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PREFACE

The AICA Services Inc. Loss Control Manual sets out the major areas of concern in managing your firm's risk exposure. This Manual will be updated annually to reflect changes in the *CICA Handbook* and practices adopted generally by the profession and suggest techniques and procedures that can assist AICA members in loss control prevention.

At AICA Services Inc. your professional liability insurance is more than terms, conditions and premiums. It's CAs working for CAs to ensure you get the professional, quality service you expect and need.

Commitment, Quality and Service

Since 1975, your national Professional Liability Insurance Committee (PLIC) has responded to your needs for competitive rates, knowledgeable service and loss prevention assistance. In 1990, PLIC incorporated the Association of Insured Chartered Accountants (AICA Services Inc.) to give members the advantages of improved and more direct service, greater flexibility and greater stability to the program in all aspects. ***We're succeeding and we're committed to continued success.***

Talk to the people who understand your professional liability insurance concerns. Call your AICA Program Representative today and find out how AICA can tailor your policy to meet the particular needs of your firm.

AICA Services Inc. - *your Association of Insured Chartered Accountants*

Our toll-free telephone numbers are 1-800-267-4734 (English), 1-800-268-2630 (French) or fax us at (416) 204-3418

DISTRIBUTION

The Loss Control Manual is provided by AICA Services Inc. to assist member firms in the development and maintenance of their risk management programs. It is essential that each and every chartered accountant in your firm reads this Manual and the subsequent annual updates.

Name	Date	Initial

LOSS CONTROL MANUAL
AICA SERVICES INC.

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1. Key Features of Your Policy

This loss control bulletin explains four important features of the professional liability insurance policy - coverage, who is insured, policy limits, and claims procedures.

Coverage

The policy is intended to pay for legal liability claims on behalf of those insured which arise out of professional services usual to practicing chartered accountants and allegedly caused by an error, omission or negligent act. The policy does not cover services performed for the insured itself or damages arising by reason of intentional acts. (The latter exclusion applies only to the actual insured who perpetrates the intentional act.)

The insurer will investigate and defend any reported claim including those claims which allege a dishonest or intentional act. If an insured is found guilty of a dishonest act, the insurer will not pay any judgment or costs arising therefrom.

As well, the policy allows insureds to add, by way of endorsement, coverage for liability imposed upon them by reason of their acting as a director and/or officer of certain not-for-profit organizations. This additional coverage does not extend to co-operatives.

Insureds

The following people and/or entities are automatically insured:

- the named insured (usually the firm name or a sole proprietorship),
- any present or former partner, executive officer, director, stockholder or employee, and
- heirs, executors, administrators and assignees of each.

Other entities such as "limited liability" companies or individuals must be specifically added by endorsement.

Policy Limits

The policy has two limits, the "limit of liability per claim" and the "aggregate amount payable". The intention of the policy is to provide coverage for each claim reported during the policy period up to the "limit of liability per claim" provided that the "aggregate amount payable" is not exceeded in any given policy period.

In addition to these policy limits, the policy also pays the costs of defense and investigation together with any interest accruing on a judgment.

Claims

The policy requires that the insured shall, as soon as practical after receiving information as to any alleged errors, omissions, or negligent acts, give written notice to the Association of Insured Chartered Accountants (AICA) in accordance with the policy. This should be done as soon as possible so that your insurer can provide you with every possible assistance to eliminate, or at least reduce, the potential exposure of the situation.

The policy requires that the insureds co-operate with the insurer and its agents both during the investigative and litigation stages of the claim.

The insurers will settle a claim only with the consent of the insured. However, should the insured refuse to consent to a settlement recommended by the insurer and elect to continue the defense of the claim, the insurer's liability shall be limited to the amount for which the case could have been settled, together with the costs and expenses incurred to that point in time.

The policy provides for arbitration in the event that there are any disputes between the insurer and the firm as to the interpretation of the policy. This is intended for the benefit of all parties so that any differences of opinion can be quickly resolved.

2. Disclosure on the Application

The responsibility rests with the applicant to divulge all pertinent information dealing with past incidents relating to claims or possible claims. The application for insurance covers this under Section J, Items 1, 2, 3 and 4.

