Horror Stories …
Cautionary Tales for Accountants

CPA Mutual®
INSURANCE COMPANY OF AMERICA
RISK RETENTION GROUP

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Preface

"Becoming involved in a lawsuit is like being ground to bits in a slow mill; it's being roasted in a slow fire; it's being stung to death by single bees; it's being drowned by drops; it's going mad by grains." – *Charles Dickens*

"A countryman between two lawyers is like a fish between two cats." – *Benjamin Franklin*

Just two well-known expressions regarding what it's like being involved in a lawsuit. Even though these sentiments were expressed years ago, not much has changed.

Many of you have never experienced a claim. Unfortunately, some of you have. And if you have, I'm sure you don't need to be reminded what a terrible waste of your money and time that bad experience was.

The claim examples contained in this booklet are just a few from CPA Mutual's files. All of these articles were written by our in-house claims handlers. Managing CPA firm risk is all we do!

Our goal in producing this document is to give you a sample of what other members have faced and perhaps a little background into why claims are filed and how they are litigated. We hope these bad experiences will help you recognize the risk you face on a daily basis and reduce that exposure for you and us.

Since our inception back in 1987, we have been involved in over 2,400 claims or incidents. Our members have spent nearly $10 million in deductible payments alone, and CPA Mutual has paid or incurred nearly $170 million. All together these claims cost an average of $80,000 each! And even worse, claims in which we paid expenses or indemnity average just under $200,000 each! The claims were not only bad experiences but expensive ones. Just more evidence of why it's important to have a company like CPA Mutual in your corner if you receive that claim notice.

CPA MUTUAL INSURANCE COMPANY of AMERICA RRG

4923 NW 43rd St #C – Gainesville, FL 32606

(800) 543-3029 – www.cpamutual.com

Going the 'extra mile' is OK, but beware of risks

While client loyalty is an admirable characteristic, the economic downturn combined with the increasing focus on accountants' liability necessitates careful evaluation of decisions to "go the extra mile" for clients.

Losses often destroy relationships, and clients in difficult economic positions may be willing to sacrifice their relationships for even modest economic advantage.

As discovered by Andy Accountant, "going the extra mile" is only good business when it does not involve significant additional risk.

For the last 10 years, Andy had audited the financial statements of Parts-R-Us, Inc. (PRU), a regional auto parts sales and distribution company owned by Eric Entrepreneur. In 2007, Eric informed Andy of his plans to acquire Cycle Parts (Cycle), a smaller specialized parts distributor owned by Sid Sneaky.

Eric asked Andy to assist with PRU's due diligence investigation of Cycle, and Andy dutifully issued an engagement letter for the consulting work. Subsequently, however, Eric informed Andy that he and Sid had agreed that Andy would review Cycle's 2007 financial statements.

Andy accommodated Eric's request and agreed to perform the review. As the cost of the engagement was being borne by Cycle, Andy's engagement letter was issued to Cycle and its shareholders.

In early March, the merger was finalized and the parties executed a stock purchase agreement. PRU paid Cycle's shareholders $500,000 and delivered a promissory note for the remaining $500,000 of the purchase price. Several weeks later, Andy issued a review opinion on Cycle's 2007 financial statements.

Although the review opinion was unqualified, it did disclose that Cycle was only marginally profitable. As with the engagement letter, the review opinion was addressed to Cycle and its shareholders.

Unknown to Andy and Eric, Cycle had experienced economic difficulties for the last several years and, to keep the company going during the downturn, Sid had been engaging in creative accounts receivable and inventory practices.

Because Andy did not detect this during the review, Cycle's 2007 financial statements were overstated and showed a marginal profit when the company had in fact lost money, as it had for the last several years.

Cycle's results of operations proved no different in 2008, and it sustained its largest loss ever. By late 2009, PRU was facing additional economic problems and sued Andy.

Although Andy's review opinion had been issued after the merger agreement was signed, PRU claimed reliance on alleged pre-merger due diligence services. It also alleged reliance on Cycle's 2007 financial statements in connection with important post acquisition decisions.

While Andy felt betrayed by Eric, and the lawsuit cost him time, effort and money, he did

learn some important lessons.

First, when the nature of the engagement changed, Andy should have revoked his original engagement letter or otherwise formally documented that the due diligence engagement had been terminated without any services having been provided.

Second, by issuing the engagement letter to Cycle, Andy placed himself in a position where he was performing attest services for both Cycle and PRU at a point in time when he had knowledge of the planned merger. Thus, both Cycle and PRU were in a position to raise conflict of interest allegations.

Aside from the professional standards issues, Andy doubled the risk of the engagement and impaired his ability to defend his work without any additional compensation. Instead of facing the risk of a claim by the buyer, Andy was at risk if either the buyer or seller was dissatisfied.

Third, Andy should have recognized that issuing the financial statements after the merger agreement was signed did not completely negate the risk of the engagement.

While this did significantly mitigate the risk and allowed Andy to resolve the lawsuit for a nominal amount, merger-related services carry significant risk, and plaintiffs' lawyers are very creative in developing theories of reliance.

With a little additional care, Andy could have avoided the lawsuit entirely.*

Business valuations – Not for the faint of heart

Business valuations can be risky business for CPAs, especially for those who do not specialize in valuations. This is particularly true when a tax or consulting engagement expands into a business valuation at the client's insistence.

Unlike planned valuations by a specialist, a CPA may perform the valuation without a proper analysis of the risks involved. To complicate matters, clients and third parties may further expand the engagement by using the valuation for multiple purposes.

CPAs perform valuations of companies for many reasons. The methodology used and the resulting value often depend on the reason for the valuation. For instance, the value of a company for estate or gift tax purposes may be different from its value for a sale or buyout.

