience of mature, responsible AICPA members.

The AICPA Vehicle Insurance Plan offers complete protection for your cars, pickup, vans and RVs, with convenient, toll-free service hours—including a 24-hour toll-free emergency claims hotline. That means no matter where an accident happens, the help you need is as close as the nearest telephone—guaranteed.

In addition to the new AICPA Vehicle Insurance Program, a complete home protection package is also available to AICPA members. Watch for future articles about the AICPA Vehicle and Home Insurance Plans. And watch your mail for complete details on both plans.

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***

Another Victory in the Courts:
California Further Limits Accountant Liability.

The California Court of Appeals recently ruled that lenders to an accountant's client may not maintain a negligent misrepresentation claim against the accountant, based upon the accountant's audit of the client. In its ruling in *Industrial Indemnity Co. v. Touche Ross & Company*, the appellate court determined that the rule adopted by the California Supreme Court in *Bily v. Arthur Young & Co.* applied retroactively.

In *Bily*, the California Supreme Court held that an accountant's liability arising from an audit of a client is governed by the Restatement of (Second) Torts, 552. Under that rule, an accountant is liable to a third party only if the non-client is a member of a limited class of persons for whose guidance and benefit the supplier intended to supply the information and only if the transaction is one the accountant intended to influence. As such, accountants are not liable to third parties for general negligence.

In *Industrial Indemnity*, the California appellate court determined that *Bily* should apply retroactively because it did not overrule prior decisions of the California Supreme Court. In its decision on *Industrial Indemnity*, the court also found that retroactive application of *Bily* would be consistent with *Bily's* goal of preventing liability out of proportion to fault.

The California Court of Appeals then determined that the *Bily* decision was applicable to the facts at bar. There was no evidence at the time that Touche Ross issued its opinion that it knew that its client intended to use the opinion to obtain a loan. Instead, the loan at issue was negotiated after Touche Ross had issued its audit opinion and the lender obtained the audit opinion from the borrower, not from Touche Ross. The evidence did not demonstrate that Touche Ross consented to, or even knew about, its client's submission of the audit opinion to the lender. The court concluded that the plaintiff, a lender to a customer whose financial statements are audited by an accountant, was not a member of the limited class who is entitled to recover from an accountant for negligent misrepresentation.

About the New AICPA Professional Liability Insurance Plan

As you may know, the AICPA has named Continental Casualty Company, one of the CNA Insurance Companies, to underwrite the AICPA Professional Liability Insurance Plan.

CNA offers insureds essentially the same coverage as previously offered by the Plan, but at more competitive rates.

To help Plan insureds further reduce their premiums, CNA sponsors a series of Loss Prevention Seminars. Approximately sixty of these seminars are scheduled for 1994. Accounting professionals who attend a seminar earn credits towards their firm's professional liability insurance premium and can earn up to four hours CPE credit, depending upon state regulations.

The premium discount can be as high as 7.5% a year for three years if all accounting professionals in the firm attend.

To help make the transition easier, most insureds will be eligible at their next renewal for an abbreviated underwriting process developed by CNA and Aon Direct Group. Additionally, Aon Direct Group, the Plan's national administrator since 1974, has organized a network of local plan representatives to ensure the most prompt and personalized services available.

The AICPA hopes you find the CNA program attractive and elect to continue with the AICPA Plan.

Rollins Burdick Hunter Direct Group is now Aon Direct Group

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