The policy covers acts or omissions of the Insured, or any other person or organization for whose acts or omissions the Insured is legally responsible, arising out of professional services for others provided that, at the inception of the coverage, the insured had no knowledge of any claim made or pending against the applicant for any prior incident, act, error or omission which could be a basis for a claim under the insurance applied for.

As the chartered accountant firm applying for coverage, you are required to fully and faithfully disclose all factors which will enable the underwriter to determine the risk of exposure. The application is designed to elicit this information for coverage. If you are doubtful whether or not a particular set of circumstances of which you are aware may or may not be resolved amicably, then doubt should be resolved in favour of disclosure. Should you fail to do so, your rights to claim coverage may be prejudiced. Of course, if you are insured under another insurance policy at the time of making the application, you must give notice of claim to your present insurer before your current policy expires.

The insurer does not, however, expect the applicant to be a clairvoyant for any claim that is subsequently made against the policy, the origin which predates the policy. In borderline cases, the test must be: Would a reasonable applicant have made the disclosure which the insured failed to make?

The rule, therefore, is **when in doubt, disclose.**

3. Claims Procedures

Under the terms of the policy, members are obligated to report a claim or potential claim as soon as it comes to their attention. There is no harm in reporting an incident; however, there is a risk of losing coverage if you fail to report a matter which later gives rise to a claim.

Keep in mind that you are a chartered accountant and not a barrister and solicitor. Do not attempt to determine responsibility or legal liability nor attempt to settle, negotiate or otherwise involve yourself in the claim process other than to provide the cooperation required by the policy.

The insurance underwriter and adjuster are critically aware of the need to protect your reputation and standing in the community and in the profession. The identity of the insured always remains confidential.

The following are the steps which normally take place at the time a member reports a claim or any incident which could possibly lead to a claim:

1. The insurance company is notified and an adjuster is appointed simultaneously.

2. The adjuster contacts the member and requests details of the allegation, reviews the circumstances which led up to it, takes statements (if required) and generally advises the member of those events next likely to occur.

3. The adjuster may contact the claimant to learn the claimant's position and perhaps obtain additional information.

4. The adjuster reports to the insurer and in some cases, to a solicitor.

5. The insurer reviews all material, may consult counsel, determines a position and instructs the adjuster.

Remember that in many cases threatened action never occurs; frequently after the initial investigation, the decision is to simply wait.

In certain cases, the procedure is to take immediate action to minimize the damage.

Once an incident is reported, caution should be exercised in discussing the matter with any one without prior approval of the insurer.

You should feel free to discuss the claims with the adjuster or solicitor at any time.

4. The Role of the Adjuster

The update entitled "Claims Procedures" outlines the normal courses of events which follow after the reporting of a claim. Ideally, any member reporting a claim should be contacted personally by an insurance adjuster within 48 hours. This ensures that the Insurer, AICA and the adjuster work together closely on your behalf. To ensure you have skilled and experienced support when you have a claim, AICA Services Inc. has investigated and negotiated the appointment of an approved adjuster.

The role of the adjuster is:

- to collect and sort out the facts as quickly as possible, and
- to recommend the action to be taken.

Prompt action by the adjuster will often minimize both the anxiety suffered by the member against whom the claim is advanced and the eventual quantum of loss.

Other potential benefits of quick action, both for the reporting of claims and for the initial contact by the adjuster include:

- protecting your rights under the policy,
- determining as quickly as possible whether the situation may be repaired, settled or defended,
- providing you with experienced advice and professional counselling at a very early stage, particularly if this is your first claim,
- minimizing potential loss to you, the client and the insurer, and
- minimizing adverse publicity.

5. How Much Insurance is Enough?

Since 1980, statistics reveal that claims are escalating at a rapid rate both in number and size. While it is impossible to calculate precisely "how much is enough", each firm should periodically review the nature of its activities and those of its clients to determine whether or not the limit of liability carried by the firm should be increased. The cost of increased limits is reasonable and can be obtained easily from AICA Services Inc.

