

# Let the Good Times Roll but – Be Wary of the Increased Risks

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This is a good time to be an accountant. CAs are in higher demand than ever before and that means more clients and more profits.

With larger firms no longer being able to provide multiple services to the same clients, the medium-sized and smaller firms are reaping the benefits. But these windfall clients can also bring dangerous pitfalls. The bottom line: Bigger and more complicated engagements add up to bigger and more complicated risk exposures – and the claims statistics are confirming this.

## Pressures from Many Sides

Certainly, the increased demand for CAs attests to the diversity, expertise and leadership within the profession - traits that clients respect and seek. However, the increasing workloads and time pressures, along with rapidly changing standards and a shrinking skilled workforce, are stretching resources and sometimes even causing some to cut corners. The challenges and pressures are further exacerbated with the number of medium-sized and small firms now taking on larger and more complicated engagements.

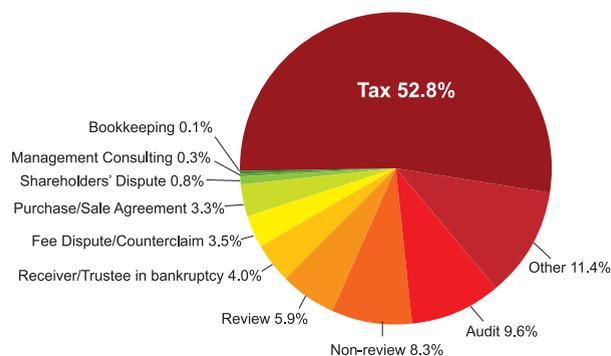
## A Red Alert

The number of claims has been rising. More importantly, this is tied to increases in the size of the claims and the settlements. Larger, high profile law firms are being retained by plaintiffs to sue accountants. This has resulted in class action suits being introduced and more complicated allegations, including breach of fiduciary duty, being more commonplace.

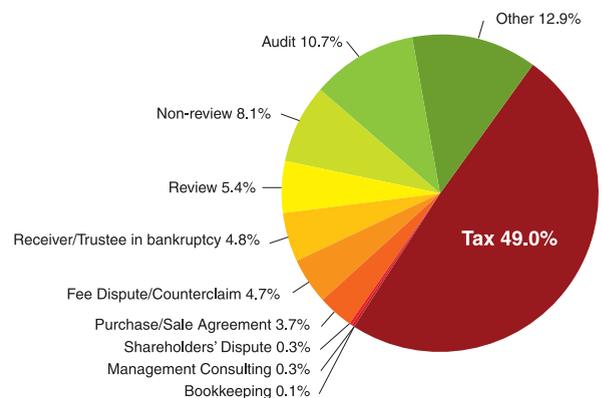
The areas of practice that are being hit the hardest may alarm you, or at the very least, raise your awareness of some important risk management areas that require close examination.

This article takes a wide-angle look at the changing landscape of risk exposures from a Canada-wide perspective – along with the comparative numbers for Ontario – based on claims statistics developed by AICA Services Inc. which provides professional liability insurance coverage for the vast majority of Canada's small to medium-sized CA firms.

Canada: Number of Claims by Area of Practice\*

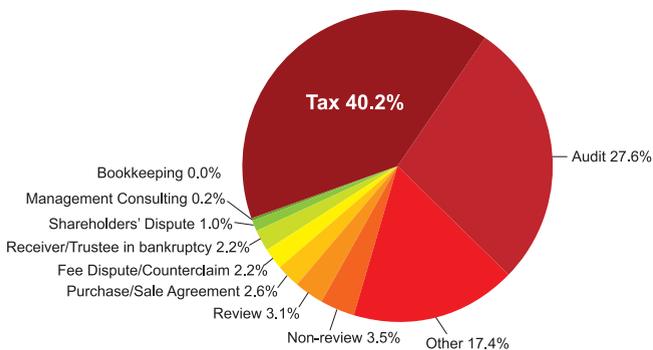


Ontario: Number of Claims by Area of Practice\*

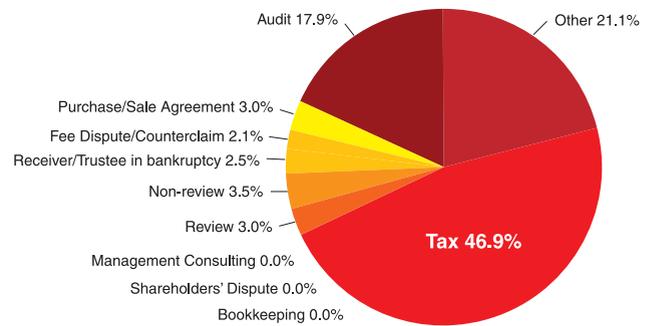


From 1999 to 2005, a staggering 52.8 per cent of all claims in Canada arose from tax engagements. More importantly, these claims accounted for 40.2 per cent of the total expenditures for damages and expenses.

## Canada: Total Incurred by Area of Practice\*



## Ontario: Total Incurred by Area of Practice\*



\* Total incurred equals all expenses and indemnity (damages).

When these statistics are broken down by the size of the firm, significant trends emerge:

- For small firms, the majority of reported claims involve tax services and compilation engagements (Notice to Reader).
- For medium-sized to large firms, the number of claims reported for audit is double the number of claims of any other assurance service. The number of claims involving tax services is also high but slightly lower than that of the smaller firms.

Another factor more prominent in the assurance services area is that "rogue" clients have been specifically targeting small firms, believing they lack the sophistication and experience to detect the client's "tricks" or can be more easily manipulated.

### Tax Engagements

Claims have arisen where small firms and sole practitioners have taken on complicated tax engagements that stretch the limits of both their expertise and their resources.

