MINIMIZING THE LEGAL RISKS OF CPA PRACTICE

PART ONE

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The public practice of accountancy has inherent liability risks that can be planned for and minimized, but not eliminated completely. The reality in this day and time is that a CPA in public practice faces the real possibility that he/she will not complete years in the practice of accounting without being sued by a client or others. Claims and lawsuits result in loss of billable hours, adverse publicity, the cost of litigation, the potential for grievances with regulatory bodies, and the cost of settlement of the claim.

We have written this article from the perspective of attorneys who represent CPAs in our legal practice. We do not here purport to present the rules under the CPA professional or peer review standards, but we are convinced that following those professional and peer review standards rules is an important factor in reducing risks. It is our goal in this two-part article that the reader will find actions to be taken (and avoided) to reduce the risks in his/her accounting practice. The first part will address primarily practice structure and operational issues; the second part will focus on legal liability and issues that can arise once a claim is made.

PROFESSIONAL LIABILITY INSURANCE

Your chances of being sued are real. A lawsuit, if not settled before trial, will wind up before a judge or a jury for trial. It is critical that you plan for the costs of the process, including legal costs and settlement costs. Your planning should include

malpractice (or "errors and omissions") insurance. When you purchase such insurance, there are many variables and details you must consider and negotiate. You and your insurance agent should fit the policy and its cost to the needs of your practice.

Some CPAs think that if they do not buy malpractice insurance – "go bare" – they will be an unattractive target for a lawsuit. That is, they believe that by buying insurance, they *become* an attractive target for a lawsuit. This is a risky position. First, most litigants will not discover that the CPA has no insurance until after the suit is filed and goes on for some time. The CPA bears the cost of the defense in the meantime, so the money "saved" by not buying insurance (and usually some more money besides) will be spent. Second, most claimants and their lawyers will not believe the assertion of no insurance since the common practice is to carry such insurance. Third, some clients will be wary of engaging a CPA in the first place if the client discovers the CPA carries no insurance, since this may be viewed as an indication of lack of quality. Fourth, this "poverty" defense has a chance of working only if the CPA and his/her firm and partners really are broke, an unlikely event because of the existence of current and future receivables unless the CPA is very unsuccessful in practice. And fifth, even if there is no insurance, the claimant can still file a complaint with the Texas State Board of Public Accountancy (State Board) before, during or after the lawsuit – and perhaps with an adverse jury finding if the CPA loses the trial – and invoke disciplinary action based on the malpractice.

Regardless of the merits of this issue, reality is clear: lawsuits are expensive to defend. If you do not have the resources to defend the lawsuit, the results of it are likely to be costly. Once a lawsuit is filed, the cost of defense can easily mount up into the hundreds of thousands of dollars. Planning to provide resources to meet this cost are critical and essential. If you cannot afford to defend a suit, you will lose. There are monetary costs to a loss, as well as the consequent report to, and action by, the State Board that will require a defense.

COMMON MISTAKES IN PRACTICE

There are common mistakes made by CPAs (regardless of how experienced they may be). The first deadly mistake is the failure to make a deadline. Management systems to avoid this type of mistake are a critical part of any well-run practice, but used alone are not the best practice. Do not get caught in the trap of practicing in a hurried mode and performing work by rote, relying on computers and check lists, and failing to step back and ask critical questions or perform appropriate due diligence. Such practices lead to unhappy results.

You must be frank with your boss and your clients both as to what expectations your boss and the client should have, and the limits of your performance. Failing to so communicate with clients is a common mistake that often leads to claims for malpractice. Consider also the failure to be frank with your boss or your clients regarding mistakes made. Frequently, if a mistake is made, and the mistake and any corrective actions are dealt with promptly and forthrightly, the mistake has a way of resolving itself without harm to the client or to the CPA. Inevitably, a cover-up will create a bad consequence. The corollary of a staff person failing to be frank with his/her boss and co-workers is the failure of the boss to supervise staff. It is the supervisor's responsibility when errors occur because of lack of supervision and clearly, the professional standards require proper supervision and management of staff; merely checking the box does not fulfill this requirement.