Consider the type of work performed by your firm

The type of work performed by the firm is an important factor in determining its exposure to liability. Three areas which seem to be generating greater losses relative to the amount of work done are:

- Corporate audits
- Tax or estate planning
- Receivership or bankruptcy

You should always consider who the potential plaintiff might be. In areas 1 and 3 above, third parties, not your client, are likely to be suing. They are the investors and creditors who can suffer losses if the company or business which was the client of the chartered accountant fails. If any of your clients have loans in excess of your insurance coverage, it would be prudent to increase your coverage.

Review your coverage

In reviewing your coverage, the limits of liability you choose should reflect:

- the increasing frequency of claims,
- the increasing severity of actions against professionals,
- the nature of the work performed,
- the nature of your client's activities, and
- the obligations of your clients to third parties and the consequences of a business failure.

The lowest limit available in your professional liability program is $250,000. However, $250,000 coverage is inadequate for most practices. AICA encourages the purchase of higher limits to increase the protection of both the practitioner and the public and to advance the image of the profession.

Never forget that partners are jointly and severally liable. It may not be your mistake but a mistake by another partner puts all of your assets at risk as well as those of the other partners.

6. Changing Firms or Leaving Public Practice

Partnerships come and go, merge, expand or fade into history. Chartered accountants who are planning to move from one firm to another, withdraw from public practice, or retire must review their insurance needs before they make the change.

If you are changing firms (but remaining in public practice), note that the policy wording provides coverage to:

> *the named Insured, any present or former partner, executive officer, director, stockholder or employee of the named Insured while acting within the scope of his duties as such.*

The significance of the last phrase "while acting within the scope of his duties as such" is that claims against present or former members must arise out of services performed on behalf of the named Insured. The policy in force at the time a claim is made will not respond to any other claims, *i.e. those arising out of acts or omissions of the member when he/she was in practice with an unrelated firm.*

If you are changing firms or leaving public practice, make sure you are insured for your past work. Notably, your protection for past acts and omissions depends on the existence of your former firm and the continuation of appropriate insurance coverage.

The prudent course of action is to determine whether or not your former firm is still active and still carrying insurance which provides protection for those duties performed while you were a member of that firm. If the former firm no longer exists, insurance is available to protect you for your prior acts or omissions, but it must be purchased separately. For more details about this coverage, contact your AICA program representative.

If you are now practicing with a new firm, review your potential exposure and ensure you are still covered for prior acts, errors or omissions.

If you are planning to retire from public practice, a discovery policy may be required to provide for "prior acts".

Checklist When Leaving Public Practice

If the firm is dissolving or is letting its insurance lapse:

- □ Review your files for potential claims and give notice while your current insurance is in force.
- □ Consider the likelihood of claims surfacing long after the work was performed and whether they will be statute barred by the limitations act of the jurisdictions in which you practiced.
- □ Talk to your AICA program representative to determine if you need to purchase insurance to protect yourself from future claims (a "discovery" or "run off" policy).

7. PLANNING FOR RETIREMENT

When you retire, your professional liability doesn't.

The chartered accountant approaching retirement has many concerns - responsibilities to clients, perhaps the firm's continuity or the sale of the practice, agreements with partners and certainly personal financial planning. One area that is too frequently overlooked is the practitioner's continuing risk exposure.

Although the time frame varies from province to province, professional liability for work performed by a chartered accountant can extend years into retirement. Your past obligations to clients and third parties could, within the applicable legislated time frame, result in a claim for work performed during your practicing years. A retirement discovery policy will not only protect your continuing risk exposure but also in the event of death, protect your estate and therefore your family. As part of your planning for your retirement, be sure to talk to your AICA program representative.

8. Admitting Liability

Confession may be good for the soul but it could cost you more than you think. Before admitting liability either expressly or implicatly, whether in writing or orally, report the claim and seek advice from either the adjuster or lawyer appointed by the program. In the past, some insured members have needlessly jeopardized or lost their coverage by breaching Condition 3 of the policy which states:

> *"The Insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense."*

The following are three situations where insureds can prejudice their rights or the proper settlement of the claim:

- The insured admits liability when another party, (for example, a lawyer), is partly or wholly liable for the loss.
- The insured admits liability because of an error in the work performed. However, the error may not have been the cause of the loss claimed.
- The chartered accountant reimburses a client for interest charges on late tax payments.

If a claim is made against your firm, keep in mind:

- Another party may be legally responsible for the error, omission or negligent act.
- The error, omission or negligent act may not have been the cause of the loss.
- The amount claimed may not be the true measure of the damages suffered.

