AREAS OF RISK AND MITIGATION

GENERAL INFORMATION

- The risk of litigation can be managed through the use of initial client screening, limitation of services provided, and through the production of high-quality work.

IDENTIFYING AREAS OF RISK

- In addressing risk areas, the parties that can potentially bring a lawsuit and the grounds upon which such parties can bring a lawsuit should be identified. Then, the risks should be evaluated to determine the costs and benefits of the risk. Finally, risks should be quantified and a likely range of loss in dollar figures should be established.
- Additionally, the principal areas of business risk should be identified. Risk comes in the following forms:
    - Litigation
    - Sanctions imposed by public or private regulatory bodies
    - Impaired professional reputation

SPECIFIC RISKS

Tax Claim Risks

- **Incomplete or Incorrect Documentation from the Client Relating to Extension Payment Calculations**
    - Claims can arise in the area of tax payment where all the information required to determine the correct amount due has not been provided by the client. At some point in the future when the CPA has the actual tax data that was previously not provided, the client owes a higher tax amount, along with late-payment penalties, because the client's previous estimates were grossly underestimated. In such cases, a client may often demand that the late-payment penalties be paid by the CPA.
        - **Risk management plan**: the client should be sent the extension form along with a written confirmation of the information provided by the client which was used in calculating the extension payment. Prior to the deadline, the client then has the opportunity to review the information and correct any erroneous information or provide additional information. The written confirmation constitutes evidence of the representations made by the client as to the tax data should a late-payment penalty be incurred.

- **Non-CPA Return Preparer**
    - If the return preparer is a non-accountant, disclosure to the client of that fact is necessary. The specific engagement letter should identify the individual's qualifications who will be preparing the return. If the qualifications of a non-CPA are not identified, the client may believe the preparer is an accountant, which could form the basis of a subsequent claim for fraud, or could broaden the scope of the duties owed to the client by the firm.
        - **Risk management plan**: provide disclosure of non-accountant return preparers in the initial engagement letter.

- **Estate Tax-Return Issues**
  - Missed estate tax-return filings can occur based upon the irregular filing deadline for such returns, which is based on the date of the decedent's death. Late-filing penalties can exceed $100,000 because of the relatively high tax amounts typically reported on these returns.
    - **Risk management plan**: implement a calendaring system for estate tax-return deadlines. [*See* materials provided on Tax Filing Deadlines and Recommended Calendaring Systems] If a calendaring system has already been implemented, use the system. Additionally, the following should be avoided to the largest extent possible:
      - practicing or providing services in a hurried fashion,
      - failure to perform due diligence where appropriate, and
      - practicing by rote.
  - Late-payment penalties can be incurred by CPAs who do not know that an extension for payment request for estate taxes requires a separate portion of Form 4768 to be completed; such an extension for payment is not automatic and requires reasonable cause to be demonstrated. The IRS can exercise discretion as to the granting of an extension for payment.
    - **Risk management plan**: request a payment extension far in advance of the due date for the estate tax payment deadline in the event that the estate tax payment extension request is denied by the IRS.

- **Deductibility or Non-deductible Expense Issues**
  - Incorrect advice given to a client relating to the deductibility of expenses or the inclusion of non-deductible expenses on a client's tax return can result in potential claims by a client. In addition to client claims, this scenario could give rise to an investigation by the accountant's local board of accountancy and the Office of Professional Responsibility, resulting in sanctions or other penalties for the tax preparer, or disbarment.
  - Although an accountant is not required to audit a client's business activities, an accountant must act with reasonable diligence in the preparation of tax returns.
    - **Risk management plan**: ensure that the tax data organizer clearly states that it is not the accountant's responsibility to audit a client's business activities. Additionally, the tax data organizer should contain a client provision that states that the business expense items contained in the client's records are ordinary, necessary, and reasonable. A provision should be included that states that the client represents that the client has adequate records or reasonable documentation to support amounts of expenses and that such expenses were actually incurred in the normal course of business. The tax data organizer should be signed by the client. Where an accountant knows or has reason to know that an item listed as a business expense is actually a personal expense, or that the expense was not actually incurred, the expense should **not** be included on the income tax return, and the client should be advised that the expense is non-deductible. Such advice should be memorialized in writing. If the client

still insists on classifying personal expenses as business expenses, the relationship should be terminated through the use of a disengagement letter, which memorializes the termination.

Other Risks

- **Choice-of-Entity Issues**
  - Selecting the appropriate organizational form in which to conduct a business enterprise's activities can have complex and profound consequences for new and existing business.
  - Claims arise where the CPA, rather than the client, chose the entity deemed best and failed to memorialize the advice given to the client regarding the choice of entity.
  - The entity selection must be made by the client, not the CPA. The CPA should provide the client with the pros and cons for each entity applicable to the client's needs, but leave the ultimate decision to the client.
    - **Risk management plan**: the advice provided and the client's choice should be thoroughly documented and memorialized. In the event of some unforeseen future event, such documentation will prevent a client from later asserting that some other entity selection would have prevented or better addressed that unforeseen future event. A complete list of all available entities, including each entity's positive and negative aspects, should be provided to the client and the date and information provided should be documented. The client can then make an informed choice as to entity selection.

- **Disclosure of Confidential Information**
  - Disclosure of confidential information to third parties is limited in the absence of certain exceptions or conditions such as in response to a search warrant, subpoena, or with the client's written consent and is prohibited by professional rules, state accountancy boards, and the IRS.
  - Compliance with a subpoena that is invalid based on a technical reason may place the accountant at risk for a regulatory or ethical violation.
    - **Risk management plan**: seek legal advice regarding whether and how a subpoena should be responded to before complying with a subpoena.

