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PROFESSIONAL LIABILITY SPOTLIGHT

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Financial planning: Remember to plan for risk

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The evolution of data gathering tools, data scanning and population technology, and other tax automation products have many tax preparers concerned that the days of consistent revenue from tax compliance services may soon be coming to an end. As a result, many CPA practices are evolving to include tax and personal financial planning (PFP) services. While this is a common way to expand your practice, performing PFP services is not without professional liability risk. Remember that when clients lose money resulting from poor investment performance or heirs question the estate planning performed for a PFP client, the financial planner is often blamed. Consider these recommendations to help you plan for this risk.

CONDUCT THOROUGH CLIENT ACCEPTANCE PROCEDURES

As with any CPA service, undertaking due diligence before accepting a new client and regularly reevaluating the risk presented by a current client are essential. Consider this scenario:

> A client engaged the CPA to provide advice regarding when to exercise incentive stock options (ISOs). After the CPA had provided the advice, the client exercised the options and realized a $5 million gain. While this may seem like a windfall, the never-satisfied client sued the CPA, alleging that he could have received an additional $1.2 million in proceeds if the CPA had provided better advice and explained how ISOs operated. In hindsight, the CPA realized the relationship with the client had always been contentious, with the client taking no responsibility for his actions, even if he was clearly responsible. The CPA also regretted having inadequate documentation of client discussions.

The first step in avoiding a professional liability claim is working with the right clients. What makes a good client? Some items to consider include, but are not limited to:

- **Integrity and reputation:** Is the client honest and forthright?
- **Respect for the advice of professionals:** Does the client listen to and value your advice?
- **Timely and complete responses to information requests:** Is the client responsive, and does he or she provide complete information when requested?
- **Willingness to accept responsibility for decisions:** Does the client recognize that while the CPA can provide advice and make recommendations, the client is the ultimate decision-maker?
- **Financial acuity:** Does the client have a sufficient level of financial knowledge to articulate his or her level of risk tolerance and understand the CPA's recommendations?

Conflicts of interest represent another risk CPAs providing PFP services should consider during client acceptance. In fact, the Statement on Standards in Personal Financial Planning Services (SSPFPS) Section 100.20 and the AICPA *Code of Professional Conduct* (the Code) include provisions outlining circumstances that CPAs should consider as creating conflicts of interest. The Code also can raise awareness of how to identify whether a conflict exists and how to evaluate the threat's significance. For more information and tips to manage risk related to conflicts of interest, read "Professional Liability Spotlight: Managing Conflicts of Interest," *JofA*, Nov. 2017.

EVALUATE THE CLIENT'S SITUATION

According to SSPFPS Section 100.19, a CPA should possess competence in PFP principles and theory that enables him or her to identify the client's goals and objectives, gather and analyze relevant information, consider and apply appropriate planning approaches and methods, and use professional judgment when developing financial recommendations. In other words, the CPA should evaluate the client's individual situation to determine his or her willingness and ability to accept a certain level of risk. This risk tolerance is then used to determine what financial planning is in the client's best interest.

An analysis of risk tolerance should be performed for each client at the outset of a relationship and, while not required by the SSPFPS, updated regularly, provided the client is receptive. Investments suitable for a client as a single 25-year-old may not be appropriate when the same client is 40 years old and married with two children.

Negative outcomes may occur when a CPA providing PFP services has not performed this analysis, especially if a conflict of interest exists. Consider the following:

A tax client approached his CPA saying that he wanted to purchase an annuity because a friend spoke endlessly about the benefits of one during a round of golf. The CPA, wishing to respond to her client's request, sold the client an annuity without hesitation. Two years later, the client needed cash to pay his child's college tuition and wanted to cash out the annuity. However, the annuity contract had a negligible cash surrender value. As a result, the client sued

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the CPA asserting that she failed to act in the client's best interest and was more interested in obtaining a large commission on the sale of the annuity. The CPA's defense was hindered because the conflict of interest from the CPA's commission had not been disclosed to the client.

Even if clients think they know what they want, the CPA should still evaluate each client's situation, retaining a copy of the analysis and any updates in the workpapers. Consider having clients sign off on or otherwise approve the documentation of their risk tolerance.

Any commissions or referral fees the CPA receives must be disclosed to the client in writing as required by the Code ("Commissions and Referral Fees Rule," ET §1.520.001). SSPFPS Section 100.22 states that the disclosure should be in writing.

VET ALTERNATIVE INVESTMENTS

Most clients invest in traditional stocks, bonds, and mutual funds. However, some clients may prefer alternative investments, such as limited partnerships, real estate investments, hedge funds, or private bond offerings. Claims against CPAs have arisen from losses related to these types of investments, especially those that turn out to be fraudulent schemes. Consider this story:

A CPA advised a client to establish a trust as part of an estate planning services engagement. The trustee hired the CPA to manage the trust's investments, and the CPA invested a substantial amount of the principal in private bonds of a seemingly promising startup business. However, like many startups, it failed. The bonds were worthless, and, following the client's death, the trust's beneficiaries sued the CPA for breach of fiduciary duty and providing improper investment advice, alleging they did not fully understand the investment's level of risk.

All investments bear risk, but when alternative investments are recommended, additional due diligence should be performed. Investigate the promoters, including past performance of other investment offerings. Critically evaluate the prospectus, including the audit report. Conduct additional due diligence as appropriate for the particular investment. When the analysis is complete, advise the client of the risks associated with the alternative investment and, as always, retain documentation of the analysis and discussion.

ONE MORE THING

Any CPA providing formal financial planning advice can experience a professional liability claim, but following these steps and adhering to professional standards, including having the requisite level of competency to provide such services, may mitigate the risk of a successful claim. More frequently, however, claims emanate from informal or off-the-cuff investment advice, which may be provided by CPAs who are not PFPs. In these situations, CPAs may not realize that advice in a casual conversation or a response to a random client question could expose them to risk. For information on how to mitigate the risks related to informal advice, read "Professional Liability Spotlight: The Accidental Investment Adviser," *JofA*, March 2014.

Resources

The AICPA has numerous resources to aid CPA financial planners in complying with relevant practice guidelines and determining when they go beyond providing financial planning advice that is "solely incidental" to a practice, including the following:

- Tax and Financial Planning Services
- The Adviser's Guide to Financial and Estate Planning
- The CPA's Guide to Investment Advisory Business Models

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