In connection with all attest function work, written fee agreements are now required by the professional standards. Although this is not true in other areas of public practice, failure to obtain written fee agreements that define the scope of the work and the basis upon which fees will be charged, as well as setting forth the expectations on client cooperation, can (and does) lead to ultimate misunderstanding, disagreement and expanded claims by clients of failure to do work that the CPA did not agree to perform. An engagement without a written fee agreement is that much more difficult to defend.

Many CPAs may fail to be frank not only with the client, but also with himself/herself as to whether he/she has sufficient experience and training regarding the work involved in the engagement. Practicing in an area where you do not have requisite knowledge or experience is a sure formula to making an error that will lead to a malpractice claim. Do not undertake an assignment that you are not competent to complete without seeking additional guidance or qualification.

Getting along with clients is critical. If you are not comfortable with (or do not trust the ethics of) a client, you should consider whether retention of that client is appropriate. Such issues with a client frequently lead to the CPA failing to do his/her best work and failing to communicate with the client. Avoidance of communication with a client can lead to a malpractice claim. It is a practice likely to lead to sanction by the State Board should the client complain to that body. A common effect of failure to maintain a good relationship with a client is the client does not pay. This can lead to the most likely way to draw a malpractice lawsuit and a complaint to the State Board – sue a client for a fee.

There is frequently pressure for billing to achieve financial goals set by a firm. A common mistake is yielding to the temptation to write down excessive time to placate your boss or deal with the pressures of the situation. This is a sure way to create problems with clients.

Finally, in the context of common mistakes, the failure by many CPAs to read and understand admittedly complex rules of the American Institute of CPAs (AICPA) Professional Standards and other standards, such as Circular 230 and Section 6694 of the Internal Revenue Code (IRC), can leave the CPA open to performing work in a non-ethical manner, notwithstanding the CPA's view of himself/herself as an ethical person. Merely understanding the general ethical rules in our society does not translate into an understanding of the specific requirements of CPA ethical standards applicable in particular fact patterns.

continued on next page

MINIMIZING LEGAL RISKS

continued from previous page

CLIENT BASE CONTROL

Many claims arise because a CPA accepts, or fails to terminate, high-risk clients. If you develop an area of expertise and limit your practice to clients' needs in that area, you are reducing the risk of the types of mistakes that are created by unfamiliarity with the work to be performed. That is a good thing. But selecting the area or areas of practice and limiting work for clients to those areas needs to be modulated by understanding that certain types of industries and services carry inherently greater risk.

If you perform audits, particularly audits of certain types of businesses, such as financial institutions and construction companies, as well as audits of financial statements used in a public securities offering or private placement offering, you should first have a clear understanding of the inherent hazards together with an appropriate fee for undertaking such risk. This type of work for certain industries is too involved and too risky to undertake as a "loss leader." Audits of financial statements that are going to be submitted to governmental agencies where the agency exercises oversight over the form and substance of the audit (such as audits of pension plans where the Department of Labor may review in detail the auditor's workpapers) should be undertaken only with a clear understanding of the rules applicable to such audits and the fastidious attention to the detail required in the performance of such audits and issuance of financial statements.

Tax engagements also contain their own set of risks, including the potential for untimely filed tax returns (or the claim by the Internal Revenue Service that the return is not timely filed), S corporation planning and planning with respect to other complex tax issues, particularly in view of the ever-changing statute, regulations and rules in the tax area. All such work requires special expertise and access to research materials to properly perform the work.

An essential element of client base control is developing an adequate set of new client acceptance and client retention procedures that cover:

- the work to be performed;
- the personnel who will perform the work;
- the desirability of the potential (or existing) client;
- conflicts of interest;
- independence issues; and
- the potential client's history with other firms.

