CPA VALUATION ANALYST MALPRACTICE

A WEBINAR
FOR NAVCA

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Presented by:

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DISCLAIMER

This presentation should not be construed as legal advice or a legal opinion on any specific factual situation or subject. Its contents are intended for general educational information only.

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BIOGRAPHICAL INFORMATION

C. P. "SALTY" SCHUMANN, C.P.A., C.V.A., C.F.F.A.

C. P. "Salty" Schumann is the managing director and founder of his firm, C. P. Schumann, P.C., which offers both traditional accounting services and the non-traditional services of business valuation and litigation on a local and a national level. He is a nationally known speaker and publisher of various articles in areas in which the firm practices. He holds both the Certified Valuation Analyst and the Master Analyst in Financial Forensic designations from the National Association of Certified Valuators and Analysts (NACVA). He has federal, district, probate, bankruptcy and tax court experience.

He currently serves on the NACVA Professional Standards Committee and was Chair of the NACVA Litigation Forensics Board and the Standards Committee for a number of years. He was also the past Chair of the Texas Society of Certified Public Accountants Litigation Member Services Section. He was also a member of the American Institute of Certified Public Accountants (AICPA) Litigation Support & Dispute Resolution Sub-committee, as well as the AICPA National Litigation Conference Committee and the AICPA Business Valuation Committee.

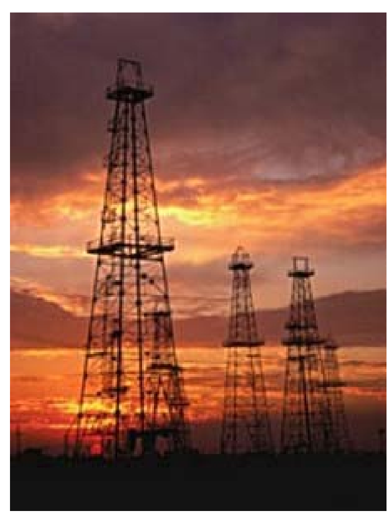
He is currently a member of the Texas Society of CPA's Professional Standards Committee.

He has participated in the writing of both the NACVA and AICPA Business Valuation Standards as well as the litigation standards applicable to CPAs.

His firm has a petroleum landman on staff and access to oil and gas information in 42 states in the continental U.S.

The firm offers the following oil and gas related services:

- Mineral Working and Royalty interest valuation.
- Second opinions on the fair market value of lease offers.
- Litigation and Expert Witness Services.
- Economic Damages.
- Property Tax Protests.
- Estate Planning.
- Cost Depletion Studies for Tax Computation Purposes.
- Due Diligence for Investment and Merger & Acquisition.
- Petroleum Forensic Document Research.



CURRICULUM VITAE

C. P. SCHUMANN, C.P.A., C.V.A., M.A.F.F.

ACADEMIC AND PROFESSIONAL CREDENTIALS

Bachelor of Business Administration - Graduate of Business Honors Program-
University of Texas at Austin – August 1972

Certified Public Accountant – September 1975

Certified Valuation Analyst – October 1995

Certified Forensic Financial Analyst – November 2000

Master Analyst in Financial Forensics - April 2013

POSITION AND EXPERIENCE

Managing Director and Shareholder, C. P. Schumann, P.C.

Prior litigation support engagements include expert witness testimony and consultation on age discrimination, asset impairment, business interruption, business valuation, breach of contract, buy-sell agreements/contracts, conflict of interest, construction delay damages, covenant not-to-compete, dissenting shareholder, divorce, economic damages, embezzlement, employee stock options, employee stock ownership plans (ESOP), estate taxation/matters, family limited partnership matters, fiduciary matters, fraud, fraudulent conveyance, gift taxation, goodwill, grantor retained annuity trusts, holding company, intangible assets, lost earnings, mail order pharmacy, mineral interests, professional malpractice, promissory notes, qualification of the expert witness (Daubert), S-corporation built-in gains, shareholder derivatives, tort law, usury, wrongful death, wrongful termination and oil and gas forensic issues.

Mr. Schumann has county, probate, district, federal, bankruptcy, and tax court experience.

Prior valuation experience includes the following industries and/or specialty fields: accounting, agricultural cooperative, agriculture implement distributor, agriculture, aircraft charters, aircraft leasing, aircraft restoration, appraisals, art galleries, auto dealers, automotive manufacturing, bakery equipment manufacturer, banks, beauty colleges, beer distributors, beverage distributors, biotech, certified public accountants, commercial law practices, convenience stores, country clubs (golf courses), dental, dry cleaning and laundry, electrical contractors, employment agencies, engineering, environmental organizations, equipment leasing, farm and ranch, fast food chains, finance companies, fireworks distributors, general contractors, highway construction, home health, hospitals, hotels, insurance, legal, management consulting, manufacturing, maquiladora, marinas, mechanical contractors, medical, oil and gas, pharmacies to include topical pain, pharmaceutical organizations, real estate, retail, retail grocery distribution, resort properties, restaurants, scrap metal dealers, software manufacturers, steel fabricators, tax preparation organizations, telephone companies, trucking, utility contractors, warehouse storage, and wholesale distributing.

PROFESSIONAL AFFILIATIONS - CURRENT

National Association of Certified Valuators and Analysts (NACVA)
Mentor Training Group

NACVA
Professional Standards Committee

Texas Society of Certified Public Accountants (TSCPA)

TSCPA
Professional Standards Committee

PROFESSIONAL AFFILIATIONS – PRIOR

Appraisal Institute Task Force

National Association of Certified Valuators and Analysts
Professional Standards Committee as a Member and Chair

National Association of Certified Valuators and Analysts
Education Quality Assurance Board

National Association of Certified Valuators and Analysts
Litigation and Forensic Board Chair as a Member and Chair

American Society of Certified Public Accountants
Litigation Committee

American Institute of Certified Public Accountants (AICPA)

PUBLICATIONS & SEMINARS - PRIOR

Has taught seminars for the San Antonio Chapter of the Texas Society of CPAs on taxation, valuation, and litigation related topics.

Has taught the two-day portion of NACVA's training center program dealing with "Valuation Fundamental Techniques, and Theory," and the topic "Business Valuation, Case Analysis - Report Writing."

2015 SEMINARS

CPA Malpractice, Mitigation and Analysis of Professional Standards presented to TACPA annual meeting, August 15, 2015.

2014 SEMINARS

Current Update on Oil & Gas Valuation presented to the San Antonio Bar Association Natural Resources Section, September 11, 2014.

2010 SEMINARS

"Business Valuation Standards and Ethics" NACVA Webinar

"Techniques for Exceptional Report Writing" NACVA Webinar

2009 SEMINARS

"Working Through the BV Standards Maze"

"Determining Reasonable Certainty with Ranges of Error for the Damage Expert" NACVA National Conference, Boston, Massachusetts, May 2009

2008 SEMINARS

"Working Through the BV Standards Maze," delivered in San Antonio, Texas, September 10, 2008

2007 SEMINARS

"Working Through the BV Standards Maze," delivered in Ft. Worth, Texas, October 22, 2007

2005 SEMINARS

"Standards Update," delivered to the 12th Annual Conference, Philadelphia, PA, June 3, 2005

"The Market Method; New Ideas For The Use Of Public Guideline Companies," delivered to the 12th Annual Consultants Conference, Philadelphia, PA, June 2, 2005

"Intangible Assets & Intellectual Property: A Global Perspective" delivered to the Intellectual Property Workshop, October 24 and December 5, 2005

2004 SEMINARS

"Business Combinations Goodwill, and Intangible Assets – FASB 141, 142 & 144," delivered to the Texas Lutheran University Accounting Department, January 16, 2004

"Business Succession, Asset Protection, Estate Planning, Wealth Transfer Tools & Other Planning Ideas" delivered to the San Antonio Chapter of the Texas Society of Certified Public Accountants on February 5, 2004

"Fraud Detection and Prevention: A Compendium of Current Issues" delivered at the Apogent Technologies, Inc. Controller's Conference, March 24, 2004

