

Most Losses Occur in Tax Practice

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Findings from a recent claims study conducted by CAMICO Mutual Insurance Company indicate that well over half of all claims reported by CAMICO-insured CPAs come from tax engagements.

The study, conducted in October 2005, included the claims experience of all of the insurer's nearly 7,000 policyholder firms in 44 states, focusing on the major causes and types of claims incurred by CPAs nationally. Tax was identified by the CAMICO survey as the most frequent type of claim, generating the largest total of claims dollars incurred, for two reasons:

the complex and continually evolving tax codes and issues regarding the engagement between CPAs and their clients.

"The technical nature of this area of taxation places most of the burden for decision-making on the CPA," says Ron Klein, vice president of Claims for CAMICO, the nation's second largest provider of professional liability insurance for CPAs. "There is usually a limit to how much the CPA can ask the client to decide in technical tax issues. It's much like a patient seeing a doctor about a serious, complex medical condition; the prob-

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lem and treatment are so critical that the patient will ultimately go with the treatment the doctor recommends.”

When it comes to investment advisory services, CPAs fall into *trouble* because they fail to perform adequate due diligence in determining the *potential* for investment fraud before any work is performed.

Klein also developed a helpful list of tips for CPAs as they enter tax season. See side bar on page 5.

CAMICO's survey of policyholders found the following practice areas to be of highest risk for liability claims: taxation, financial statements, investment fraud, and defalcation (embezzlement).

Taxation. Technical income tax issues are the primary area of loss, according to the study. In addition, S and C corporation elections are the next most risky, followed by estate planning.

Klein noted that tax professionals must be sure of their competency and ability to render the best advice possible for the client, and he cautioned about the potential for “engagement creep,” in which the scope of work expands significantly beyond the original engagement agreement between the CPA and the client.

“All clients and engagements should be re-evaluated on a regular basis, at least annually, to assure the firm is capable of performing the services required by the engagement and that the firm is practicing the services often enough to be proficient,” Klein says.

Financial Statements. In particular, financial statements involving audits, third-party creditors and occupational fraud are the second highest area of liability risk. Financial statement fraud has long been the leader in “severity” of claims, i.e., the greatest financial loss per incident, notes Klein. “The basic issue with financial statements for third-party creditors is that the client pays for the work, but the work benefits the creditor, placing the client’s interests and those of the creditor at odds with each other.”

Clients are often inclined to pressure the CPA to create statements that satisfy the bank, and as the process becomes more routine, the CPA becomes complacent and loses the skepticism necessary for a competent review or audit says Klein.

“A typical area of trouble is in the valuation of inventory or assets, where the CPA goes along with the client on how valuation is determined, which then results in a possible significant material misstatement,” Klein says. “The lender is left with an inaccurate view of the client’s business, and the CPA is exposed to liability for the misstatement, especially if the business fails.”

Investment Fraud. The third most frequent and/or severe area of claims involves investment fraud, which strikes in large dollar amounts and includes accounting services such as reviews, audits, tax and investment advice. When it comes to investment advisory services, CPAs fall into trouble because they fail to perform adequate due diligence in determining the potential for investment fraud before any work is performed.

“This is fundamental to engagement practice,” Klein says. “Obtaining background, credit and reference checks for the client and paying attention to client integrity and competency, or lack thereof, is essential if a CPA is going to make any investments on a client’s behalf or if giving advice about investments.”

Defalcation. Another area causing high losses is embezzlement by client employees, or occupational fraud, which costs U.S. businesses more than \$6 billion each year. Defalcation involves a variety of engagement types including all accounting services ranging from bank reconciliation services to audits as well as tax engagements.

Even so-called “low-level” engagements such as write-up, bookkeeping and bank reconciliations are plagued by this problem, exacerbated by client and public expectations of CPAs to always detect fraud and to advise and warn clients about potential fraud. Such expectations have increased dramatically since the accounting scandals in the early part of this decade.

CPAs cannot *possibly* detect all fraud, but they can focus on the *advice* and warning aspects of engagements.

CPAs cannot possibly detect all fraud, but they can focus on the advice and warning aspects of engagements. “The expectation to advise and warn is much less difficult than actual detection of fraud and is the heart of where the CPA can prevent losses to his or her practice,” Klein notes. “By carefully noting areas of exposure to loss and putting clients on documented notice about those areas, CPAs can reduce their own liability exposure stemming from unrealistic public and jury expectations.”

SKEPTICISM IS KEY

In all of the areas of exposure to claims liability, a basic remedy is professional skepticism.

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Risk-Reducing Advice for CPAs Entering Tax Season

CPAs wading into tax season should be aware of heightened exposure to liability as clients make crucial year-end decisions about how to manage tax liabilities for 2005, according to CAMICO Mutual Insurance Company.