As explained in bulletins entitled "Claims Procedures" and "The Role of the Adjuster", experienced professionals have been appointed by the program to investigate liability and quantum of damages.

Remember: If you personally take charge of your claim, *the risk is all yours.*

II AVOIDING PRACTICE PITFALLS

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3. **Updating Engagement Letters**

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1. The Chartered Accountant's Ten Practice Commandments For Avoiding Lawsuits

Following these ten practice commandments will help you and your firm avoid costly and time-consuming legal claims:

1. *Market your firm and its services fairly.*

   Using unwarranted superlatives in your firm brochure is dangerous. Clients may later refer to it when dissatisfied with your services.

2. *Educate your clients of the exact nature and extent of your professional services.*

   Clients sometimes think your time and cost estimates are guaranteed. At the outset, explain all the details of your mandate, particularly the factors that can influence timing and budget - then you are far less likely to have a claim filed against you.

3. *Insist on a written engagement letter (and obtain legal advice if you go beyond the standard letter).*

   If there is a claim, you can be certain at least two different versions of what your services should or should not have been will unfold.

4. *Keep written records of your conversations with clients.*

   Although the engagement letter spells out your mandate, it is just as important to keep notes of your client meetings as vital evidence beyond oral recollections.

5. *Avoid performing services outside your professional capacity.*

   Among other things, you could be jeopardizing your professional liability insurance coverage.

6. *Develop a specific plan for the performance of professional services.*

   It is important that personnel assigned to new projects be identified and advised as soon as possible. A team, preferably with a senior partner coordinating services, should be briefed on the overall plan of a project and then instructed to study the details.

7. *Keep your clients informed.*

   The more informed they are, the less chance of surprises and claims that you failed to properly carry out your services.

8. *Deal promptly with problems.*

   As problems arise, discuss them with your client and explain their ramifications.

9. *Verify representations made by a client before relying upon them.*

10. *Think carefully before suing for fees.*

    A suit for unpaid fees almost inevitably results in a counterclaim alleging professional negligence - usually for a much higher amount. Nonpayment may result from a client's inability to pay or from dissatisfaction with your services. You must weigh the amount of the outstanding fee against what you perceive may be a valid problem with your services.

2. Documentation

Three words are inevitably at the root of the standards and procedures deficiencies noted in the course of some practice reviews: **Lack of Documentation.**

The Audit Engagement

For the audit engagement, the auditor needs to document matters which demonstrate and support his opinion which includes his representation as to the compliance with generally accepted auditing standards. Working papers represent the best form of showing such evidence. The *CICA Handbook*, Section 5145.06 states "The auditor should document matters which in his professional opinion are important in providing evidence to support the content of his report."

The Review Engagement

For review engagements, it is important that the files document that review procedures were performed, consisting primarily of enquiry, comparison and discussion. Some files examined by practice reviewers resemble a compilation of numbers and lack documentation of review procedures.

Lack of Documentation Heightens Risk

Without appropriate documentation, the risk the chartered accountant's work may not meet the profession's standard is high. Not unexpectedly, the problem appears particularly prevalent during periods when workloads and time pressures are at their peak.

The following comments have been included in reports to the Alberta Practice Review Committee:

> *"There was no documentation on the evaluation of internal control or on the knowledge of the client's business."*

"Overall, there was little documentation in the file to support that an audit was performed in accordance with generally accepted auditing standards. The working papers were a compilation of numbers with no indication of what auditing was performed."

"The working paper file did not contain a non-audit review program or checklist; there was no outline of the review procedures to be followed or documentation of the review procedures actually performed (enquiry, comparison and discussion)."

"There was no documented evidence of the review of subsequent events."

"The extent of reliance on internal control was not documented."

"The balance sheet figures were well supported but the review procedures performed were not documented. There was little or no evidence of enquiry, comparison or discussion."