While findings typically are not transferable, as discovered by Adele Accountant, clients sometimes have difficulty understanding this concept.

Adele prepared an annual valuation for the employee stock ownership plan of Bickering Inc., her client. Adele did not usually perform valuations, but she agreed to the request of her long-term tax client as a courtesy.

When a shareholder dispute erupted – with no buy-sell agreement in place – two of the three shareholders, Buck and Dough, looked to Adele's valuation to determine the value of the company. According to Adele's report, the company's value had declined steadily in recent years.

Buck and Dough used Adele's valuation as leverage to negotiate a lower purchase price for the shares owned by Solvent, the third shareholder.

Solvent sued Adele, claiming that her valuation had weakened his negotiating position. Although Solvent was unable to establish that her valuation caused Solvent any damages, Adele still incurred substantial defense costs.

Adele's case contains common elements found in many business valuation claims:

- The CPA does not routinely perform business valuations, but agrees to expand the initial engagement to include the valuation at the client's request;
- The valuation is used for purposes beyond the scope of engagement; and
- The claimant alleges an under- or overvaluation of the business, affecting the dollars received or paid.

Two of the best ways to avoid business valuation claims are to screen clients carefully and to use customized engagement letters.

1. Carefully screen clients.

A good client for a tax engagement may not be an acceptable risk for a business valuation. As part of the client interview, the CPA should determine the specific purpose of the valuation, i.e., who will rely on the report. Potential conflicts of interest, present or future, should be analyzed. These may arise between business owners or between spouses in a family business for which the CPA has provided services to both spouses in the past.

The industry type and size also have a bearing on the risk. Some industries are more difficult to value than others. For example, because of the intangible nature of their assets, claims for disputed valuations are more likely to arise from valuations of service businesses than from valuations of manufacturing or retail businesses.

2. Use customized engagement letters.

Business valuations often arise from other types of engagements and may need customized engagement letters. In addition to the standard provisions, the engagement letter for a valuation should identify the client, narrowly define the intended purpose of the valuation and specifically identify the intended users of the report.

The letter should note the inherent weaknesses of the valuation process and emphasize that the valuation is not transferable. It also should state that the valuation is valid only for the stated purpose and only as of a specific date.

As a final protection against third parties, the valuation report itself should contain similar provisions, including,

- ❑ The identities of the intended recipients
- ❑ The purpose for the valuation
- ❑ A statement that valuation is an inexact science
- ❑ A statement that the report is valid as of a specific date and that the value will change over time
- ❑ A statement that the valuation is based on information provided to the CPA that is assumed to be accurate but has not been verified

Adele learned one last thing: Business valuations are not as simple as they appear. CPAs should obtain formal training in business valuations before accepting any such engagement. ∗

Striving for culture of excellence reaps dividends

'Greed is good."

That was the message in Michael Douglas' famous speech to stockholders in the 1987 movie, *Wall Street*.

"Culture" is defined by attitude and how problems are approached.

While one can take issue with numerous Hollywood portrayals, the string of corporate failures and accounting scandals over the last decade is compelling evidence that Hollywood accurately captured the culture of many American companies.

Contrary to the philosophy conveyed by Michael Douglas' character in *Wall Street*, a culture of greed (which may give rise to short-term profits) does not build companies – it destroys them.

Like the distinction between greed and ambition, the culture of an organization is subtle and amorphous. All firms espouse the highest standards and principles in their publications and formal documents. But culture does not exist on paper. Culture is defined by attitude and how you approach problems. Culture is the aftermath of action. It's created by what managers observe partners doing to bring business in the door (or to keep it), by what peers see other peers do and how the firm's control group reacts to such situations.

Building a better tomorrow requires striving for excellence today, and a culture of excellence begins with a commitment to excellence in all things. The details do matter – not because they are necessarily critical to the integrity of the end product (although they can be) but because your culture is defined by how you handle the details.

For instance, if the example is set that it is OK to skip "X" if you're busy, others may conclude that it's also OK to skip "Y" if you're really busy. As discovered by Andy Accountant, however, cutting corners can prove costly, and mergers do more than impact financial statements – they define who you are.

Andy was the managing partner of a successful CPA firm with a good reputation. The firm provided attest services, but they comprised a small percentage of firm revenue. Due to increasing competitive pressure, however, the firm decided that it had to expand its attest services and this could best be accomplished by merging with a smaller firm that had an established audit practice. As a result, Andy's firm entered a merger agreement with a firm owned predominately by Allen Enumerator.

After the merger, Enumerator assumed responsibility for the firm's audit and attest services. As Enumerator grew the firm's audit practice, Andy and the other original partners focused on other areas. Despite the importance of client screening, Enumerator's client decisions were accepted without question or review. Unfortunately, Enumerator emphasized quantity over quality and was willing to take marginal clients willing to pay higher fees.

Within three years of the merger, two of Enumerator's larger audit clients suddenly filed for bankruptcy. Subsequent investigation disclosed that both companies had been fraudulently overstating their financial statements for years. Thereafter, Enumerator, Andy and the firm were sued by the creditors of both companies.

Expert examination of the firm's files revealed numerous departures from professional standards in both engagements. It was also discovered that one of the companies had

fired its former accounting firm because of professional disagreement. Although one of the lawsuits was dismissed, the other dragged on for several years before it eventually was settled.

Andy and his partners were shocked by what they discovered during the litigation. They could not understand how Enumerator could have operated so far outside the firm's norms and culture.

What they failed to appreciate was that the firm's culture allowed Enumerator to operate the way he did and that Enumerator had influenced the firm's culture after the merger. Enumerator was in charge of the firm's attest services and operated almost autonomously. Because he was willing to compromise on professional issues to get and keep clients and to cut corners to do more work faster, the managers reporting to him accepted this as standard practice.