"Navigating The Darkside of Business Brokerage – What To Do When Things Go Wrong," presented to the Texas Association of Business Brokers, May 25, 2004

"Business Combinations Goodwill, and Intangible Assets – FASB 141, 142 & 144," delivered to the NACVA C.D.I. Conference, October 20, 2004

"Sarbanes-Oxley Act Update," delivered to the NACVA C.D.I. Conference, October 20, 2004

2003 SEMINARS

"How to Defend Your Report" and "Sarbanes–Oxley Act and FASB Update" delivered to the NACVA National Conference, May 28-31, 2003, New York City

"Business Succession Planning" delivered to the Texas Society of Certified Public Accountants 2003 Financial Institutions Conference, September 22, 2003

"Business Valuation Update for the Audit, Tax and Industry Professional" delivered to the San Antonio Chapter Texas Society of Certified Public Accountants 2003 CPE Symposium on August 28, 2003

"How to Communicate and Win at Trial" delivered to the San Antonio Women Accountants, September 24, 2003

2002 SEMINARS

"Analysis of Statement of Financial Accounting Standards No. 142 Goodwill and other Intangible Assets Including Valuation Issues for Implementation" – San Antonio Chapter of Texas Society of Certified Public Accountants, October 2002

"Trial Testimony Dos and Don'ts" – 2002 AICPA National Advanced Litigation Services and Fraud Conference, October 31, 2002, Las Vegas, Nevada

2001 SEMINARS

"High Level Dos and Don'ts – Deposition Theory & Practice," 2001 AICPA National Advanced Litigation Services and Fraud Conference, October 25-26, 2001, Dallas, Texas

"Calculating Economic Damages" – NACVA C.F.F.A. Program

August 17, 2001	Chicago, Illinois
October 19, 2001	Orlando, Florida
November 30, 2001	Las Vegas, Nevada

2000 SEMINARS

"Calculating Economic Damages: Business Loss" delivered to the 2000 Career Development Institute

1999 SEMINARS

"Formation, Operational, Tax, Valuation, Gift and Other Compliance Issues with the Family Limited Partnership" delivered to the San Antonio Chapter of the Texas Society of Certified Public Accountants, Winter/Fall

"Economic Damages," Advanced Business Learning Institute, Hyannis, Massachusetts

1998 SEMINARS

"The Family Limited Partnership," which is part of the topic "Valuation Issues in Family Owned Business," presented at the 1998 NACVA Business Learning Institute

"Recent Developments of Daubert that Affect the Exam of the Expert Witness and Guidance on Taxation for Recovering Environmental Cleanup Costs" delivered to the Environmental Section of the San Antonio Bar Association

"Qualification, Selection, Retention and Use of Financial Experts Including Confidentiality and Privilege Issues" delivered to the joint Texas Society of CPAs and State Bar Litigation Conference at the South Texas College of Law, Houston, Texas

1997 SEMINARS

"Economic Damages: Another Valuation Process," delivered to the 1997 Business Learning Institute

"The CPA as Expert Witness" delivered to the San Antonio Chapter of the Texas Society of CPAs during 1997

1996 SEMINARS

C. P. Schumann is the co-author of the seminar "Valuation Issues in Family Owned Business," which was part of the NACVA 1996 Business Learning Institute and also the author of "Separating Professional Goodwill from Enterprise Goodwill" (for divorce purposes) delivered to the 1996 NACVA fall conference.

2013 PUBLICATIONS

'Oil & Gas Valuation from an Estate and Gift Tax Point of View.' Scheduled for publication and presentation in 2014.

'Oil & Gas Cost Recovery & Depletion'

'Forward to Business Valuation Resources - Oil & Gas Valuation Treatise'

2012 PUBLICATIONS

'Erisa Litigation Compliance' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

'Variations on a Theme. Fair Market Value and Reasonably Equivalent Value. Are they the Same?' published on the C. P. Schumann, P.C. website at www.cpschumannco.com.

2011 PUBLICATIONS

'Allocation of Company and Personal Goodwill' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

'CPA Malpractice' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

2010 PUBLICATIONS

'Commercial Business Interruption Damages' published in the July 2010 issue of National Litigation Consultants' Review Newsletter

'Valuation of Oil & Gas Royalties' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

2007 PUBLICATIONS

January, 2007. 'Estimating Patent Infringement Damages' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

July, 2007. 'Valuation of Stock Options and Grantor Trusts, Intentionally Defective Grantor Trusts, Implementation, Planning and Case Study' published on the C. P. Schumann, P.C. website at www.cpschumannco.com

2006 PUBLICATIONS

October, 2006. Valuation Strategies Magazine, 'Improving Certainty in Valuation Using the Discounted Cash Flow Method'

2001 PUBLICATIONS

Book Review of "Quantitative Business Valuation - A Mathematical Approach for Today's Professional" by Jay B. Abrams, A.S.A., C.P.A., M.S.A., published in the NACVA Valuation Examiner Magazine

Interviewed for the article "Litigation Services: Dawn of A New Era" published in the July-August 2001 edition of Today's C.P.A. (Texas Society of CPA's)

AWARDS AND HONORS

Mr. Schumann was awarded the "1997 Instructor of Great Distinction" by the National Association of Certified Valuators and Analysts for obtaining an average score above 16 (on a scale of 1 to 20) for teaching 2 or more classes on the same topic.

He is also the recipient of the years 2000 and 2008 "Instructor of Exceptional Distinction Award" from NACVA for receiving an average score from participant evaluations exceeding 18 on a scale of 1 to 20, teaching two or more classes on the same topic.

Appointed for a three-year term as a member of the Steering Committee, Texas Society of Certified Public Accountants Litigation Services Member Section; Committee Coordinator, Economic Damages Section, Committee Chair for 2000 - 2001. Reappointed for a three-year term which began July 2005.

Selected as instructor and author for the Forensic Institute. The institute is responsible for the curriculum governing the new Certified Forensic Financial Analyst (CFFA) credential awarded by NACVA. The credential is designed to provide assurance to the legal community that each designee possesses a level of experience and knowledge to provide competent and professional forensic litigation support services.

Appointed by the American Institute of Certified Public Accountants to the Planning Committee for the year 2001 National Advanced Litigation Services and Fraud Conference held in October 2001, in Dallas, Texas.

Appointed by the American Institute of Certified Public Accountants to the Litigation & Dispute Resolution Services Subcommittee for a three-year term which began July 2001.

Selected by NACVA as an outstanding member for the months of January and February 2002.

Appointed by the American Institute of Certified Public Accounting to the Planning Committee for the year 2002 of the National Advanced Litigation Services Conference held October 2002, Las Vegas, Nevada.

Elected to the NACVA Litigation Forensic Board of Directors for a three-year term which began July 2002.
Appointed as Committee Chair to the NACVA Professional Standards Committee for the years 2004 – 2005 and 2005 – 2006.

Selected to interview with the Appraisal Foundation for a position on the Appraisal Standards Board – 2007.

Selected to the Round Table Group Expert Witness Network in June 2008. The group is a collection of industry experts who together form what has been called the "Mercedes-Benz" of expert think tanks.

Appointed as a member of the Texas Society of Certified Public Accountants Professional Standards Committee for a three-year term which began June 2012. Reappointed in April 2014.

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APPRAISER MALPRACTICE

In a perfect world, appraisal malpractice should be limited to violation regarding standards issues, not the ultimate value.

However, such is not the case.

Notwithstanding the public company venue (Delange – Dissenting Shareholder Rights and Fair Value), the appraisal malpractice arena has not reached a feed frenzy.

Litigation is always an issue as they require courts to perform complex financial analysis, an endeavor that extends will buy and core legal background and expertise.

The following information on common appraisal errors that affect reliability and relevance have been extracted from the Tudofranks article which appeared in BV Update November 2000. The article was written primarily to comment on divorce.

Lack of paradigm and improper use of data

The first focus of the analysis should be on whether there is a generally accepted valuation model.