Ron Klein, vice president of claims for CAMICO, says that the technical nature of the tax issues and the financial complexity of business clients can create heightened risk exposures for CPAs who provide tax advice and services for business clients.

In this environment, "the tax professional must be sure of his or her competency and ability to render the best advice possible for the client," he says. "In addition, there are a number of fundamental steps the CPA can take to mitigate the risks associated with tax work.

"In the realm of income taxation, the CPA's job is to advise and warn the client about alternatives and their possible benefits and risks," Klein adds. "Once the choice of alternatives is made, document why the choice was made and the client's involvement. The CPA may also get a second opinion from another tax specialist, much like a doctor getting a second opinion from another specialist."

Klein offers the following loss control techniques to accountants involved in tax engagements:

Screening. Careful screening of the firm's clients and engagements will help to avoid "engagement creep," whereby the scope of an engagement begins to extend beyond the competencies of the CPA firm. All clients and engagements should be re-evaluated on a regular basis, at least annually, to assure the firm is:

- Capable of performing the services required by the engagement, and
- Performing the services frequently enough to be proficient at them.

Identifying High-Risk Clients. Some clients are more risky than others. The risky clients can be identified by:

- Running credit checks,
- Examining previous financial statements,
- Examining the client's prior accounting firm's management letters, and
- Interviewing the client, the client's key personnel, bankers, legal counsel, prior accountants and auditors.

S Corp Elections. Clients who make choices about S corp elections do so primarily for tax benefits. When they do, they make assumptions about the future, which is unpredictable. When events make their choice less beneficial than originally thought, the CPA is exposed to liability. CPAs can also face liability from not consulting with clients regarding S elections. For example, a consultation should occur when a closely held C corporation has substantially appreciated assets. In helping clients decide about corporate disposition, CPAs should:

- Provide the client with a full consultation of all negative and positive tax ramifications involved.
- Document the consultation in an "informed consent" letter, providing a brief summary of issues discussed.
- In the letter, provide places where the client can acknowledge they have read and understood the summary letter and that provide the client an opportunity to affirmatively indicate they either do, or do not want an S corp election.

- Informed consent is always important, but it is even more so in this situation because of its technical nature and the limited ability of the client to discern the pros and cons," says Klein. "Documentation will prevent the client from later asserting that your firm is responsible for unexpected events and for less than optimal results."

Estate Tax Planning. Generally, there is a very long lead time between the time estate planning decisions are made and the time that the results of the decisions are known. Memory of the CPA's advice and the client's decisions fade over time, making documentation of the advice and decisions all the more important. CAMICO offers the following risk avoidance ideas for estate tax planning:

- Make it a policy to put all planning advice in an "informed consent" letter, outlining the positive and negative consequences of all options in terms the client will understand and obtain the client's consent. Without this letter, it is easier for claimants to make it appear the CPA made the decisions.
- Tax professionals must be certain of their competency in this area and must be sure to document both: 1) the reliance upon the attorneys drafting the estate plan; and 2) which professionals are responsible for each aspect of the plan.

"When a client dies, the CPA may be dealing with unhappy, potentially litigious beneficiaries," Klein notes. "We know that there will be no deposition from the deceased client, so the documentation from the original planning and decision-making process becomes the CPA's primary line of defense."

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ticism, according to Klein. "Exercising skepticism goes hand-in-hand with the CPA's ability to detect fraud and to advise and warn clients of weaknesses in their systems of financial control," he says. "There is no absolute assurance that fraud has not been concealed from the CPA or the client, and this leaves both vulnerable unless the CPA exercises skepticism and the client exercises good judgment and control."

CPAs can do much to improve the ability of clients to protect their wealth and businesses, such as offering additional services to assist clients in understanding their responsibility to prevent and detect fraud with adequate internal controls. CPAs can also do more to "convince clients that spending a little more up front to provide those controls will be financially justified in the mid to long term," Klein says. For their part, CPAs need to "be careful to limit the scope of their engagements to closely match their competency and skills to the client and the engagement and to be thinking constantly about client fit and fitness as part of their standard operating style."

PLUS SYSTEM IS UTILIZED

The study was CAMICO's first using the company's Professional Liability Universal System (PLUS), an underwriting, claims, finance and policyholder service platform that was custom built for CAMICO. The PLUS system tracks data on clients from underwriting through claims. Claims and loss prevention staff determined the areas of practice that are the most risky by examining claims data based on both frequency (number of occurrences) and severity (total dollar losses) through 2004. (See Exhibits 1 and 2)

"CPAs who practice in these areas will be interested in this data," Klein says. "The most risky areas tend to correlate with the levels of complexity, but there are also general practices that can be improved to reduce the risk of liability."