The firm's culture also allowed for the compartmentalization that prevented these problems from coming to the attention of the other partners.

So what lessons can be learned from Andy's experience?

1. Mergers are one of the most significant and potentially damaging decisions a firm can make. In addition to investigating the financial implications and professional reputation of the parties involved, due diligence with respect to significant audit clients is critical.

2. Client screening should be recognized as an essential responsibility of all partners. Audit clients should not be accepted without thorough review and approval by a firm committee, and clients that have fired or been fired by another accounting firm should not be accepted.

3. Firm culture is a critical component of long-term success. A culture of excellence emphasizes the collective good and does not allow compartmentalization. It stresses and rewards integrity and attention to detail. It fosters communication and allows concerns about an engagement decision to be raised outside the direct chain of command and addressed without reprisal. It emphasizes quality over quantity and recognizes that the long-term value of excellence is greater than the short-term profits of expediency.

As Andy learned, a partnership of autonomous individuals places each partner at risk.*

Time Records
More important than you may think

Time sheets are a necessary evil of an accounting practice. Keeping accurate, up-to-the-minute billing records can be a painstaking chore. Their importance to a firm is often emphasized by managing partners and practice management consultants, who point out that accurate timekeeping plays a critical role in a firm's profitability and productivity.

From a claims perspective, time records can be a positive or negative aspect, depending on their content.

However, time records also play another important role: They memorialize the tasks that one performs. From a claims perspective, this can be a positive or negative aspect, depending on their content.

Clyde the CPA found out the hard way that imprecise entries could lead to unintended results. Clyde's client, Mrs. Winston, was in need of investment advice. Clyde referred her to his favorite stockbroker, Seymour Schlappy. A decade later, Mrs. Winston sold her seafood market in Orlando, Fla., and retired.

Several years later, a trust officer from Mrs. Winston's bank offered her a complimentary review of her investment portfolio. The review revealed that Seymour had engaged in excessive trading for the purpose of generating commissions (a practice referred to as "churning") and that he had invested in inappropriate classes of mutual funds – those that gave Seymour the highest commissions.

Mrs. Winston brought a lawsuit naming both Seymour and Clyde as defendants. She claimed damages totaling more than $5 million.

Initially, the case against Clyde looked ripe for dismissal. After all, Clyde merely introduced Mrs. Winston to Seymour, and that was more than 15 years earlier.

Clyde defended his innocence, insisting that his engagement was limited to tax advice and the preparation of financial statements. He stated that at no time did he provide investment information or advice.

As usual, the first items requested by Mrs. Winston's attorneys were Clyde's billing records. Much to the dismay of Clyde's defense counsel, the entries included the following:

- "Conferences with client and broker regarding investment in mutual funds"
- "Conferences with Seymour regarding client's investments"
- "Analyze and research an investment possibility"
- "Professional services rendered in connection with financial and tax planning"
- "Conferences with client and Seymour regarding taxes, mutual funds and other matters"

Those entries created the requisite ambiguity for the plaintiff to present a fact issue strong enough to prevent an early dismissal. The time entries turned the case from one that was likely to be dismissed into one in which Clyde faced significant exposure.

Sadly, the fact was that Clyde probably did not actually give "investment advice" to Mrs. Winston. His involvement with the investments likely was limited to general comments and tax advice as it related to the investments. Unfortunately, Clyde's careless use of the words "investments" and "financial" in perhaps a dozen time entries over the course of many years effectively expanded the engagement.

Another word that has the potential to cause trouble is "audit." Unless the entry is in reference to an actual audit engagement, the word "audit" should never appear on a billing statement. For example, compilations should not be described as "audit procedures."

The importance of documentation in the claims process cannot be overstated. Accountants should approach time sheets as they do letters and other forms of client communication. Poorly drafted billing entries can nullify the strongest engagement letter. However, carefully drafted time entries that accurately and clearly depict the services provided to the client may provide vital documentation in the event of a claim.∗

A word to the wise: 'Put it in writing'

"To communicate through silence is a link between the thoughts of man." – *Marcel Marceau*

The silent approach to communication may be fine for a mime, but it can lead to trouble for accountants. While the importance of engagement letters is stressed repeatedly, written communication is often also advisable during the course of the engagement.

One area where lack of written communication repeatedly opens the door for claims is preparation of estate tax returns. Typically, the executor either fails to contact the accountant by the due date or fails to provide the information necessary to complete an accurate return in a timely manner.

The trouble usually begins when the executor discovers the possibility of personal liability for the penalties. Placed in such a predicament, the executor's recollection of facts is often less than accurate.

The question is not "What did the accountant do wrong?" It is "What will the executor claim that the accountant did wrong in an attempt to avoid liability?" If the accountant does not have evidence to disprove the allegations, it becomes a swearing contest.

Keep in mind that in a lawsuit, verbal communication may be the equivalent of silence. A single letter probably would have prevented a lawsuit against Adele Accountant.

Adele's long-time tax client, Danielle Decedent, passed away on Date 1.The estate tax return was due on Date 2.

In accordance with Decedent's wishes, the Acme Brokerage trust department was named executor of the estate, and Adele was engaged to prepare Decedent's estate tax return. Adele advised Acme's trust officer of the information that Acme needed to provide for Adele to prepare the 706.

Decedent's estate included a large collection of expensive Native American pottery, jewelry and kachina dolls, so appraisals were required. Acme did not contact Adele until one week prior to Date 2 and still did not have the required appraisals.

Adele obtained an extension and informed Acme that the return was due on Date 3.Two weeks after Date 3, Adele contacted Acme to advise the trust officer that, due to its failure to provide the requested information in a timely manner, the return was now late.