The second area crucial to the paradigm is whether there is sufficient appropriate data available to derive a reliable result, even if the valuation profession could agree on a comprehensive, detailed model for the type of valuation in question.

Uniformity key to reliability

The critical issue for the purpose of either admissibility or weight should be whether, utilizing a particular appraisal methodology, the professional practice appraiser has the ability to produce "reasonably uniform and reliable results" in a goodwill determination.

No consensus regarding methodology

Alternative measures of "fair compensation" are virtually endless and produce radically different results in the ultimate goodwill computation.

There also does not appear to be a consensus regarding the methodology for productivity adjustments. Nor is there any agreement regarding the nature and extent of goodwill depreciation, which is a critical component of any capitalization rate determination.

To relate there is no reasonable consensus regarding quantification of the risk factors is a vast understatement. Similarly, appraisers generally are not able to tie an estimate of any change to an established formula for consideration of the risk factors or to data regarding quantification of the changes.

Unreliability of data used

The data the appraisers utilize frequently suffers from gross unreliability.

In all too many cases, appropriate data regarding a particular profession or subspecialty is not available, resulting in a decision by the appraiser to rely on the next best fit. The impropriety of such an approach and inherent limitations on reliability should be obvious, since the appraiser cannot reasonably estimate the extent of the difference between the proxy and the non-existent data. Care also must be given to avoid statistically impermissible mixing of data from independent sources.

Similarly, with respect to numerous adjustments appraisers make to income statements and balance sheets, there is a comparability issue with respect to the survey data, which once again introduces significant error into the ultimate valuation report.

Failure to convert business from cash basis to accrual

Conversion of a business from cash basis to accrual is necessary to determine the business's actual status and profitability.

Talismanic reliance on the past as predictor of future

All too often, appraisers rely on averages of past earnings, without appropriate investigation regarding likely future market conditions.

Failure to discount receivables to present value

All too frequently, appraisers either fail to discount receivables to present value, or fail to do so in an appropriate manner. Many businesses fail to remove uncollectible receivables from their balance sheet, particularly businesses reporting income on a cash, as opposed to an accrual, basis.

Failure to consider contingent liabilities

There are certain risks associated with a business that are subsumed within the capitalization rate. On the other rate, other forms of risk, including the risk of malpractice liability in the professional practice context (or products liability for a business), are subsumed within the business's ordinary cost structure through procurement of insurance coverage. Most professional practice appraisals fail to accrue (or adjust for) the expense of insuring against contingent liabilities which may be brought in the future, arising out of acts undertaken during the marriage.

The value of the contingent liability is not speculative in this instance, since it may be determined as the cost of procuring "tail coverage." Although it would be premature to procure a "tail policy" in connection with the divorce, since the professional practice will be ongoing (and there may be continuing insurance coverage on a "claims made" basis for so long as the professional continues to pay malpractice premiums in the future), that does not obviate the need to consider this "community" liability in connection with the divorce. A declining portion of any continuing insurance coverage is to provide insurance coverage for marital acts with post-decree separate property earnings. Tail coverage does not fully cover the risk value of the contingent liability, since there would be a deductible in the event of any claims, and there also always is the risk of a claim that exceeds the amount of insurance coverage.

The latter factor presumably is included in the risk factor dictated by the capitalization rate. However, it would seem to be inappropriate to determine that capitalization rate - and hence, the risk factor - without determining adequacy of the professional's liability insurance coverage and the likelihood of claims. The capitalization rate theoretically should be different for a professional who had minimal insurance coverage than for a professional who carries maximum insurance coverage.

Improper or incomplete adjustments for shareholder loans

Commonly, appraisers will enter a balance sheet and income statement adjustment recharacterizing loans to shareholders as shareholder compensation. In doing so, however, appraisers typically fail to enter corresponding adjustments to business expenses such as the corporation's share of FICA (if the employee was below the FICA limit), Medicare tax, and any related unemployment or other state taxes. Failure to accrue these expenses overstates profits and, therefore, goodwill and overall business value.

In addition to the foregoing, interest income derived by the corporation on officer loans also should be eliminated from income, if the officer loans are to be treated as compensation. The same adjustment would need to occur to the normalized net income statements for the professional practice.

According to plaintiff attorney, the following areas are often manipulated by the valuation.

Qualifications of the Expert

There are numerous types of people who think themselves experts with the qualifications to value businesses.

Business valuation is heavily dependent on accounting concepts, so at a bare minimum, a business valuator should have an accounting or finance degree. Preferably, the business valuator will also be a certified public accountant (CPA).

Valuation Method Used

The business valuation expert should follow the Uniform Standards of Professional Appraisal Practice (USPAP) in completing his or her valuation. Under USPAP standards, there are three approaches to valuation: the income approach, the market approach, and the asset approach.

Conclusion

In general, practitioners should look critically at the valuation. Manipulation of the income stream and changes to the capitalization rate based on subjective factors should be analyzed. Unsupported marketability discounts should be criticized and analyzed. Valuators who select the asset approach in the face of substantially higher income approach and market approach valuations should be criticized. And, finally, comparables used for market approach valuations should be analyzed and criticized by the practicing lawyer.

The following issues are major reasons for malpractice actions.

1) Acceptance of engagements with no experience or training

2) Suit for collection. Complacency based on long-term relationships.

3) Non compliance with Standards both AICPA, tax and valuation societies.

4) Lack of review.

5) ESOP and Fair Value Issues

The following case as presented for review. Remember most are state specific so they may not apply in your venue.

CPA standards such as objectivity are also an issue.

When working with a client on a business valuation, the CPA assumes one of the following roles: an adviser who is compensated to determine a value that – within the constraints of sound valuation theory – is most advantageous to the client or, alternatively, one who is compensated to perform an objective valuation of a company.

The CPA should be very clear to communicate which of these very different roles he or she is being paid to take on and document it in an engagement letter. This possibility of being an advocate versus being neutral requires knowledge and a commitment to remaining independent.

"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

While CPAs often try to be a one-stop shop for all their clients' needs, considering the absolute need for independence and objectivity when performing a business valuation, they may need to consider passing the valuation work to others outside the firm in certain situations.

The following narrative is intended to be applicable to a tax malpractice case in the state of Texas.

Accountants who agree to provide accounting services owe the client a common law duty to exercise reasonable care. This duty of reasonable care requires the Accountants to exercise the degree of care, skill, and competence that members of the profession would normally exercise under similar circumstances.

Accountants breach their duty by their failure to comply with the recognized industry standards of care. In particular, the Accountants fail to remain free from conflicts of interest and fail to maintain integrity and objectivity by subordinating their judgment to a client by Rule 501.73 of the Rules of Professional Conduct promulgated by the Texas State Board of Public Accountancy, and by failing to exercise due professional care in the performance of professional services as required by Rule 501.74 of the Texas State Board of Accountancy. Additionally, Accountants can violate the American Institute of Certified Public Accountants (AICPA) Professional Standards Code of Professional Conduct, and the AICPA Statement on Standards for Tax Services.

The AICPA Code of Professional Conduct, Rule 102, is clear: "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interests, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

Conflict of Interest, Rule 102

When performing any professional service, Rule 102 requires that a CPA shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. As revised, interpretation 102-2 broadens the definition to include any existing relationship. The CPA firm is employed by the entity, and not the owners of the entity. Decisions regarding elections should be made by the owners, not the CPA firm. CPA practitioners should explain any election to the taxpayer and document in writing both the disclosure and the client's decision to authorize the election.

Determining Professional Liability

Tort principles provide that professionals have a duty to exercise a level of care, skill, and diligence commonly associated with that of other members of their profession under similar circumstances. Contract principles require practitioners to competently perform the task undertaken.

For a plaintiff to prevail in a malpractice action against a tax preparer, the plaintiff must prove: (1) the tax preparer owed a duty to the taxpayer, (2) there was a breach of that duty, (3) the plaintiff suffered injuries, and (4) there was a proximate cause between the injury suffered and the duty.