Exhibit 1.

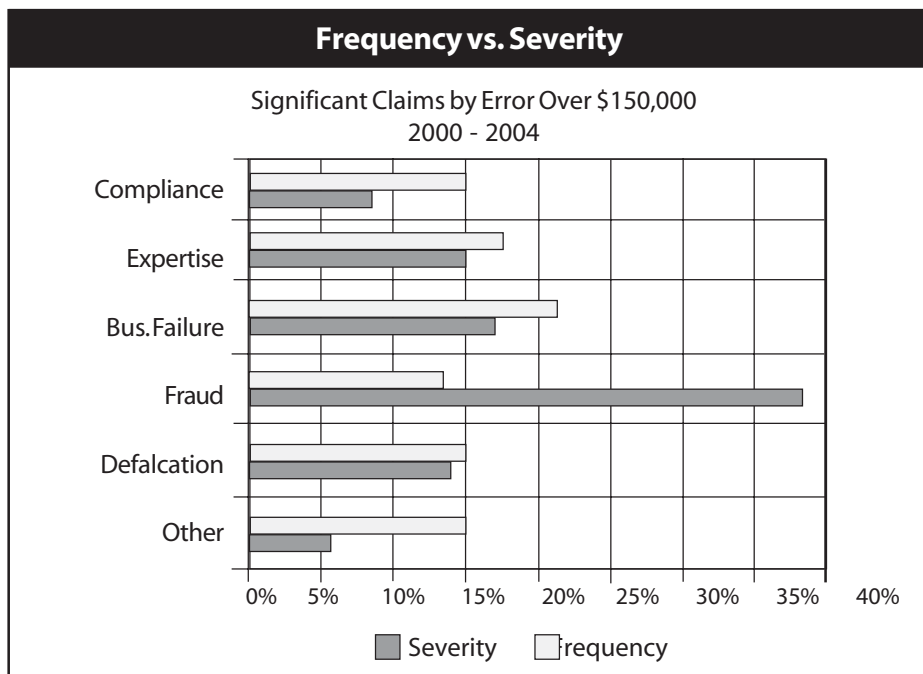


Exhibit 2.

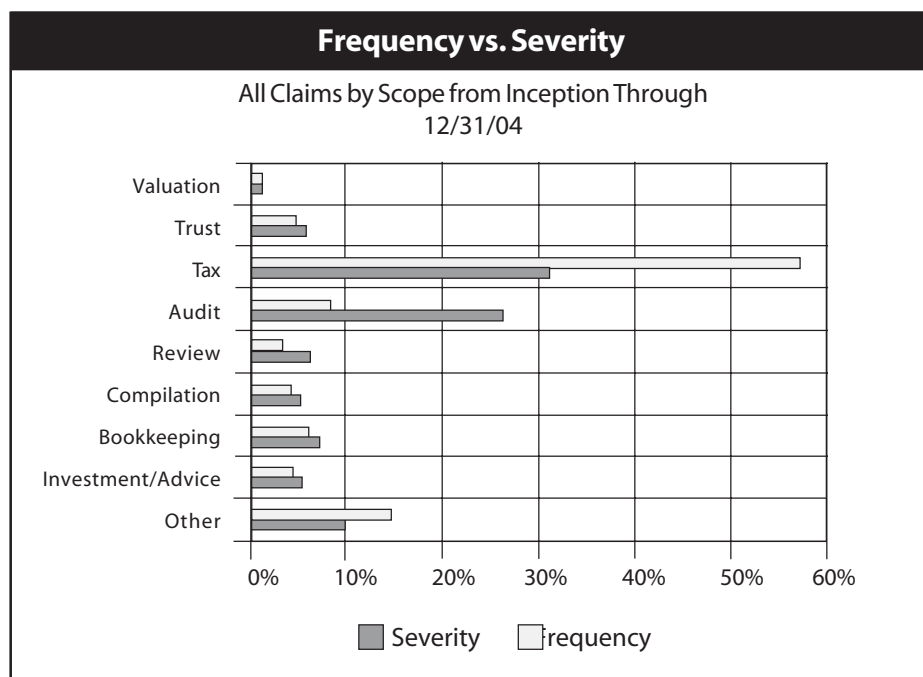


Exhibit 1 shows that fifty-five percent of all CAMICO claims have come from tax engagements. This high frequency has in turn resulted in a large total of claims dollars incurred (severity).

Exhibit 2 illustrates that financial statement fraud has long led all other types of

fraud in terms of cost per case. Fraud also leads all significant CAMICO claims by a wide margin in terms of severity.

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