Acme's response was to terminate Adele's services and to file suit against her for the subsequent IRS late filing penalty assessment in the amount of $200,000.

Acme knew that the appraisals were necessary for preparation of the return. Acme also knew that the return was due on Date 3.Although Adele had previously discussed those topics with Acme, she had not memorialized those conversations in writing. Thus, she had no proof of the prior communications.

Had Adele sent a reminder letter noting the requested information and the date by which she would need the information to file the return in a timely manner, it is likely that Acme

would not have filed the suit.

Is there a duty to tell someone a fact that they already know? Perhaps not, but without evidence that the information had been conveyed, it is a jury question. Due to the high costs and risks associated with a jury trial, it was prudent for Adele to settle the case.

Similarly, executors who fail to contact an accountant until after the due date have, with surprising regularity, claimed that the engagement began well before the due date. A letter at the outset stating the undisputed (at the time) fact that the accountant was not engaged until after the due date of the return may appear to be unnecessary. However, it could be the key to avoiding a future claim. Without such a letter, the accountant still has defenses, but if such a communication exists, the executor probably will not even make such an allegation.

The lesson to be learned from Adele's situation is applicable to other types of engagements as well. If there had been any doubt in Adele's mind as to whether Acme was aware of the impending due date, she probably would have sent a reminder letter. However, Adele learned that sometimes it is wise to send a letter even when it states what, at the time, is obvious to all parties.

Perhaps the lesson itself is obvious, something that all of us already know, but sometimes we need a reminder, too.∗

Attention to detail required for the big picture

While the phrase "You can't see the forest for the trees" is often used to refer to an inability to recognize something that is seemingly obvious, it is more traditionally equated with the difficulty of seeing the "big picture" when you are immersed in the detail. In some respects, auditing is akin to trying to see a forest while amid the trees.

The big picture is the ultimate goal, but it must be created through observation of the detail. As discovered by Andy Accountant, when the detail is not accurately observed, the resulting picture is distorted.

Andy and his firm audited the financial statements of XYZ Corporation, a local farm equipment distributor, for many years. While Andy had never had any significant problems with the engagement, shortly before Andy was to begin work on the 2010 audit, XYZ was unexpectedly taken over by its primary creditor, Big Bank.

The resulting investigation revealed that XYZ's financial statements had been fraudulently overstated for the last three years and that its debts significantly exceeded its assets. As a result, Big Bank was insufficiently collateralized and lost millions of dollars. Subsequently, Big Bank filed a lawsuit against Andy.

Expert analysis disclosed that XYZ's CFO accomplished the fraud through the interrelated mechanisms of delaying the recording of accounts receivable payments and fraudulently overstating rebates due from vendors. With regard to the accounts receivable, customer payments went directly to a "lock box" maintained by Big Bank where they were credited against XYZ obligations or deposited in XYZ accounts.

Despite this arrangement, the CFO was able to overstate accounts receivable by delaying the posting of payment information received from Big Bank. This allowed the CFO to double count receivables by including them both as part of lock box cash and as outstanding accounts receivable.

To allow for reconciliation at year's end, the accounts receivable overstatement was eliminated, and the reduction in accounts receivable was then offset with an equivalent reduction in company payables, the latter being accomplished by recording fraudulent vendor rebate entitlements. To support the rebates, the CFO forged rebate documentation and presented it to Andy as evidence of the entitlement.

Although hindsight is 20/20, in retrospect, Andy recognized that a number of red flags had been present. First, during the last three audits, the CFO was very slow to produce the accounts receivable reconciliation at year's end. This may have been particularly significant given that XYZ's industry was somewhat depressed.

Second, while Andy confirmed nearly 100 percent of the rebates, he did so through third-party documentation. Since most of the supporting documents the CFO provided were photocopies, Andy should have considered direct confirmations.

Third, while Big Bank had not taken any action, XYZ was frequently out of compliance with its loan covenants. Although the deviations were not substantial, they did suggest a marginal ability to meet debt obligations.

Fourth, the debt confirmed by Big Bank was less than the debt shown on XYZ's books.

Despite the discrepancy, Andy did not attempt to reconcile the balances or conduct further inquiry or testing.

Finally, although not evident in the work papers, it appears that Andy's long association with the CFO and overconfidence in the security provided by the lock box arrangement contributed to his failure to conduct more extensive testing.

While the bank's failure to require monthly reconciliations of accounts receivable and other negligence by both the bank and XYZ's senior management enabled the case to be settled for a fraction of the alleged loss, the situation might have been avoided entirely if Andy had been more attentive to some of the red flags that were present.

Acme's response was to terminate Adele's services and to file suit against her for the subsequent IRS late filing penalty assessment in the amount of $200,000.*

Sometimes we just don't know what we don't know

"Real knowledge is to know the extent of one's ignorance." - *Confucius*

Knowing when to seek help or ask a question is a valuable trait.

Unfortunately, Adele Accountant discovered too late that, when you venture outside of your home jurisdiction, state and local tax traps lie in wait.

> The bottom line is, if you are not absolutely sure - and perhaps even if you are - consider seeking confirmation that your understanding is correct.

Bigfee, Inc., was a longtime client based in Adele's home state of Ignorance. Bigfee decided to purchase the assets of a manufacturing company located in Neighboring state.

Bigfee's president asked Adele if she would be able to continue to prepare all of their tax returns, including state and local returns required by Neighboring state. Adele checked a few reference materials and assured Bigfee that she could prepare all of the returns. She said there was no need to engage a Neighboring accountant.

Five years passed, and all appeared to be well, that is, until Bigfee received a personal property tax return notice from the Village of Greed. The taxing authority alleged that no personal property tax returns had been filed since Bigfee purchased the company five years ago.