In cases of tax return preparation, illustrating these four elements and the interconnectedness is straightforward. The first element is typically memorialized in an engagement letter that delineates the scope of the accountant's duties and responsibilities to the taxpayer. Alternatively, the tax preparer verbally agrees to prepare the taxpayer's tax return and undertakes this task.

The second element arises when the tax preparer makes a significant error or omits salient information that results in the preparation and submission of a flawed tax return. The details of the Accountant's lack of due care have been mentioned.

The third element includes the direct and consequential damages that stem from a tax preparer's failure to fulfill his or her duties and responsibilities.

The fourth element draws a causal connection between the second and third elements.

The following terms and definitions may be helpful:

Audits and Auditor's Opinions
An audit is the verification of a company's books and records pursuant to federal securities laws, state laws, and stock exchange rules that must be performed by an independent CPA. Generally, accountants must use generally accepted accounting principles (GAAPs) and generally accepted auditing standards (GAASs).

Accountant's Liability to His or Her Client for Breach of Contract and Fraud
Under common law, accountants may be found liable to clients who hire them under several legal theories, including contract, fraud, and negligence.

Accountant Malpractice
Accountant malpractice occurs when the accountant breaches the duty of reasonable care, knowledge, skill, and judgment that he or she owes to a client when providing auditing and other accounting services to the client.

Accountant's Liability to Third Parties
Under Section 552 of the Restatement (Second) of Torts, an accountant is liable only for negligence to third parties who are members of a limited class of intended users of the client's financial statements. The provides a broader standard for holding accountants liable to third parties for negligence than the Ultramares doctrine.

Foreseeability Standard
Under the foreseeability standard, an accountant is liable for negligence to third parties who are foreseeable users of the client's financial statements. This provides the broadest standard for holding accountants liable to third parties for negligence.

Accountant's Civil Liability
Accountants can be liable for violating various federal and state statutes, the most important of which is federal securities laws.

Accountant's Criminal Liability
Accountants can be criminally liable for violating certain federal and state securities laws and for other law violations.

Accountant / Client Privilege
Accountant/client privilege says that an accountant cannot be called as a witness against a client in a court action in that state. About 20 states have enacted laws to that effect. Federal courts do not recognize the privilege.

Accountant's Work Papers

Some states have enacted statutes that say an accountant's work papers cannot be used in a court action in that state. Federal courts do not recognize this statute.

TERMS:

- Accountant Malpractice - occurs when the accountant breaches the duty of reasonable care, knowledge, skill, and judgment that he or she owes to a client when providing auditing and other accounting services to the client.

- Audit - the verification of a company's books and records pursuant to federal securities laws, state laws, and stock exchange rules that must be performed by an independent CPA.

- Certified Public Accountant (CPA) - an accountant who has met certain educational requirements, has passed the CPA examination, and has had a certain number of years of audit experience.

- Engagement - a formal entrance into a contract between a client and an accountant

- Foreseeability standard - a rule that an accountant is liable for negligence to third parties who are foreseeable users of the client's financial statements. Provides the broadest standard for holding accountants liable to third parties for negligence.

- Generally Accepted Accounting Principles (GAAPs) - standards for the preparation and presentation of financial statement

- Generally Accepted Auditing Standards (GAASs) - standards for the methods and procedures that must be used to conduct audit

- 1976 Tax Reform Act - an act that imposes criminal liability on accountants and others who prepare federal tax returns if they (1) willfully understate a client's tax liability, (2) negligently understate the tax liability, or (3) wrongfully indorse a client's tax refund check.

- Privity of Contract - the state of two specified parties being in a contract

- Racketeer Influenced and Corrupt Organizations Act (RICO) - an act that provides for both criminal and civil penalties for securities fraud.

- Section 10(b) - a section of the Securities Exchange Act of 1934 that prohibits any manipulative or deceptive practice in connection with the purchase or sale of any security.

- Section 11(a) - a section of the Securities Act of 1933 that imposes civil liability on accountants and others for (1) making misstatements or omissions of material facts in a registration statement or (2) failing to find such misstatements or omissions.

- Section 18(a) - a section of the Securities Exchange Act of 1934 that imposes civil liability on any person who makes false or misleading statements in any application, report, or document filed with the SEC.

- Section 24 - a section of the Securities Act of 1933 that makes it a criminal offense for any person to (1) willfully make any untrue statement of material fact in a registration statement filed with the SEC, (2) omit any material fact necessary to ensure that the statements made in the registration statement are not misleading, or (3) willfully violate any other provision of the Securities Act of 1933 or rule or regulation adopted thereunder.

- Section 32(a) - a section of the Securities Exchange Act of 1934 that makes it a criminal offense for any person willfully and knowingly to make or cause to be made any false or misleading statement in any application, report, or other document required to be filed with the SEC pursuant to the Securities Exchange Act of 1934 or any rule or regulation adopted thereunder.

- Section 552 of the Restatement (Second) of Torts - a rule that an accountant is liable only for negligence to third parties who are members of a limited class of intended users of the client's financial statements. Provides a broader standard for holding accountants liable to third parties for negligence than the Ultramares doctrine.

- Ultramares Doctrine - a rule that an accountant is liable only for negligence to third parties who are in privity of contract or a privity-like relationship with the accountant. Provides the narrowest standard for holding accountants liable to third parties for negligence.

- Uniform Securities Act - an act that has been adopted by many states. It was drafted to coordinate state securities laws with federal securities laws.

- Work Product Immunity - a state statute that says an accountant's work papers cannot be sued in a court action in that state. Federal courts do to recognize this statute.

Diagram of How a Case Moves Through the Courts Guide to a Civil Lawsuit
Civil Cases
Settling Cases
Pre-trial Procedures in Civil Cases
Jurisdiction and Venue
Pleadings
Motions
Discovery
Pre-Trial Conferences
Civil Trials
Officers of the Court
The Jury Pool
Selecting the Jury
Opening Statements
Evidence

Direct Examination
Cross-examination
Motion for Directed Verdict/Dismissal
Motion to Settle Case Within Policy Limit
Presentation of Evidence by the Defense
Rebuttal
Final Motions
Closing Arguments
Instructions to the Jury
Mistrials
Jury Deliberations
Verdict
Motions after Verdict
Judgment
Appeals

WHEN ARE EXPERT WITNESSES LIABLE FOR THEIR MALPRACTICE?

What is Expert Witness Malpractice?

There are two parties concerned with the performance of experts: the party that hires the expert to testify and the opposing party. Their goals are at odds. The hiring party wants effective testimony as measured by a beneficial effect on the judge and jury, while the opposing party wants the expert discredited and the testimony stricken. Dissatisfaction by either party, without more, is not evidence of malpractice. As in other malpractice actions, it must be found that the expert performed below the standard for the profession he/she represents, and that this substandard behavior caused the party's injuries. Thus the party claiming malpractice must show both the standard for such experts and that, but for the expert's deviation from the standard, the party would have won. However, unlike other malpracticing professionals, the expert witness occupies a privileged place in the legal system. This is illustrated in the recent case, LLMD of Michigan v. Jackson-Cross.[1]

This case began when plaintiff Wintoll sued a group of lenders for not honoring their commitment to finance an industrial rehabilitation project. After the lawsuit commenced, plaintiff, through his attorney, contacted the expert, Charles Seymour, chairman of Jackson-Cross. Plaintiff needed testimony on the valuation of the lost business opportunity and other costs associated with the defendant's conduct.

It appears that Seymour was not deposed prior to trial and first testified about this calculation on the stand before the jury. On cross-examination, defense counsel showed that the damages calculation was based on an underlying mathematical error which rendered the calculation useless. Seymour conceded the error, and also was forced to admit that he could not correct the calculation because he did not prepare the original report. This so undermined his credibility as a witness that the judge struck his testimony. Wintoll was forced to rely on a much lower estimate based on other witness testimony, and agreed to settle the case for $750,000. Seymour subsequently provided a corrected estimate of $2,700,000 in lost profits, and Wintoll sued him and Jackson-Cross for the difference.