Review the Rules of Professional Conduct

The Council of the Alberta Institute stresses the importance of documentation in its Guideline 218.1, "Retention of Documentation and Working Papers", of the Rules of Professional Conduct:

"Cases may arise where a member may be asked to substantiate procedures carried out in the course of an assignment. If the member's files do not contain sufficient documentation to confirm the nature and extent of the work done, the member concerned may well have great difficulty in showing that proper procedures were in fact carried out. The importance of adequate documentation cannot be over-emphasized; without it, a member's ability to outline and defend professional work is seriously impaired." [1993]

As a first step, you should review your provincial Rules of Professional Conduct. Next, review your firm's practices and establish protective documentation procedures where necessary.

Refer to Resources

Two CICA publications that are beneficial for re-examining your documentation standards are:

- **Professional Engagement Manual** (PEM) and the professional engagement forms contained therein; and
- **Performance of a Review of a Financial Statement**, Auditing Guideline, August 1987.

The PEM Manual is available through the CICA Professional Development Department - Publications. The second reference can be found in your *CICA Handbook* under "Auditing Guideline". As well, there are a number of other relevant publications, checklists and other literature available to assist practitioners in reviewing their documentation standards.

* *This article first appeared in the Practice Review column of the Alberta Institute's Newsletter and is reprinted here with the Institute's kind permission.*

3. Updating Engagement Letters

The most important document in a chartered accountant's file is one that too often receives the least attention from the accountant. The engagement letter has become a common, if not an almost universal part of accounting practice in Canada, but all too frequently accountants have treated it as merely a formality.

Misunderstandings Result in Claims

Claims against chartered accountants commonly arise from a misunderstanding about what the accountant was supposed to be doing for the client and, more importantly, what the accountant was not doing, for example:

- The chartered accountant will produce numbers or an opinion for a limited purpose and the client will rely on it (or claim to have relied on it) for purposes far beyond what was intended. Thus, a proforma projection of future income and expenses based on certain assumptions may be taken by the client as an assurance that those numbers can be achieved.

- Advice on the immediate cash flow or tax consequences of an investment will be taken by the client as the accountant's stamp of approval on the wisdom of the investment.

- Occasional financial or tax planning advice may be interpreted by the client as a relationship in which the accountant is looking out for and protecting all of the client's financial interests.

When such disputes enter the litigation process, the lawyer defending the accountant and, ultimately, the court will look first for the engagement letter to see what the client should or should not have been expecting the accountant to do. All too often, the document is of no help. It turns out to be a form letter that talks about the annual preparation of financial statements and tax returns. While the client may be in and out of the chartered accountant's office on a regular basis throughout the year, these frequent visits will not be apparent in the engagement letter.

If the claim involves one of those other visits when the client was given advice not directly related to work mentioned in the engagement letter, the court is left with no documentary evidence as to what the engagement was or how much work the accountant was actually committing to do.

In the first example above, the chartered accountant may have prepared pro forma cash flow projections for a business which the client is considering purchasing. The chartered accountant may state that the projection was based on revenue and expense figures supplied by the client or the vendor of the business and that the client clearly understood that these figures were simply assumptions. The client, however, will state that he or she understood no such thing and thought the chartered accountant had provided some measure of review or verification.

The case comes down to the accountant's word against the client's about what was said in their meetings and what the accountant said he or she was going to do or not do as part of the engagement. When such a case gets to court, there is usually no way of predicting what a judge might decide, but it is likely the client's word will be accepted. Courts will often find that the matter was much more important and out of the ordinary for the client and the client is therefore likely to have the more vivid and accurate memory of what was said.

Review and Update

To avoid this kind of situation regularly review your engagement letters to determine if they accurately reflect all of the services being performed as well as the purpose and limitations of the advice being given.

Even if the services really are limited to the once a year preparation of financial statements and tax returns addressed by most engagement letters, this review is still necessary. An engagement letter that simply says the chartered accountant is preparing tax returns based on information supplied by the client may be appropriate, but if the chartered accountant is, at the same time, offering some advice on future tax planning, the nature and scope of that advice should be referred to in the engagement letter.

If it is the client's habit to seek other kinds of advice on a regular basis throughout the year, the engagement letter should outline the nature of that advice and the limitations upon its use. As the advice is given throughout the year, the engagement letter should be reviewed regularly and if the advice is going beyond the scope set out in the engagement letter, the appropriate changes should be made.