Furthermore, had the returns been filed, a certificate of exemption for manufacturing equipment would have exempted all such personal property each year for the five preceding years. So, not only did Adele fail to prepare the required returns, but Bigfee also lost the opportunity to claim the exemption. The additional avoidable tax liability was approximately $200,000.Penalties could not be abated, and amended returns would not fix the problem.

Shortly thereafter, Adele received a demand letter from Bigfee. Adele contacted a local accounting firm, but by that time it was too late to resolve the problem. Sometimes we just don't know what we don't know. This is especially true in the state and local tax arena where obscure taxes and rules abound. Hindsight being 20/20, it is easy to say that Adele should have sought the advice of a local accountant at the outset of the engagement.

Was it ignorance, apathy or some other reason that kept her from doing so? The upset client might be inclined to conclude that Adele was at best ignorant, or perhaps even greedy. Did Adele simply not want to take the risk that another accountant would steal her client, or at least divert a portion of the fees away from her firm? It was a costly oversight, one to which she could offer no defense. In addition to paying damages, her firm lost Bigfee as a client.

Adele's case is by no means exceptional. Even with the various research tools available to return preparers, such errors are surprisingly common. Accountants preparing state and local returns for filing with taxing authorities outside their home jurisdictions may overlook certain taxes, fail to file required returns or schedules, or neglect to properly claim available credits or exemptions.

Typically, assuming that the tax was avoidable, there are few defenses available to prevent a finding of liability and damages. Sometimes, even within one's home jurisdiction, there are areas of state and local taxation, particularly involving credits, that may warrant outside assistance. The bottom line is, if you are not absolutely sure – and perhaps even if you are – consider seeking confirmation that your understanding is correct.

"He who asks a question is a fool for five minutes; he who does not ask a question remains a fool forever." – *Chinese Proverb*∗

Divorce cases hold potential liabilities

"Marriage is about love; divorce is about money." – *Anonymous*

Unfortunately, divorcing clients may attempt to increase the amount of money they receive by making a claim against their accountant.

When clients divorce, accountants are put in a variety of uncomfortable positions. CPAs are routinely served with subpoenas for depositions and client records.

Potential claims arise from perceived conflicts of interest and lack of objectivity, tax advice that allegedly benefits one party over the other and accusations that valuations intentionally overvalue or undervalue a marital asset.

Divorcing clients are rarely pleased with the terms of their divorce, and the accountant is an attractive target to blame for a less than favorable outcome.

Adele Accountant learned the hard way to be wary of conflicts of interest in divorce situations.

Adele was engaged to perform a valuation of Pete's Paving, a paving company owned jointly by a divorcing couple, Peter and Wendy Disso. The divorce was proceeding amicably.

Peter had offered to buy Wendy's share of the business for $500,000, and counsel wanted to determine whether this was a fair price. Adele determined that the value was $1 million.

Wendy agreed to sell her one-half share for $500,000.Peter refused to agree unless the payments were deductible, so Adele suggested a structure whereby the buyout was deductible to the corporation. The parties reached an agreement and finalized the divorce.

Adele continued to prepare tax returns for Peter, Wendy and the corporation. After Wendy received the final payment under the agreement, she was not satisfied with her standard of living.

When the judge refused to grant her attempts to get more money from Peter, she turned her attention to Adele. Wendy claimed that Adele's valuation was flawed, and that Adele failed to advise her that the distribution could have been structured so that it was tax free to Wendy.

Wendy alleged that Adele deliberately concealed the alternate tax structure and deliberately miscalculated the value of the company. Wendy sued Adele and claimed damages of approximately $1 million.

Adele did not believe that there was a conflict of interest, so she did not disclose the potential conflict and did not seek Wendy's consent. Defense counsel determined that AICPA Code of Professional Conduct, ET §102.03, provided some support for Wendy's allegations.

Without a waiver, facts were not favorable. Adele's valuation was identical to the amount proposed by Peter, and her tax advice favored Peter over Wendy.

Adele was taken aback as she truly felt that she was merely trying to work out an acceptable buyout for the couple. She thought that her job was done when Wendy and her counsel voluntarily agreed to Adele's first suggested resolution without asking for

alternatives.

Adele's failure to disclose the potential conflict and obtain a waiver created an appearance of impropriety and risk of a large verdict.

Despite defenses that otherwise would have probably led to a defense verdict, settlement was the most prudent course of action.

We are aware of at least three cases with facts similar to those in Adele's case. Defense counsel in one case recommends that any time an accountant has prepared joint returns for a divorcing couple, the accountant should consult counsel and obtain conflict and confidentiality waivers from both parties.

If they refuse, the accountant should withdraw and cooperate only as required by law to prevent being accused of favoring one party over the other.*

Deepening insolvency claims present increased risk for auditors

"I will go down with this ship. And I won't put my hands up and surrender. There will be no white flag above my door." – *Dido*

Tough economic times force business owners to make tough choices.

Management may have to decide whether to continue the fight to keep the company afloat or close up shop. Such times also force accountants to make difficult risk management decisions.

Professional liability claims from audit engagements tend to increase following economic downturns.

Business failures can lead to suits against the auditor by creditors, shareholders and others. At a minimum, auditors should make sure that their decisions regarding the stability of the company and their advice to management is well-documented.

A more difficult decision is whether to terminate engagements with clients that are likely to fail. Terminating audit engagements with struggling clients is often the best way to avoid liability claims arising from business failures.

Adele Accountant learned that, when the client is an insolvent insurance company, the state insurance commissioner, as liquidator, will also pursue a claim.

Adele audited XYZ Insurance Company, a property and casualty insurer, for five years. YZ suffered large losses two years in a row due to exceptionally bad weather As a result, admitted capital and surplus dropped to a negative number, rendering XYZ insolvent. Adele made appropriate disclosures to management and the insurance commissioner.