Seymour defended with a claim of witness immunity: the right of a witness in a legal proceeding to testify without fear of legal retribution. What seemed a simple malpractice case was now cast as a complicated public policy choice between an alleged need to encourage testimony by paid witnesses and assuring that expert witnesses testify in a professional manner.

Witness Immunity

There are two types of witness immunity; immunity against criminal prosecution based on the testimony and immunity against civil liability for harm caused by the testimony. If a witness lies on the stand or in deposition, the witness may be prosecuted for the crime of perjury. All witnesses at all times, irrespective of any immunity claims, are subject to perjury charges if they lie in sworn testimony. Witnesses may also be prosecuted for crimes that they admit to in testimony, unless the government has granted them immunity for testimony. In the case of perjury and admitted crimes, the prosecutions are brought by government prosecutors and not by the parties to the lawsuit. They provide no remedy for a private party injured by expert witness malpractice or other civil wrongs, such as defamation by the witness. Private parties must bring lawsuits under tort law or under specific statutes that provide remedies for the underlying harm. The leading United States Supreme Court case on witness immunity, Briscoe v. LaHue,[2] arose from a private action for deprivation of civil rights under a federal law.

Resolving the Wintoll Case

Based on the Briscoe case, the trial court accepted Seymour's claim of witness immunity and granted summary judgment for the defendant. The appeals court affirmed the summary judgment, affirming that the doctrine of witness immunity barred the plaintiff's claim against the expert. The Pennsylvania Supreme Court accepted the case on the issue of whether witness immunity applies to a party's own witnesses.

This case should be reviewed by anyone who is employed as an expert witness. This is an important change in the law in Pennsylvania and may portend a trend in other states. Experts should consider redrafting their retainer contracts to subject malpractice disputes to arbitration.

THE PROCESS

Lawsuit Against A CPA

If the CPA has malpractice insurance, the insurance company generally hires the lawyer and pays the legal fees and expenses incurred after the CPA's deductible is used and up to the limit in the policy. Many policies have "disappearing limits" – each dollar spent on defense reduces the amount of coverage left from the policy limit if the case is lost and the CPA ends up with a judgment against him/her. So the cost of defense can be important even if the CPA is insured.

There are only two ways lawsuits are disposed of – they are settled or they are tried. There are no other ways. In fact, 95 percent of all lawsuits filed are settled before trial. Most lawsuits are settled or tried within about two years of the filing.

If a malpractice case goes all the way to trial, the CPA can usually expect the lawyer fees and expenses, along with the necessary accounting expert witness fees (another CPA), to run well over $250,000 over the two-to three-year period. Even if the case settles, some substantial portion of those fees will be incurred before settlement.

For CPAs, the most common lawsuit is for malpractice. Malpractice is the failure to act as a CPA using ordinary care would have acted in the same or similar circumstances. A lawsuit alleging malpractice must be filed within the later of two years (Texas law) of the date of the alleged negligent act or the date the client (using ordinary care) should have discovered the malpractice.

If the claimant alleges intentional fraud, breach of fiduciary duty or breach of contract against the CPA (and not mere malpractice), the claimant has four years (Texas law) after the alleged fraudulent act or discovery of the breach or ending of the fiduciary relationship within which to file the lawsuit.

This discovery element of the statute of limitation rules that delay the starting time for limitations can make the time period uncertain. If the client alleges he/she did not know of the bad act of the CPA, the date to start measuring the time limit is the date the client using ordinary care should have discovered the alleged bad act. In the case of tax services, for example, a long history of Texas case law holds that the discovery does not occur until Internal Revenue Service (IRS) action (which may not occur until a number of years after a return is filed). A judge or jury has to decide that question based on the particular facts involved. Predicting the result of that (or any) decision based on any particular facts is never easy. There are also other situations that may delay the required starting time to file a lawsuit, such as if the client is not an adult, is incompetent, or is in the military and overseas.

A CPA firm should set up a system so that all records are automatically and reliably kept for more than four years after the event in the records. In the case of tax services, as an example, this would be four years after the time to assess the tax has expired. An additional buffer period of at least two years (for a total of six additional years) would certainly be prudent.

The system should automatically identify clients who (i) are minors, (ii) are trusts with minor beneficiaries, (iii) are or may become incompetent in the near future (such as clients who are very elderly or in bad health), or (iv) are in the military. The system should automatically keep these records for several years after the minors come of age, the death of the incompetent client, or completion of the military service of the client.

If the CPA is an officer, director, employee, partner or agent of the client' or a partner with another CPA, or is a friend or relative of the client, the system should keep the records for the entire period of the relationship and until more than four years after that relationship ends.

<u>Spoliation of Evidence</u>

One of the pitfalls for all persons who face lawsuits is spoliation – the destruction, loss or alteration of records and other evidence of events before or during the lawsuit – when the party knew or should have known that a lawsuit was likely to result from the events.

Spoliation can occur intentionally (when the party knowingly destroys or hides the evidence), by accident (hitting the wrong key on the computer), by negligence (careless thinking or not thinking about preserving data), or by bad practices (not regularly keeping data, not backing up data, not stopping an automatic purging of files or not identifying and pulling data from the purge, and not training staff to recognize and save potential evidence).

The penalty for spoliation before the lawsuit is filed usually is that the trial court can instruct the jury to presume the lost, destroyed or altered evidence would have shown that the CPA actually committed the complained of act, or caused the damage and sometimes even the amount of the damage claimed. The penalty for spoliation after the lawsuit is filed may include that kind of instruction, plus a sanction of paying the cost to reconstruct the evidence if possible, or even contempt of court (fine and jail time) if the court finds the spoliation to be intentional or reckless. Because of the time periods of the statute of limitations discussed above, the starting time period necessary for preserving potential evidence may be many years before a lawsuit is filed (if it ever is).

Evidence that can be spoiled includes:

- Papers
- Computer files
- Time and billing records
- Voice mail recordings
- Text messages and e-mails
- Bank records
- Travel records
- Diaries and calendars
- Phone records
- Internal notes and personal notes and
- Electronic and hard copies of any of these, back-ups of any of these, and even deleted potions of these that might still reside in some technical part of the computer system.

In addition to your required duty to preserve records for professional accounting purposes (including under tax statutes), you should set up a document retention system and procedures to reorganize and identify an event that might give rise to a complaint or suit. Once your procedure identifies such an event, your procedure should protect any evidence from any purging practice. Your procedure should also automatically protect the evidence from access that might alter the evidence. For example, routinely opening a computer file to view it, or do ordinary maintenance or services.

If a CPA settles or loses a malpractice or other civil lawsuit based on his/her professional practice, that fact must be reported within 30 days to the Texas State Board of Public Accountancy (TSBPA).

HOW TO RESPOND TO A CLAIM

Step 1: Notify the carrier.

Step 2: Limit communications with third parties.

Step 3: Respect your legal boundaries.

Step 4: Review and preserve documents.

Step 5: Collaborate with counsel.

Step 6: Chronicle the engagement.

Step 7: Assist in expert selection.

Step 8: Approach Settlement negotiations with care.

Step 9: Prepare your testimony.

Step 10: Voir dire

Step 11: Attend the trial.

Step 12: Attend jury instruction phase.

JURY ISSUES, BIAS AND THE EXPECTATION GAP

If time and budget allow, juror reaction to mock direct and cross examination of key witnesses can be a useful tool in final preparation and as a means of fine tuning case strategy.

Most jurors believe that lawyers and accountants together have the responsibility to advise clients regarding the risks of accounting advice.

Jurors believe, however, that accountants sometimes do a poor job, and fail to recognize that their work is only as good as the information the client provides and that the client is responsible for the accuracy of that information.

About one in five believe the client is fully responsible for mistakes, 50% thing that both the client and the accounting firm are equally responsible; the rest are not sure.

Most jurors are likely to see some justification for both sides' positions in an accounting malpractice case. Since these cases usually involve impersonal business transactions, jurors are unlikely to be strongly committed to either side of an emotion level. Thus, escaping responsibility entirely will be difficult for most defendants, although strong facts and witnesses could overcome jurors' tendency to spread blame among the participants.