And when a client seeks advice beyond the terms of the existing engagement letter, a separate engagement letter should be prepared setting out the advice that has been requested and the work that will be done to provide it. If time does not permit the preparation and signing of an engagement letter at the outset of this new engagement, the chartered accountant should at least ensure that any document produced or letter setting out an opinion contains a clear statement of its purpose, the information or assumptions on which it was based, and the limitations upon its use.

If the client is given the advice and acts upon it, sending out an engagement letter for the client's signature two months later will not protect you. The engagement letter is not a form to be seen to by support staff or the office manager. It is on the chartered accountant's file and the accountant should always be conscious of whether or not it truly reflects his or her relationship with that client.

4. Screening Potentially High Risk Clients

Client screening and acceptance procedures can prevent the awkward situation of later having to terminate a 'problem' client. Before congratulating yourself for obtaining a new client, interview the prospect to determine not only the magnitude of the job, but also any potential risks. In particular, a history of frequent turnover of prior accounting firms should alert you. Merely asking general questions such as "Is there anything I ought to know?" will not likely elicit the information you need for assessment and action.

Before accepting a new engagement, consider the benefit of the new client given the costs of providing the services. Consider: Is there a higher risk associated with this client?

Ask Questions

Some of the areas to be considered:

- *How did this client find your firm?*

If a direct referral was made, contact the referring party for background information about the prospective client.

- *Why did the client decide to retain this particular firm?*

Although the answer may not be candid, it is important to ask this question. For example, a prospect seeking a "more flexible" chartered accountant many have parted with a previous one because the chartered accountant refused to adopt questionable tax or accounting treatments. If fees are a past issue, determine the magnitude of the fees the prospect considered inappropriate.

- *What accounting firms have been engaged by the client over the past 10 years?*

Clarify that you intend to contact them and you may require a letter authorizing such persons to discuss the prospect's affairs with you. This could evoke a defensive response or at least cause the prospect to be more candid about any past problems. Contacting former accountants is a standard procedure even if the engagement does not necessitate any such consultation.

- ☐ *What accounting systems and accounting principles are presently used by the prospect in compiling financial reports?*

Try to determine the prospect's knowledge and understanding of the business's accounting matters. In particular, inquire about accounting personnel. For example, a high turnover in accounting could signal that records are not up-to-date, postings are incomplete or improperly executed, or there could be more encompassing management problems.

Review Recent Financial Statements

Ask to review the prospect's most recent financial statements as well as those for the past five years.

Businesses experiencing financial problems tend to cause problems for their chartered accountants. In your perusal of the financial statements, pay particular attention to significant operational changes, changes in accounting principles, downward trends in operating results, an absence of inventory and accounts receivable write-offs - in essence, any factor which signals potential problem areas.

The answers to these and other questions will not necessarily enable you to avoid all potentially problematic engagements, but should help you avoid many potential liability claims.

5. Fee Collection Without Lawsuits

Unfortunately delinquent accounts sometimes only can be recovered with legal action; however, preventive practice can help reduce the likelihood of bad accounts and time-consuming lawsuit situations.

Three proven strategies for maintaining good client relationships and avoiding fee collection problems are: document, educate, and communicate.

Document

- Make sure that there is always an engagement letter for all engagements.
- Document a clear understanding and agreement with the client about the work to be undertaken and the terms for billing fees and payment of those fees at the outset.

Educate

- Educate your client on all the factors involved with the engagement.
- Explain the anticipated time and related costs, including any staff arrangements.
- Establish realistic client expectations.
- Avoid overselling your firm and don't guarantee absolute results.

Communicate

- Ensure that you maintain open communications with your client.
- Stay in touch with your client and advise the client on a current basis of the engagement's status.
- Don't hide problem areas from the client. Discuss the problems and make a combined effort to rectify them.

6. Credit Union Audits

Claims by credit unions against their auditors have increased dramatically. Not only have the number of claims risen, but also the value of the claims has escalated substantially to the point where claims can exceed policy limits.

Most credit union claims result from theft or embezzlement by credit union employees, the Credit Union Reserve Board then advancing a claim against the auditor based on negligent performance of the audit.

The test of negligence by an auditor is one of fact and depends upon the consideration as to whether other auditors would have acted in the same way as the auditor in question. It is evidence of ignorance and lack of skill if the auditor has acted contrary to the established practices universally recognized by members of the profession.