As has become common practice for insurance commissioners, the insurance department sued Adele and her firm. The commissioner claimed that Adele overvalued XYZ's assets. But for Adele's errors, the commissioner alleged, the department would have received earlier notice of the insolvency and stepped in to prevent further losses.

Claims for deepening insolvency are a developing legal theory.

Courts disagree as to whether it is a separate tort cause of action, a damage theory – or even a basis for recovery at all. One thing is certain, claims based on deepening insolvency create an increased risk for auditors of struggling businesses.

Insurance company audits present unique risks.

They are governed by rules with which the auditor may not be familiar. If the company fails, the auditor may face a greater likelihood of a suit than in audits of other industries.

In addition, some state insurance commissioners are reported to bring claims against the auditors of virtually every insurance company that goes into liquidation. The commissioner has a team that pursues the claims against auditors, and they engage law firms that specialize in such claims.

The commissioner's representatives may establish close ties with the law firms and the judges who regularly hear such cases. The fact that the plaintiff is a state official may influence jurors and judges in a way that is not good for the auditor.

Any struggling audit client poses a risk, regardless of the industry. Management is often compelled to hold on too long to a business that is beyond saving.

The current uncertain economy makes this an ideal time to take a hard look at client lists and take steps to make sure that you don't go down with the captain of a sinking ship.*

Professional skepticism vital to independence of jury belief

"There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues." - *Kenneth Lay, Aug. 20, 2001 (Note: Enron filed for bankruptcy on Dec. 2, 2001.)*

Remember the scene in the 1996 movie *A Time to Kill* when Matthew McConaughey makes his closing jury argument?

Close your eyes for a moment, and imagine Ken Lay's quote on a big white poster board, prominently displayed before a jury. Imagine it placed adjacent to large blowups of audit work papers addressing accounting, trading and reserve verifications.

Imagine a deep, booming voice incredulously asking the defendant, "And just what exactly did you do to verify that what Mr. Lay told you was true?"

Now put yourself in the scene. Imagine that the blowups are taken from your audit work papers, that you are on trial, and that your defense counsel is trying to convince a jury that you are not responsible for damages caused by the CFO of a now-bankrupt former audit client that overstated assets or understated liabilities.

Now imagine that you audited the company in question for 20 years and never had cause to question management's integrity or representations.

Except, of course, you did. That's the problem.

Every year, for 20 years, you had an obligation to obtain sufficient, competent evidential matter to provide reasonable assurance that management's financial statement assertions were free of material misstatement. You also had an obligation to remain independent.

While regulatory bodies evaluate the technical nuances of independence of fact and appearance, at trial, independence of jury belief is what matters.

While conceptually similar to independence of appearance, independence of jury belief is the jury perception of your professional skepticism that ultimately arises from the clash of witnesses, documents and attorneys in the crucible of litigation.

Convincing a jury that you failed to exercise sufficient professional skepticism is an important first step in convincing them that you should be held responsible for damages arising from the fraud. Once your professional skepticism is successfully placed in question, it becomes much easier to convince the jury to resolve complicated, conflicting facts and professional standards issues against you.

As discovered by Andy Accountant in the battle for independence of jury belief, factors you may have thought mitigated the risk of the engagement, such as your extensive knowledge of the client and how well you knew senior management, can be used by an experienced attorney to convincingly question your professional skepticism.

Andy audited the financial statements of XYZ Company. While XYZ had modest profit margins and substantial credit facilities that it fully utilized, the company had been in

operation for over 30 years, and Andy had worked with its senior management for 20 of them. He was, therefore, quite surprised when XYZ unexpectedly sought bankruptcy protection and the company's lender (Lender) filed a lawsuit against him, seeking damages arising from his failure to detect an alleged fraudulent overstatement of XYZ's assets.

Because there were no glaring audit deficiencies, Lender's counsel built his case on the theory that Andy had become complacent and overly trusting of management.

He argued that Andy's extensive knowledge of XYZ's financial operations should have made him suspicious of changes in the company's historical performance and that the fraud would have been detected if he had performed additional testing in these areas instead of accepting management's explanations for the variations. Lender's counsel pointed out that Andy's audit approach and procedures showed little, if any, change over the years, and that the fraud had exploited this fact.

He also pointed to the fact that Andy's work papers referenced management representations without including any supporting evidential matter and included factual errors, missing signoffs and incorrectly completed check lists.

Finally, Lender's counsel pointed to the long, profitable relationship between Andy and XYZ and his close relationship with XYZ's management. The counsel argued that the audit defects were evidence that Andy had become complacent and overly reliant and accepting of management representations.

So, does this mean that long-term audit engagements give rise to valid independence concerns? No.

Does it mean that minor defects in audit work papers prove that the audit as a whole did not comply with professional standards? No.

Does it mean that auditors have an obligation to verify all management representations or materially change their audit approach and procedures every year? Absolutely not.

Although this case was resolved for a nominal amount as a result of strong legal defenses, and there were compelling and likely meritorious responses to the alleged professional standards violations, it still illustrates how a few small changes can substantially mitigate the litigation risk of an audit claim.

While there is much to be said for long-term audit engagements, why not take a look at few of them this year and ask yourself what you could do to improve your prospects of winning the battle for independence of jury belief if a claim were asserted.

Why not make a few changes to your audit approach or procedures or have another partner perform a cold review this year?

Why not do something that improves your prospects for detecting management fraud and demonstrates your professional skepticism even if it is not mandated by professional standards?

The additional time it would have taken Andy to address all the alleged audit errors and defects is nominal compared with the total time invested in the audit, but it would have paid huge dividends if it had been necessary to defend the audit at trial.

