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PROFESSIONAL LIABILITY SPOTLIGHT

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Early Warning Signs of a Large Malpractice Claim

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Unfortunately, there is no crystal ball to tell CPA firms what will happen when a new client or engagement is accepted. Everything could go smoothly, or a dispute could arise. If a dispute does arise, can a firm predict whether it will be resolved quickly or drag out for years, resulting in a significant claim and headache?

CNA, the endorsed underwriter of the AICPA Professional Liability Insurance Program, has identified common indicators of claim severity. Take note of these warning signs to help mitigate the risk of a large claim before it happens to your firm.

RED FLAGS RELATED TO CLIENT TYPE

History has demonstrated that certain types of clients or clients displaying certain characteristics tend to result in larger claims.

ATTEST SERVICES

Financially distressed clients

When a business fails, the CPA firm that provided audit, review, or even compilation services is often sued. A bankruptcy trustee may be appointed and may seek recovery from any source it deems to have contributed to the company's failure. The persistence of the bankruptcy trustee, combined with the large dollar amounts that are generally lost when a company fails, helps to drive large claim amounts.

Financial institutions

Disputes related to audits of banks, credit unions, insurance companies, and other financial institutions tend to result in larger claims. These industries generally have complex accounting rules and governmental regulators that step in to help ensure account holders and policyholders do not suffer losses if the institution fails. Similar to a bankruptcy trustee, regulators often vigorously pursue the CPA firm to help recover the losses.

NONATTEST SERVICES

High-net-worth or celebrity clients

This red flag is noted in more than half of all large claims related to nonattest services, making it one of the highest-risk clients a CPA firm can have. Here, "celebrity" status is subjective. Clients who deem themselves to be more important or higher-profile than the "average person" fall into this category. Large claims typically result due to a number of factors:

- The client may be less concerned with recovering alleged losses than with punishing the CPA he or she believes has wronged him or her.
- High-profile or high-net-worth clients have the financial means to engage in "scorched-earth litigation," resulting in extensive, time-consuming, and expensive discovery until they obtain the result to which they feel entitled.
- Juries are frequently enamored with a client's celebrity status and tend to grant awards in staggering amounts that are often not in line with the actual damages that may have been caused by the CPA.

Over-reliance on CPA firm/lack of acceptance of management's responsibilities

Clients seek out and rely upon the advice and counsel of their trusted CPA when making significant decisions about their life or business. However, the client is always ultimately responsible for the outcome of these decisions and, thus, should be involved in making them. A client who shifts this responsibility to the CPA, or who refuses to participate in the CPA firm's services, is likely to shun accountability for any negative outcome and blame the CPA.

RED FLAGS RELATED TO SERVICE DELIVERY

Alleged ethical violation

The AICPA *Code of Professional Conduct* (the Code) guides CPAs' ethical behavior. Since not every situation is or can be addressed by the Code, CPAs can apply judgment. However, plaintiff attorneys will also apply their own judgment, misconstruing a set of facts or circumstances to give the appearance of a CPA's impropriety. This frequently makes a claim more difficult to defend, as juries tend to impute greater liability to the CPA firm if misconduct is alleged, especially if such allegations relate to independence or the existence of a conflict of interest.

Embezzlement or fraud at the client

Regardless of the service delivered, CNA regularly defends CPA firms against professional liability claims alleging a failure to detect a theft or fraud at the client. These types of claims almost always involve large damage models. Unfortunately, jurors seem to believe that CPAs, especially auditors, should detect every malfeasance at a company and do not tend to give as much credence to the client's own responsibilities to prevent and detect fraud.

Continued.

Scope creep

One of the first things a defense attorney will review to understand the CPA's duty of care for a specific engagement is the engagement letter. A strong engagement letter can help aid claim defense. However, if the CPA deviates from the scope outlined in the engagement letter, its effectiveness is diminished. The scope of the CPA's responsibilities may be infinitely expanded depending upon the allegations made by the client.

Provision of investment advice

Advising a client on the merits of a business transaction or an investment may result in a large claim if the investment does not yield the results expected by the client. Claims related to investment advice can arise even if the CPA is not specifically engaged to provide such advice. This is a common area of scope creep, especially for tax practitioners.

OTHER CONSIDERATIONS

Size of the alleged loss, regardless of liability

Courts can be reluctant to release defendants early on in a lawsuit when large damages are alleged, which can result in protracted litigation and significant defense costs. In addition, since no engagement is perfect, even if the CPA firm's estimated percentage of liability is small, a small percentage of a large damages number can still result in substantial exposure.

Damage models that include multiple types of damages, including lost profits and consequential and other indirect damages, can inflate the alleged amount to a point where the CPA may face personal exposure beyond insurance policy limits.

RISK MANAGEMENT CONSIDERATIONS

Consider employing one (or more) of these risk management practices to respond to the potential risk of a large claim. Generally speaking, the higher the risk, the more risk management strategies should be employed. Clients or engagements that exhibit multiple red flag indicators may be outside of the firm's risk tolerance and not the right fit for the firm.

Pay attention to client acceptance and continuance

When performing client acceptance and continuance evaluations, be mindful that certain clients present a higher level of risk, and adjust your response accordingly. For example, when dealing with a high-risk financial institution audit client, the CPA firm may assign a technical expert to audit the client's allowance for loan losses. Or, for a high-profile celebrity client, a firm may require written change orders as well as an extremely detailed engagement letter that delineates the exact scope of services to be provided as well as the limitations of the services.

Include risk allocation provisions in engagement letters

To help manage defense costs and the potential amount of the firm's liability exposure, consider including provisions such as mediation, indemnification, and limitation of liability and limitation of damages provisions in engagement letters, where permissible. Many professional liability insurers, such as CNA, have sample provisions available for policyholders.

Be mindful of the perception of ethical violations

Perception can often be just as important as, or more important than, reality in the defense of professional liability claims. Documentation of a firm's consideration of and response to threats to independence and objectivity can help thwart a plaintiff attorney's attempt to replace the CPA's judgment with their own. Read "Professional Liability Spotlight: A Framework for Maintaining Ethics Compliance," *JofA*, Nov. 2019, and "Professional Liability Spotlight: Managing Conflicts of Interest," *JofA*, Nov. 2017, for more risk management tips.

Consider the expectation gap and the importance of scope management

Many large claims result from a misunderstanding of the roles and responsibilities of the client and the CPA firm. Pay attention to and proactively address the risk of an expectation gap to help ward off a claim. Read "Professional Liability Spotlight: Failure to Detect Theft and Fraud: It's Not Just an Audit Issue," *JofA*, Feb. 2014, to learn how to address the risk of a claim related to embezzlement at the client organization. "Professional Liability Spotlight: Don't Let Scope Creep Lead You Out of Bounds," *JofA*, Sept. 2015, provides tips on how to manage the risk of scope creep. Review "Professional Liability Spotlight: The Accidental Investment Adviser," *JofA*, March 2014, to understand how to avoid claims related to investment advice.

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