Recommendations

Develop compelling demonstrative evidence to illustrate the chain of responsibility for financial information.

Since escaping responsibility entirely will be difficult, focus on the de-selection of possible punitive jurors during voir dire.

Most are not interested in learning technical auditing and accounting terms and will ignore them during deliberations.

Recommendations

Simplify technical language in opening, and minimize technical explanations during testimony by focusing on the purpose of accounting and auditing standards.

In addition to these fundamentals that apply to most malpractice cases, it is also important in developing an overall strategy to focus on the key facts and issues in the case as perceived by jurors. Jurors create their own hierarchy of case issues that can only be determined by analyzing deliberation groups on a case-by-case basis. Thus the best possible trial strategy is achieved by combining an understanding of how jurors are likely perceive the specific issues in the case with the broad-based attitudes and beliefs outlined here.

The Expectation Gap in the Legal System: Perception Differences Between Auditors and Judges

Source: Dr. D. Jordan Lowe, Accounting, Virginia Polytechnic Institute and State University

The difference between what the public expects from the auditing profession and what the profession actually provides has been called the “expectation gap”. The profession argues that one cause of the expectation gap is the public’s failure to appreciate the nature and limitations of an audit.

The expectation gap, and its related effects on auditor legal liability, has been presumed to be caused by diverging perceptions by the auditing profession and third party litigants regarding the profession’s role, responsibilities, and related performance. Prior research regarding the expectation gap has focused on diverging perceptions of different groups (i.e. financial analysts, bank loan officers, small business owners, and auditors). While this research has identified an expectation gap between auditors and certain third-parties, it has neglected examining the perceptions of judicial litigants.

The expectation gap has been most conspicuous in legal decisions. Judicial litigants often appear to apply, as a standard, the concept that an audit is a comprehensive check on a corporation’s financial activities (Kaplan 1987). A business failure is often interpreted to be an audit failure, regardless of the level of procedures and tests performed by the auditor.

The auditing profession's concern that the expectation gap is contributing significantly to the number and magnitude of successful auditor "malpractice" suits has increased in recent years as losses have intensified.

Table 1
Expectation Gap Between Judges and Auditors

	Mean Judgments (Std. Deviation) Judges	Auditors	Difference*
Audit Knowledge			
1) The financial statements contained in the annual report to stockholders are primarily the responsibility of corporate management, and not of the external auditor (CPA).	4.89 (3.26)	8.88 (2.16)	3.99
2) External auditors cannot look at every client transaction. They must rely on samples and tests of relationships in conducting an audit.	6.96 (2.49)	9.71 (1.11)	2.75
The Auditor's Role			
3) One role of an auditor is to be an insurer against large stockholder losses.	3.73 (3.42)	1.31 (1.93)	2.42
4) The role of the external auditor is to be a public watchdog.	6.37 (2.85)	3.03 (2.99)	3.34
5) One role of the auditor is to actively search for fraud, no matter how small.	6.54 (2.88)	0.78 (1.47)	5.76
General Attitudes Toward the Profession			
6) The current standards of audit practice are very high.	5.92 (2.22)	8.13 (1.31)	2.21
7) The big auditing firms make plenty of money in the good times, so they should share in the stockholders' losses, too, in the bad times!	3.11 (2.86)	0.99 (1.59)	2.12
8) The big corporations and their big auditors (CPAs) work hand-in-glove and only tell the public what they want to tell them.	4.79 (2.83)	2.91 (2.36)	1.88

*All mean differences are significant at $p < .001$

Attitude Scale

Please respond to these questions by indicating a number in the response column using the following scale:

Strongly Disagree 0....1....2....3....4....5....6....7....8....9....10 **Strongly Agree**

USING THE ENGAGEMENT LETTER TO MITIGATE CLAIMS

CPAs are not required to use engagement letters when providing services. However, using engagement letters does provide a convenient means of outlining the engagement to prevent misunderstandings and to provide for a method of resolving future disputes about the engagement should the need arise. Underwriters of professional liability insurance for CPAs value engagement letters in that they currently quote lower (5 percent less) premiums for those CPAs who use engagement letters on all engagements than for those CPAs who do not use them.

Limitation of Liability

Liability of C. P. Schumann, P.C. and its owners, employees, and subcontractors for errors and omissions, if any, in this work will be limited to the amount of its compensation for the work performed in this engagement.

Venue

This contract is intended to be interpreted under Texas law.

Fiduciary Issue

The parties to this contract specifically intend that neither this agreement, nor any course of dealings between them shall create fiduciary obligations.

Mediation (Not Arbitration)

Disputes arising under this agreement including the scope, nature and quality of services to be performed by us, and other terms of the engagement but not our fee shall be submitted for mediation. A competent and impartial third party, acceptable to both parties, shall be appointed to mediate, and each disputing party shall pay an equal percentage of the mediator's fees and expenses. No suit or arbitration proceeding shall be commenced under this agreement until at least 60 days after the mediator's first meeting with the involved parties. If the dispute requires litigation, the court shall be authorized to impose all defense costs against any non-prevailing party found not to have participated in the mediation process in good faith.

Failure to Pay

We will invoice you on a monthly basis and all invoices are due upon receipt. **We will discontinue services if your account balance becomes 45 days past due.** You acknowledge and agree that in the event we stop working on or withdraw from this engagement as a result of your failure to pay on a timely basis for services rendered, we shall not be liable to you for any damages that may occur as a result of our ceasing to render services.

Retainer

Our engagement will require a retainer of $5,000.00 which should be delivered with the signed engagement letter. **We will hold the retainer received and apply it to your final bill or refund it to the extent that it exceeds such billing.**

Conclusion

The engagement letter is an important and simple tool for mitigation of malpractice claims. The letter identifies through limiting language the responsibilities of both the CPA and client for the successful completion of the engagement and the parties whom the CPA and client intend to rely on the CPA's work. The engagement letter also serves to manage clients and their expectations by clearly defining, at the outset, the scope of the work that the CPA will perform. The engagement letter is a means for reducing the risk of being on the receiving end of a malpractice threat or claim, and will better position CPA firms in the event they do face such claims.

Sample Engagement Letter for Expert Witness Engagement

August 15, 2013

Attorney representing defendants
Address
City, State Zip

CASE NO.: and Styling

Dear Mr. Attorney:

This letter will serve to confirm our understanding and agreement whereby you as attorney for the defendants have retained our firm to perform services in this matter. It is our understanding that we will be retained as an expert witness for the purpose of rendering our opinion as to whether or not the Plaintiff has sustained economic damages relating to lost profits and/or diminution of value due to the actions of the defendants pursuant to their malpractice claim.

We understand that all work performed, as well as information disclosed to us, will be subject to the rules for discovery for expert witnesses.

In performing our engagement, we will be relying on the accuracy and reliability of the Company historical financial statements, forecasts of future operations, and other financial data. All reports, statements and information provided by the Plaintiff are assumed to be true and correct and will be the basis of our opinions. Our engagement cannot be relied on to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist.

Your firm will determine the scope of the work performed. All reports and documents prepared for this engagement may not be used for any other purpose without our consent. All work papers and other documents used by us during the course of this engagement will be maintained in segregated files. At the completion of the engagement, the originals and all copies thereof will be returned to you.

Our opinions will be based upon our review of the discovery documents that you make available to us.

We understand that you have been retained by Malpractice Carrier and that their signature acknowledges their agreement with the terms of this agreement.

It is also understood between the parties to this agreement that we may terminate this agreement upon a substitution of attorneys for any reason or good cause.

The primary assumptions and limiting conditions pertaining to our opinions are summarized below:

1) Neither all nor any part of the contents of our report shall be disseminated or referred to the public through advertising, public relations, news or sales media, or any other public means of communication, or referenced in any publication, including any private or public offerings, without our prior written consent and approval.

2) Unless otherwise stated, no effort will be made to determine the possible effect, if any, on the Company due to future federal, state, or local legislation.