Claims arising out of long-term audit engagements are not uncommon, and professional

standards often represent minimum requirements, not best practices.

With the continuing financial turmoil and the ongoing recession, why not raise the bar a little this year?*

Early retirement?

"It took some time before the public learned that to appreciate an Impressionist painting one has to step back a few yards and enjoy the miracle of seeing these puzzling patches suddenly fall into place and come to life before our eyes." – *Ernst Gombrich, art historian*

Auditing is both an art and a science. And, like an impressionist painting, each imperfection diminishes the quality of the final work. Where imperfections are significant or abundant, the final work does not faithfully depict the scene.

Because a single error can result in an audit failure, the old adage that a chain is only as strong as its weakest link is sometimes an apt auditing analogy.

Generally, a single audit defect results in an audit failure only if the audit is tested at a critical weak link. Unfortunately for Andy Accountant, his firm's audits of Any Not-For-Profit, Inc. (NFP) are more aptly characterized by the chain analogy.

Andy's firm audited NFP for many years. In September 2010, NFP's bookkeeper, Kathy Convicted (KC), retired after 14 years of service. When the subsequent bookkeeper had difficulty reconciling various accounts, NFP asked Andy to investigate. Andy's investigation eventually revealed that KC had embezzled approximately $900,000 over an eight-year period by employing a forged check scheme that took advantage of NFP's glaring internal control failures.

Although NFP's controller told Andy that she received and reviewed NFP's bank statements each month, she actually turned the statements over to KC unopened. She further represented that the signature stamp was kept in a locked drawer. In truth, the only time it was actually locked away was when Andy conducted field work for the annual audit.

While the embezzlement was hidden in a sophisticated way, the basic mechanics were simple and exploited the two vulnerabilities that NFP's controller told Andy did not exist.

To accomplish the embezzlement, KC used NFP's accounting software to print a check made payable to herself. She then voided the check on the computer system and removed her name from the payee field.

Because the system did not keep hard-coded detail records, the fact that KC was the original payee was not discoverable. After printing the check, she simply signed it with the signature stamp and deposited it into her personal account. Because KC received NFP's bank statements unopened, she was able to remove and destroy the fraudulent checks each month without detection.

To conceal the missing cash, KC would input an accounts payable invoice that reduced cash. She then input a long list of changes to numerous expense accounts with NFP listed as the vendor so the amount of the forged check was split into small amounts and appeared as nominal expense allocations for support services.

Although KC was convicted and consented to a civil judgment in the amount of the embezzlement, the funds had been taken to cover gambling losses, and the judgment was of little value. Facing a large loss, NFP filed suit against Andy's firm.

Initial expert review suggested that Andy's audit was not deficient. Detailed examination,

however, revealed that checks used in the embezzlement had been included in the audit sample group in four of the eight years of the embezzlement, including two checks in the second year of the embezzlement.

This problem was compounded by the fact that the defense expert considered the number of checks selected for testing to be at the low end of an acceptable range. Although the expert opined that the size of the sample group was minimally sufficient, he had to admit that the smaller sample size increased the importance of thoroughly testing each check in the sample.

Investigation of the testing procedures revealed that the junior staff member who performed the testing had accepted KC's explanation for the missing checks and marked the step as completed without commenting on the missing checks.

In deposition, the staff member said he had accepted KC's explanations for missing checks without comment or follow-up because she had worked for NFP for so long, seemed committed to its mission and "just didn't seem like the type of person who would be dishonest." Because the procedure was marked as completed, Andy's review of the workpapers did not disclose the problem.

While auditing involves many subjective judgments, like art, some audits are better than others. Although the rest of the audit was sound, it failed because it was tested at a critical weak link.

Because Andy had relied on NFP's misrepresentations regarding internal controls in conducting the audit, and NFP had 12 opportunities each year to detect it by simply following the internal controls it represented existed, the case was eventually settled for a fraction of the total loss.

Because the weak link in the audit occurred at a critical point, however, the audit failed, and Andy was forced to accept some responsibility for allowing the embezzlement to continue. ✻

Beware: Watchdog function can result in liability risk

"The civilized man has a moral obligation to be skeptical, to demand the credentials of all statements that claim to be facts." – *Bergan Evans (1904-1978)*

While it is unclear who originated the phrase "public watchdog" in describing the function of auditors, one of the most common attributions in recent articles and commentaries is the U.S. Supreme Court opinion in *United States v. Arthur Young*, 465 U.S.805 (1984), wherein the court noted that:

"The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." 465 U.S. 817-818.

Although recent examples of auditor liability for failure to discharge this obligation abound, auditors are sometimes faced with highly complex issues and, as discovered by Andy Accountant, efforts to fulfill the public watchdog function can also give rise to litigation and potential liability.

Andy audited the financial statements of Universal Widget, Inc. (UW) since its inception in 1997.In August 2009, Andy's practice was acquired by another firm, but the new firm agreed to audit UW's financial statements for the year ended Dec.31, 2009.

In prior years, UW's president and other related parties lent funds to UW.I n exchange, UW paid significant interest and issued warrants to the lenders that allowed them to acquire UW stock at the existing market value.

The warrants contained a provision that neither the number of shares that could be acquired nor the price per share would change in a reverse stock split. In November 2009, UW's board and shareholders representing a majority of UW's outstanding stock approved a 200-to-1 reverse stock split. Then the related parties exercised their warrants.

The result of the transaction was to increase the related parties' ownership of UW from 70 percent to 99 percent at a cost that was 200 times less than the cost of the transaction if the stock had been purchased at its post-reverse price.

Although Andy was aware of the anti-dilutive warrant provision and enactment of the reverse when audit planning began, he had been assured that the legality of the reverse had been addressed by UW's legal counsel and was not a concern.