**Managing the Risk:** Before you accept a tax engagement, make sure you have the required expertise, experience and knowledge of the client and the particular industry. Do not proceed with engagements that are beyond your expertise.

Practitioners who commonly only prepare T1 and T2 returns will get involved in restructuring plans for their clients without fully understanding the pitfalls, particularly S84.1 problems.

With medium-size practitioners, the expertise is there, but aggressive tax planning strategies are implemented with no documentation of the risks and rewards of the advice. Sometimes the practitioner has acted on the fear that documentation would be a road map for the CRA to reassess. However, this position leads to the rewards of the plan being reaped by the client and the risk being transferred to the insured.

Your plan should have merit; therefore, it should be documented. The clients in these cases inevitably claim to have no knowledge of the risks. Further, they maintain that had they known the risks, they would not have proceeded. In these cases, the court asserts that considering the importance of the information, the practitioner should have documentation.

**Managing the risk:** Clearly explain the risks and rewards of a tax planning strategy to the client and document it. Without documentation, you are assuming all of the risks while your client obtains all the rewards.

### Audit and Review Engagements

Audit and review engagements account for 15.5 per cent of all claims and 30.7 per cent of the total incurred for damages and expenses. The biggest area of claims continues to be the audit, representing 9.6 per cent of the number of claims and 27.6 per cent of the total incurred.

The areas causing the majority of claims are:

- Fraud detection;
- Purchase and sale transactions; and
- Investment decisions.

### Fraud

The largest number of claims in the assurance services area involves auditors failing to detect the misappropriation of funds by employees. Now that auditors are required to consider the existence of fraud in the financial statements, all work should be approached with an attitude of professional scepticism.

**Managing the Risk:** Plan each audit carefully with particular emphasis on understanding the entity and how it is managed and controlled.

Instruct members of the audit team to immediately report suspicious matters to the audit practitioner/partner before discussing them with the entity's staff.

Where there is cause to doubt the integrity or honesty

of management, seek legal advice before reporting to the audit committee or its equivalent.

Be careful of who you follow up with when investigating irregularities.

Section 5135 of the *CICA Handbook – Assurance* provides guidance on the auditor's responsibility to consider fraud. The key requirement for auditors is to consider the possibility of fraud in planning the engagement and responding appropriately. The section includes three useful appendices that should be referred to when planning the engagement.

### **Purchase and Sale**

In these claims, users typically rely on general-purpose statements for a purchase and sale transaction. When determining materiality, the auditor must also consider the qualitative factor – the purpose for which the statements are being prepared. The materiality for a purchase and sale would arguably be lower than that used for general purpose statements. Consider also that a purchase and sale agreement will often stipulate the accounts being used to determine value – such as accounts receivable and inventory.

**Managing the Risk:** Before accepting the engagement, determine the identity of the users of the financial statements and the purpose for which the statements will be used.

Clarify the engagement objectives, scope and limitations in the engagement letter.

Another problem area is where one shareholder sells to another shareholder. Typically, the accountant is approached by both parties to act for them. Members are reminded of Rules of Professional Conduct – rule 210 – Conflict of Interest. In this example, a conflict exists and the CA can only work for a party if both have consented to the CA accepting the engagement and have agreed to the conflict management plan. Even then, consent can be withdrawn at any time. It is prudent to work for neither.

**Managing the Risk:** For a purchase and sale transaction between shareholders, advise each party to seek independent legal and accounting advice.

### **Investment Decisions**

Claims continue to involve shareholders, investors and creditors relying on the financial statements. There is greater success defending shareholders' claims given the Hercules defence. An audit is not designed to assist a shareholder in making decisions that involve his or her own personal interest. However, a new and disturbing phenomenon is emerging – user groups are advancing class actions. Paralleling the U.S. model, lawyers are becoming more aggressive in this area.

### **Compilation Engagements**

The most notable trend is that the number of claims arising

from compilation engagements is almost 10 per cent of all claims reported, with the majority of these involving small firms. The claims often arise from lenders having relied on financial statements with a Notice to Reader.

**Managing the Risk:** If a bank or other user contacts you, do not engage in a discussion about the financial statements. Clearly warn the caller that the statements were not prepared for that purpose. Communicate the limitations of the Notice to Reader.

The Notice clearly informs readers of the nature of the work. However, you cannot assume that investors and lenders are sophisticated users who understand the accountant's limited involvement in the preparation of the statements.

The financial statements are compiled from information supplied by management, typically for tax purposes. If the statements are subsequently used to procure financing, these users *should* know that they were not prepared with them in mind. Indeed, these users *should* demand an audit or review for their purposes.

**Managing the Risk:** If you are aware that the client plans to use the financial statements for financing purposes, encourage the client to have a review performed. Put this advice in writing.

If the Notice to Reader is not appropriate for the intended use, do not provide the service.

Too often it is found that the practitioner fell into the trap of doing extra work in the compilation engagement, thinking this will mitigate the risk exposure. However, the courts will consider *what you ought to have done* and *what you actually did*. If the practitioner did extra work beyond the scope of the engagement and failed to detect a problem, the practitioner cannot hide behind the Notice to Reader claiming that further procedures were not warranted.

**Managing the Risk:** To avoid misunderstandings with clients, document the terms of the engagement in an engagement letter.

### **Opportunities and Challenges**

The rising demand for CAs is expected to continue. At the same time, the profession faces significant challenges. Enjoy the good times, but take heed of the risk exposures in a changing environment.

Reviewing your risk management strategies and implementing changes to those areas that need to be improved are essential steps for reducing the likelihood of a claim. Remember, the best loss prevention strategies are founded on planning, communicating and documenting.

### **Practice Resources Available Online**

To download some helpful practice resources, including a *Risk Management PowerPoint* presentation, visit [www.aica.ca](http://www.aica.ca).