3) Events and circumstances frequently do not occur as expected and there will usually be differences that may be material. Accordingly, to the extent that any of the information used during this analysis and report requires adjustment, our opinion could be different.

4) All facts and data contained in our report will be considered to be true and accurate to the best of our knowledge and belief.

5) No investigation of legal fees or title to the property will be made, and the Company's claim to its property ownership will be assumed to be valid. No consideration will be given to liens or encumbrances that may be against the property, except as specifically stated in our report.

6) We will assume that there is full compliance with all applicable federal, state, and local laws and regulations in the United States of America, unless the lack of compliance is stated, defined, and considered in our report or disclosed to us by third parties.

7) Public information, purchased private information, and industry statistical information are from sources we deem reliable; however, we will make no representation as to the accuracy or completeness of such information, and will accept the information without further verification.

8) None of the owners or employees of our company or independent contractors have any personal interest with respect to the parties involved, or any other interest that might prevent us from performing an unbiased opinion. Our compensation is not contingent on an action or event resulting from the analysis, opinions, or conclusion in or from the use of this report.

9) Our report will reflect facts and conditions existing as of the cessation of the Company.

10) This contract is intended to be interpreted under Texas law.

11) Liability of C. P. Schumann, P.C. and its owners, employees and subcontractors for errors and omissions, if any, in this work will be limited to the amount of its compensation for this engagement.

12) The parties to this contract intend that neither this agreement, nor any course of dealings between them shall create fiduciary obligations.

Our engagement as expert witness will require a retainer of $7,500. We will hold the retainer received and apply it to your final bill or refund it to the extent that it exceeds such billing. Although you and your law firm have retained us for the above proceeding, it is understood and agreed that there is no liability on the part of yourself or your law firm for the fee for any services to be rendered by us pursuant to this agreement. Our fees remain your client's responsibility.

Our firm's billing rates range from $75.00 - $350.00 per hour. We will invoice you on a monthly basis and all invoices are due upon receipt. **We retain the right to discontinue services if your account balance becomes 45 days past due.** In the event we discontinue services, we are not liable to you or your client or the retaining insurance carrier for damages. In addition to billable time, we will also bill for out of pocket costs to include travel, industry or risk research, and any out of state CPA registration fees.

Billing Rates for C. P. Schumann, P.C. are as follows:

Partner	$350.00 per hour
Senior CPA	$175.00 per hour
Junior CPA	$120.00 per hour
Para Professional	$90.00 per hour
Clerical	$75.00 per hour

Our initial estimate of our fee to prepare our report is $12,500.

Our fees are not contingent upon any specific damage amount determined by our firm. We shall use our best efforts in the performance of the assignment, and shall be entitled to full payment of all fees without regard to any ruling of the court or ultimate use of our opinions.

You and your law firm, or the court itself, will advise us with sufficient notice of the work to be performed by us and the requirement for appearance in court.

We will not retain work papers or data files that have been superseded or updated. If you wish us to maintain the superseded data, please indicate your specific request(s) in writing when returning a copy of this engagement letter.

Disputes arising under this agreement, including the scope, nature, and quality of services to be performed by us and our contractors, and other terms of the engagement, except for our fees, shall be submitted to mediation. A competent and impartial third party, acceptable to both parties, shall be appointed to mediate, and each disputing party shall pay an equal percentage of the mediator's fees and expenses. No suit or arbitration proceeding shall be commenced under this agreement until at least 60 days after the mediator's first meeting with the involved parties. If the dispute requires litigation, the court shall be authorized to impose all defense costs against any non-prevailing party found not to have participated in the mediation process in good faith.

My Curriculum Vitae is attached as Exhibit I.

Our initial production request will be submitted at a later date.

If this letter meets with your approval, please return a signed copy to us along with the retainer requested.

Thank you for the opportunity to be of service.

Very truly yours,

C. P. Schumann, C.P.A., C.V.A., M.A.F.F., President

Acknowledged:

______________________________ ____________________

Mr. Attorney Date

Approved:

______________________________ ____________________

Your Malpractice Carrier Date

DAMAGES

In a claim against an accountant, the following types of consequential damage recoveries have been allowed:

- loss of business reputation;
- loss of fair market value to a business; and

- lost profits

Because tax law is generally perceived as a specialty, the standard of care may be higher than in other attorney malpractice situations. To establish a prima facie cause of action, a plaintiff must show "(1) a duty owed by the attorney to the plaintiff . . . ; (2) breach of that duty . . . ; (3) injuries suffered by the plaintiff; and (4) a ‘proximate cause’ relationship between the injury suffered and the attorney’s breach of duty." The standards for accountants are similar to those for attorneys.
In tax malpractice, as in other types of professional malpractice, the plaintiff generally is "entitled to recover for all injuries proximately caused by the defendant’s [negligence]." The plaintiff is entitled to recover for the loss of any expected benefit that competent performance would have yielded.

There are three broad areas in which tax representation, and consequently malpractice, may arise: tax planning, tax return preparation, and subsequent representation. Damages that may be recovered are only for those injuries that have actually occurred.

Damages are usually divided into two categories: direct and consequential. Direct damages are those damages . . . that are immediate, natural and anticipated consequences of the wrong. Consequential damages are compensation for those injuries that flow, because of the direct damages and, therefore, depend on special circumstances that are not necessarily anticipated.

One other aspect of recoverable damages needs to be focused on, and that is the general requirement imposed on an injured party to mitigate damages. Under normal tort principles, damages that may be minimized or reduced through reasonable efforts are not recoverable.

Query: Suppose client failed to provide documents.

Elements of damages. In tax malpractice situations, the most direct types of damages encountered consist of additional taxes resulting from the malpractice, interest and penalties imposed on the additional taxes, and corrective costs incurred in attempting to eliminate or mitigate all or some of the foregoing damages.

Because the determination of recoverable damages is a matter of state law, differences among the states are to be expected and do in fact exist. Thus, although there seems to be general agreement that penalties and corrective costs are recoverable, the situation concerning taxes and interest is different. As to taxes, although the language encountered would seem to suggest a more fundamental disagreement, it appears that most states allow recovery of the additional taxes caused by the malpractice. What is not recoverable are other taxes incurred by the plaintiff, that is, taxes that would have been incurred even in the absence of the malpractice. With respect to the interest imposed on a tax underpayment, three distinct approaches are evident: One approach permits the recovery of such interest from the defendant; one approach denies any recovery of such interest; and a third approach stands between these two extremes and permits recovery of some interest, but only to the extent that the interest paid by the plaintiff to the government exceeds the interest earned by the plaintiff on the tax underpayment.

Generally, no recovery is available for any emotional distress or mental anguish that might result from a tax professional's negligence.

The recoverability of attorney fees depends on the nature and type of attorney fees involved. Where the fees are incurred to correct the damages flowing from the defendant's negligence, these are corrective costs and are recoverably as core damages. However, attorney fees incurred to prosecute the malpractice action against the negligent tax advisor are, generally, not recoverable as damages.

What About Interest

STATES FOLLOWING:		
Traditional View Allowing Recovery of Interest	No-Interest Recovery View	Intermediate View-Depends on Facts and Circumstances
Alabama	Alaska	Massachusetts
Arizona	California	Nebraska
Florida	New York	New Jersey
Illinois	Washington	Pennsylvania
Iowa		South Dakota
Louisiana		Texas
Maryland		Virginia
Nevada		
North Carolina		
Ohio		Federal district court for Oregon
Oklahoma		
Wisconsin		
Wyoming		
Totals 13	4	7(8?)
(Oregon?)		

This table is intended solely as a current snapshot and only as a very general guide. Cases may lend themselves to different interpretations and changes may always occur. The only thing that seems reasonably certain is that the traditional view allowing the recovery of interest is, and probably always was, the majority view. The no interest view is clearly a minority view – even if the two transient adherents are taken into account.

Punitive Damages

The ability of a plaintiff to recover punitive damages varies widely among the states. Generally speaking, punitive damages cannot be awarded against an accountant without a finding that the accountant acted willfully or with malice in reckless indifference to the rights of others. Conversely, mere negligence in misrepresenting the financial condition of a client is not a grounds for imposing punitive damages.