Due diligence includes background checks on management of significant clients and even the simple, but frequently overlooked, Internet search for information regarding the potential client, as well as its significant owners, directors and senior officers; this is an essential part of the process. Be wary of the prospective – or existing – client who withholds what seems to be important information. Do not be blinded by potential lucrative fees that may accompany the prospect for a new client when serious warning signs suggest future litigation hazards. No future fee is worth the potential of

future lawsuits and complaints filed with regulatory bodies. The CPA should also conduct a continuing analysis of whether an existing difficult client is worth the risk and cost of retaining that client.

FIRM ORGANIZATION AND MAINTENANCE

You should be very careful regarding whom you associate with in your practice. Before you form a relationship or join a firm with one or more CPAs, make sure that those CPAs maintain the same high standards of ethics and practice that you do. Guilt by association is certainly applicable to the practice of accounting. You should inquire about claims against your potential future associates. Who are their clients and are they desirable clients? Is the work that they do high risk and are you going to have problems with their liabilities? You need to look at their existing engagements, and how they track and bill time. In this context, a delay or refusal to supply information regarding such issues should be a definitive warning.

Management systems are critical to the maintenance of a quality practice and avoidance of situations that will lead to malpractice claims or complaints to regulatory agencies. These systems include deadline calendars, file retention and destruction policies, billing and account receivable systems, practices for retainers (particularly new clients), supervision systems, maintenance and updates of proper forms and form letters, and control over relationships of firm members that may lead to liability, such as activities as a trustee or executor, service as a for-profit or nonprofit corporate executive or director as an agent for service process. The firm should maintain a process for risk management, including access to legal counsel – remember, an ounce of prevention is worth a pound of cure. Prompt attention to the detail of required notices of potential claims to insurance carriers is a must.

When you cease to do work for a client, client termination letters are a critical step in limiting liability. Similarly, quality control systems to ensure independence, avoidance of conflict of interest, library maintenance, supervision of staff, hiring policies, control of continuing education, etc., are essential parts of the process to avoid claims. Obviously in this day and time, computer security (in office, portable USB drives and laptops) is critical; such security includes both physical security for the equipment, and password and encryption protection for software.

TRAINING

All CPAs understand State Board rules mandating that CPAs maintain their competency through continuing professional education (CPE) and reporting of attendance to the State Board. The State Board rules prohibit undertaking any engagement that the CPA cannot reasonably expect to complete with due professional competence.

Many CPAs schedule the cheapest CPE possible without necessary regard to how the CPE fits their area of practice or improves their competence. Such practices are a major mistake. You should consider the quality of any professional seminars and the relevance to your practice in completing your CPE requirements. Voluntary work with TSCPA, its chapters or AICPA frequently enhances the CPA's competence, and such enhancement can be used to develop more profitable and less risky practice.

CLIENT COMMUNICATIONS AND CLIENT RELATIONS

Clients frequently judge the competency of the work that the CPA does by availability for communication and ability to communicate. Failure to communicate with clients will frequently generate antipathy and cause the client to take adverse actions, such as to file a claim in a court or a complaint with a regulatory agency such as the State Board or the IRS Office of Professional Responsibility. Availability to take telephone calls, willingness to respond by e-mail, and to otherwise communicate with the client frequently will solve problems before they develop. Remember, however, e-mail is forever and great care should be taken as to how one communicates by e-mail.

Proper billing and collecting fees regularly is a critical component of communication. Your work performed does not become more collectable the longer you wait to bill it. A final note in connection with communication with clients is the need to provide clients with copies of work that you have performed and the portions of their files to which they are entitled without complaint or hassle. The State Board frequently receives complaints regarding CPAs who have refused to give clients their files or have delayed in returning communications to them and does not deal kindly with the CPA who treads improperly in this context. (Editor's Note: Please also see the article, "Got Ethics in TSCPA? The Professional Ethics Committee and its Role" on page 19 of this *Today's CPA* issue.)

ANALYZING YOUR PRACTICE FOR RISK

Before you can define the scope of your risks once a claim is made, it is important to undertake a risk management analysis of your practice and to conform your practice's operation to the best practices to minimize risk. Part two of this article will discuss issues for which you need advance information to complete the risk management process, including which issues may arise in the unhappy event that a claim is made. ■

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