Immediately after the initial planning meeting, Andy's partner, Experienced Ed, took over the audit due to Andy's temporary suspension from practice before the SEC.

Fieldwork on the audit proceeded, and review partner Observant Al began his examination of the work papers on March 26, 2010, five days before UW's March 31, 2010, Form 10-K filing deadline.

The next day, Al advised Ed and quality control partner Careful Carl of his concern that the reverse might constitute an illegal act. On March 28, 2010, Al and Ed informed UW's president

of this concern and requested clarification from UW's attorney that the reverse was a legal transaction.

UW's response to the inquiry was agitated and, in its request for an automatic extension of the filing deadline, UW made numerous factual assertions about the audit process that suggested the filing delay was the result of its auditors' failure to address various issues in a timely manner.

Andy's firm contested UW's factual assertions and, as the relationship with UW continued to deteriorate, engaged legal counsel to assist them in addressing the legal issues presented by the reverse.

While Andy's firm initially requested a legal opinion that arguably included subjective elements upon which UW's counsel could not opine, UW refused to negotiate regarding the scope of the legal opinion and sent a letter indirectly accusing Andy's firm of asking it to alter legal documents, issue false or misleading public filings and coerce its legal counsel to issue a legal opinion that was not usual or customary.

As a result, Andy's firm resigned just four days before UW's Form 10-K extension deadline.

While UW engaged a new auditor within days of the resignation, and the 2009 audit was completed in June, UW's stock was delisted as a result of its late Form 10-K filing.

Despite the fact that UW rescinded the anti-dilution provision in the warrants prior to the completion of the 2009 audit, UW filed suit against Andy's firm alleging that it deviated from professional standards in accepting the engagement, planning and staffing the audit, conducting initial and subsequent reviews and withdrawing from the engagement.

In addition to costs and expenses, the lawsuit sought to recover millions of dollars in alleged lost profits.

The case was ultimately tried, and a defense verdict was issued. While the court was concerned about the possibility of Andy's firm being overly sensitive and noted that it would have been better if the issues regarding the reverse had been identified and addressed earlier in the audit process, it found that Andy's firm:

- Had a legal obligation to have a review process that was designed to detect oversights and questionable issues
- Had a legal obligation to confirm the legality of the reverse
- Did not act negligently by seeking to resolve issues detected during the review process

Although terminating an audit engagement shortly before a significant deadline presents significant litigation risk, Andy's firm acted appropriately in requiring UW to adequately address the legality of the reverse.

Andy's firm also helped ensure a defense verdict by engaging legal counsel to assist them in addressing a legal issue that was beyond their ability to evaluate and by establishing a record of their good-faith efforts to resolve the issue with UW prior to resigning. ∗

Try thinking like a juror: Put on a defensive mindset

What is the proper mindset to adopt to minimize malpractice exposure?

One logical answer might be to determine the applicable standards for a particular engagement and adhere to those standards.

That may be fine for a professional standard, but it may not be sufficient to create the appropriate thought processes to avoid a claim.

Practitioners are aware of the importance of documentation as a means of claim avoidance. he more difficult task is determining when such documentation – or other steps – is required to avoid a claim.

To properly address potential claim situations, you must enter any engagement with the proper mindset.

The following tax claim serves as an example of how taking a somewhat narrow view of one's duty may lead to unnecessary exposure.

A group of investors decided to develop a golf course. The investment group was formed primarily through the efforts of a lawyer named Sigsbee Bigfee.

Bigfee was an investor in the venture and served as both project manager and general counsel. Over a 10-year period, the group invested $20 million in the project. Bigfee received approximately $10 million for legal services and project management fees.

Bigfee engaged Adele Accountant to prepare the corporate tax returns. Adele properly prepared the returns based on the information provided, but she and another accountant at her firm noted that the fees appeared to be very high.

Had she considered the possibility that claims might result from her actions, she might have taken steps to limit her exposure.

The other accountant asked Adele if they had a duty to question the fees. Adele quickly responded that they were engaged only to prepare the returns so did not have a duty to go beyond the information provided by the taxpayer's representative.

The fees were disclosed in returns provided to the board of directors. However, because of the way they were categorized, it may not have been obvious that some entries referred to fees paid to Bigfee.

Bigfee became insolvent, and the investors sued Adele's firm for $6 million. The plaintiffs claimed that Adele should have questioned the reasonableness of the fees and confirmed the executive committee's knowledge and approval of the fees.

Experts confirmed that Adele did not deviate from the standard of care. But, did she take the best course of action to avoid a claim?

It was not Adele's practice of accountancy that led to the claims, but arguably her mindset contributed to the situation. Had she considered the possibility that claims might result from

her actions, she might have taken steps to limit her exposure.

Adele's clients knew the relevant facts that led to their losses and could have limited their damages. Adele's narrow view prevented her from writing letters and taking other steps that would have left no doubt in a juror's mind as to the plaintiff's knowledge of the facts.

Adele's mindset was that she did not owe the clients any further duty and had fulfilled her obligations for the engagement. She knew the facts, and she knew that the clients were likewise aware of those facts. The end result was that attorneys profited from what was an otherwise frivolous claim.

An alternate mindset is more appropriate for claims prevention. Consider trying to think like a juror.

Is this an unacceptably high professional standard?

Yes. But, this is not a discussion about professional standards. It's a suggestion that you adopt a mindset when approaching engagements that may prevent claims and minimize exposure.

Try to step back and look at the facts from the perspective of a layperson sitting on a jury. Although most cases never reach a jury, the question of what a jury is likely to decide often determines the settlement value.

When one takes such an approach, facts are created and documents are written, not just for the client but also for the jury. ∗