Where punitive damages are imposed, they are measured by a number of factors, including the egregiousness of the accountant's misconduct, the accountant's financial resources, and the need to set an example for others and to deter similar, future misconduct.

Prejudgment Interest
Historically, the common law has not allowed a plaintiff to recover interest on the amount of damages awarded in the lawsuit until entry of judgment. An exception is made under this rule to allow a prevailing plaintiff to recover prejudgment interest where the damages were for a liquidated amount or could be calculated, as an arithmetic function, from objective facts (such as accounting records).

Even so, prejudgment interest has been denied in suits against accountants, both in jurisdictions following the common law and in those where a state statute allows prejudgment interest to be taxed. Prejudgment interest in an accounting malpractice case has been held to accrue from the date when an undetected diversion of funds occurs, rather than when the plaintiff makes a demand for payment of the defalcation to the accountant. *Gemstar Ltd. v. Ernst & Young*, 185 Ariz. 493, 917 P.2d 222, 238 (1996).

The amount is determined by state law.

Professional Fees
The general rule in American jurisprudence is that a party cannot recover the attorneys' fees incurred in litigating a dispute, even if the party ultimately prevails.

A corollary to this rule is that a plaintiff in a malpractice action may be able to recover professional fees incurred outside of the malpractice lawsuit, if they were required to attempt to rectify, mitigate or correct the accountant's error. An example of this is found in situations where a new accountant is hired to handle an audit by the IRS, triggered by the initial accountant's negligence. Such remedial fees may be recoverable even if the contest with the IRS is unsuccessful. One court even allowed a client to collect attorneys' fees incurred in a separate lawsuit which was brought as a result of the CPA's negligence.

The jurisdictions are split on whether a plaintiff can recover the fee paid to the accountant for negligently rendered services (or whether the accountant is entitled to a deduction from any damage award for the amount of unpaid fees). Some courts allow the plaintiff to recover for previously paid professional fees if the accountant's negligence made the accountant's services wholly worthless. Other courts allow the accountant to claim the offset for an unpaid fee. It has also been held that a client is entitled to recover fees incurred to correct improperly audited financial statements and related accounting issues.

CONFLICTS OF INTEREST

Be wary of representing two parties at once, such as a divorcing couple, an estate and its beneficiaries, or a buyer and seller who "just want you to write the agreement."

Exercise caution when considering whether to sue a former client. Never sue for a fee.

Avoid joint representation in those potential conflict situations where there is real risk of conflict.

If any potential conflict exists, seek permission from each affected client to disclose your representation and its effect on all clients, before accepting representation. Absent each affected client's permission, withdrawal is the only option.

Avoid becoming a director, officer or shareholder of a corporation while also acting as the corporations' accountant.

Unlike some formulations of legal rules pertaining to conflicts of interest, the CPA's formulation derives from the requirement that a CPA must be objective in the performance of any professional service. Rule 102, entitled "Integrity and Objectivity," requires:

> In the performance of any professional service, a Member shall maintain objectivity and integrity, *shall be free of conflicts of interest*, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

ET §102.01, 2 AICPA *Professional Standards* at 1771 (2010) (emphasis added).

The Code of Professional Conduct amplifies the conflict-of-interest rule, explaining when a conflict of interest occurs, identifying the type of engagements to which the conflict-of-interest rule applies and discussing when conflict-of-interest waivers may be used:

> A conflict of interest may occur if a Member performs a professional service for a client or employer and the Member or his or her firm has a relationship with another person, entity, product or service that could, in the Member's professional judgment, be viewed by the client, employer or other appropriate parties as impairing the Member's objectivity. If the Member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from such client, employer or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the Member should consider Rule 301, *Confidential Client Information*…ET §102.03, 2 *AICPA Professional Standards* at 1771 (2010).

How Do IRS Conflicts of Interest Rules Impact You?

Circular 230, the Treasury regulations governing ethical standards applicable to practice before the Internal Revenue Service (IRS), deals with conflicting interests at Section 10.29 (31 C.F.R. §10.29). It forbids federal tax practitioners (a defined term that includes CPAs) from having conflicts of interest. Conflicts of interest are defined as representation of one client that is directly adverse to that of another client, or as representing a client in circumstances creating a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

However, a practitioner may represent a client despite a conflict of interest if the practitioner reasonably believes he/ she can provide competent and diligent representation to each affected client and if all affected clients waive the conflict by giving their written informed consent. Circular 230 has at least two major potential effects on covered practitioners: (1) violation of a

Circular 230 standard may subject the practitioner to sanction by the IRS Office of Professional Responsibility (OPR); and (2) Circular 230 may be used in a lawsuit for damages filed by a client in connection with asserted errors and omissions by the practitioner as the standard to which the practitioner should be held in performing services. Thus, CPAs have a strong interest in understanding the standards to which they will be held under Circular 230.

<u>The Conflict of Interest Provisions Are Not the Same</u>
The requirements for waiving a conflict of interest are a good example where Section 10.29 of Circular 230 presents a higher and different standard than that of the Code and SSTSs. Underlying the distinction between the Code and Circular 230 conflict of interest rules is the fast that Circular 230 Section 10.29 tracks the American Bar Association (ABA) Model Code of Professional

The following are examples of situations in which conflicts of interest may arise:

- Providing corporate finance services to a client seeking to acquire an audit client of the firm, when the firm has obtained confidential information during the course of the audit that may be relevant to the transaction

- Advising two clients at the same time who are competing to acquire the same company when the advice might be relevant to the parties' competitive positons

- Providing services to both a vendor and a purchaser who are clients of the firm in relation to the same transaction

- Preparing valuations of assets for two clients who are in an adversarial position with respect to the same assets

- Representing two clients at the same time regarding the same matter who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership

- Providing a report for a licensor on royalties due under a license agreement while at the same time advising the licensee of the correctness of the amounts payable under the same license agreement.

- Advising a client to invest in a business in which, for example, the immediate family member of the member has a financial interest in the business

- Providing strategic advice to a client on its competitive position while having a joint venture or similar interest with a competitor of the client

- Advising a client on the acquisitions of a business which the firm is also interested in acquiring

- Advising a client on the purchase of a product or service while having royalty or commission agreement with one of the potential vendors of that product or service

- Providing forensic investigation services to a client for the purpose of evaluating or supporting contemplated litigation against another client of the firm.

Waiver of Conflicts
In order for a waiver to be effective, such a waiver should be comprised of these elements:

- It should be written.
- It should disclose in a meaningful and understandable way exactly what gives rise to the conflict for the CPA.
- It should disclose in a meaningful and understandable way hot the conflict might jeopardize the interests of each client.
- It should be signed by each client.
- It should include a recommendation that each client seek independent legal advice before signing the waiver.
- It may include a release and hold harmless from any claim or complaint that the CPA has violated any applicable professional standard or rule of conduct.

The rules in Section 10.29 track the language in the American Bar Association Model Rules (the "ABA Rules"). They are terse and apply to a CPA only where the CPA is practicing before the IRS. However, the American Institute of CPAs' Code of Professional Conduct (the "AICPA Code") and other professional standards may still apply if Section 10.29 does not. A CPA subject to the Statements on Standards for Tax Services (SSTS) is generally required to follow them and other AICPA professional standards as a minimum standard. Thus, if Section 10.29 applies and provides a stricter rule on the definition of how to deal with such a conflict a CPA should follow Section 10.29. Underlying Values The Circular 230 standard on conflicts of interest emphasizes conflicting professional responsibilities. It differs from the AICPA Code and other standards that emphasize the broader values of integrity and objectivity (and in attestation engagements, independence) as compared to the ABA Rules that are based on the values of advocacy and loyalty. Unstated is the extent to which the interpretations of Section 10.29 will follow the comments on the ABA Rules or case law interpreting them. Unfortunately, the IRS and Treasury have not provided further guidance and to date, there is no case law or administrative law judge decisions that could provide guidance as to how OPR will interpret Section 10.29.