RISK MITIGATION

Generally

- Risk can be mitigated through an accountant or firm's careful consideration of whether to accept and perform a specific engagement.
- Contract language for a given engagement can be carefully worded and legal consultation in contract drafting should be obtained for any customization of a contract.
- As soon as you discover a client's illegal or unethical conduct, or as soon as you reasonably believe that a client may bring suit, contact your insurance carrier and/or a lawyer.

- Recognize that the accountant-client privilege and the federal tax law accountant-client privilege in Section 7525 are limited. Neither privilege can be invoked in criminal proceedings, and the privileges are construed narrowly in other situations. The privileges should not be relied upon without legal counsel in respect to dealings with the IRS, Department of Labor, or other federal and state agencies.

Contractual Provisions Limiting Liability

- An accountant **cannot** contract out of liability for intentional wrongdoing; in such a case, a punitive damages waiver will be ineffective.
- Where an accountant performs ordinary commercial services, including consulting work in the context of nonattest engagements, language in the engagement letter that limits liability will likely be enforced because there is no public interest at stake.
- However, where a CPA operates in a licensed firm performing attestation services there exists a strong public interest in such an engagement, which likely means that clauses limiting liability will be disallowed.
- The relationship between an auditor and a client is not fiduciary relationship.
- Where the client of an auditor is publicly traded, or a financial institution, or an insurance company, the use of language limiting liability is addressed in certain applicable laws and/or regulations, and such engagements are subject to regulatory oversight. The applicable regulation should be consulted in regard to language limiting liability in engagement letters.
- If a client is a business which falls outside of the regulatory scope and the engagement is for nonattestation services, a liability-limiting clause will likely be upheld as written if the language does not offend public policy.
- It is prudent to check with a local attorney to identify specific state board or state society requirements or restrictions regarding limitation of liability.

Complete Immunity

- Contract language or clauses providing complete immunity for an accountant will likely **not** be upheld by a court.
- The SEC does not allow language providing complete immunity from liability for an auditor's negligence. The SEC has found that such an indemnity agreement impairs the auditor's independence.

Punitive Damages Waivers

- Punitive damages waivers are sometimes used in an effort to limit or eliminate damages for deliberate or reckless wrongdoing.
- Courts will **not** enforce a punitive damages waiver because such a waiver seeks to limit or eliminate liability for intentional or reckless misconduct.
- Effectively, inclusion of a punitive damages waiver will provide no protection from liability.

Alternative Dispute Resolution (ADR) Provisions

- ADR refers to mediation or binding arbitration where a mediator or arbitrator aids in attaining a settlement.

- ADR is appropriate for client disputes, but an ADR provision is not binding on third parties who may have a dispute.
- Some uncertainties, such as venue, can be avoided through ADR provisions, and ADR is often less time consuming and less expensive than resorting to the court system.
- ADR provisions generally do not impair the independence of the accountant.
- Clauses containing ADR language are likely to be upheld by addressing courts.
- Such provisions provide a simple and effective means of approaching malpractice litigation.
- ADR clauses that are not unconscionable should be included in engagement letters.

STEPS TO TAKE IF YOU ARE SUBJECT TO A CLAIM

Immediate Steps for Client or Third-Party Claim

- Inform your management representative of the claim and contact your insurance carrier to give formal notification. Follow the precise procedure as stated in your insurance policy.
- Retain an attorney. This should be done immediately so as to invoke the protections afforded under the attorney-client privilege.
- Do not ignore a claim.
- Do not attempt to contact the client or third party that has brought suit. What you say will be used against you in litigation.
- Do not destroy any documents. Doing so will likely be construed as spoliation of evidence and can cause substantial problems with severe consequences.
- Do not discuss the claim with co-workers or other individuals and do not seek a second opinion. Those discussions and opinions are not privileged and are discoverable in litigation by the opposing party.
- Do not send your client a letter or memo acknowledging error or fault. Such a letter or memo is discoverable in litigation by the opposing party.
- Do not alter, supplement, or update any previous work documents.

AICPA or State Board Investigations

- The AICPA and state accountancy boards are required to follow up on complaints received, regardless of whether a complaint appears frivolous.
- Your insurance carrier should be informed of the notice from the regulatory body, and if necessary, a lawyer should be consulted.
- Upon receipt of the notice of complaint from the regulatory body, a compelling letter should be drafted by you (or by your lawyer) responding to any questions contained within regulatory body's letter. Additionally, the tone of your letter should be respectful, and the letter should contain a statement of your position and the reasons for your belief that your client was not caused any harm.
- Ensure that any deadlines contained within the notice are met with compliance. Alternatively, if an extension is needed to reply to the notice, call the regulator to request an extension. Make sure that you memorialize any extension granted in a letter to the regulator.
- Before sharing or disclosing client information, request clarification from the regulator as to whether the regulator has obtained permission from the client for you to share

confidential client information in response to the complaint. Do not contact the client yourself to inquire whether permission has been granted.

- Many of these complaints and the investigations by the regulatory body will likely be closed. Many stated accountancy boards and the AICPA will send you a letter informing you that their investigation of you has been closed.
- If your responsive letter to the regulatory body is insufficiently convincing, then a full, formal investigation of you may take place and culminate in an administrative hearing. If the situation progresses beyond your initial responsive letter, an attorney should be consulted.