Causes of Credit Union Claims

The following lists some of the characteristic situations relating to credit unions and their auditors which have resulted in claims:

Credit Unions

- Most credit unions from which auditors have received claims are small businesses, located in rural areas with a small number of credit union members.
- The internal business control procedures normally found in most financial institutions are sometimes lacking.
- The Board of Directors of some credit unions are comprised of members of the local community who may be unsophisticated in financial matters.
- A lack of expertise on the Board of Directors can result in members of the Board failing to adequately question their auditors and the draft financial statements.
- The relationship between the Board of Directors and the managers of the credit union does not seem to be properly structured and on many occasions, a relaxation of the rules for members of the Board of Directors occurs.

The Auditors

- In most of the cases where claims have arisen from credit unions, the auditors did not appear sufficiently experienced in the audit of financial institutions to perform the type of audit necessary to expose defalcations by the staff.

- Most of the auditors against whom claims are being made are located in rural areas or in the same town as the claimant credit union.

- The auditors have generally failed to set up adequate auditing procedures and checks to ensure appropriate investigation and confirmation of the financial items have been carried out.

- Some auditors may have been retained by the credit union for "bargain rates".

- The defendant auditor is often reluctant to admit (to herself or himself) that an error may have occurred.

Where the Law Stands

Canadian law appears to take the stance that an auditor does not have a duty to discover all frauds and defalcations. Quite the contrary, the auditor's duty is to perform sufficient testing of the transactions to be able to form the opinion that the financial statements are fairly presented.

Auditors are not obliged to check every transaction and the extent of their testing depends on their assessment of the internal control set up by the client. However, if they fail to properly assess the internal controls with the result that their opinion as to fairness of the financial statements is not based on adequate information and sufficient analysis, or if by the very nature of the scope of the testing they should have discovered the fraud, then very likely the auditors will be found negligent and liable for the damages suffered by their failure to discharge their duty to properly audit.

Notwithstanding that the partner in charge of the audit does not perform this "field work", that partner remains responsible for the conduct and supervision of the staff members who actually do the audit work. Section 5150.01 of the *CICA Handbook* states:

> "The work should be adequately planned and properly executed. If assistants are employed, they should be properly supervised."

Supervision is defined in Section 5150.07(c) as:

> "keeping informed of auditing problems encountered by the assistants during the examination so that their significance may be evaluated."

When an auditor conducts the audit by assessing the internal controls and checking the transactions, he is not expected to approach these tasks with suspicion or a foregone conclusion that something is wrong. However, if an auditor does come across any suspicious circumstances, then it is his duty to probe the matter to the bottom. If such inquiry does not eliminate his suspicions, he must report it to the shareholders.

Defences

Defences have included the contributory negligence of the directors of the credit union, a lack of negligence on the part of the auditors, and compliance with G.A.A.S. but in each case, they have not always been successful.

Contributory Negligence of the Directors

One avenue of defence is the contributory negligence of the directors of the credit union. However, the law in Canada and the United States appears to conclude that an auditor should not be excused from negligence just because the directors or management of the company were negligent.

The Canadian cases make the point that in a public company where the auditors owe a duty to shareholders, that duty is unaffected by the negligence of servants or directors of the company.

In the case of **Grinrod and District Credit Union v. Cumis Insurance Society Inc.** (Unreported November 10, 1983), Justice Dohm of the British Columbia Supreme Court determined that the directors were not negligent in failing to cover an overdraft. He found that in light of the expertise and background of the directors, their actions were reasonable. This judgment again emphasizes that credit unions with unsophisticated directors may in fact be obtaining unwarranted relief from the courts.

Negligence by the Auditors

A 1984 case in British Columbia in **Revelstoke Credit Union v. Miller & Barry** (2 W.W.R. 297) resulted from defalcations by the credit union's manager with respect to unauthorized overdrafts and the alleged negligence of the auditors in failing to detect them. In this case, the Chief Justice of British Columbia found the auditors liable.

On the issue of negligence, the Chief Justice concluded:

> "On the evidence I cannot say that the generally accepted auditing standards (G.A.A.S.) required the auditors to do more than they did at the time of the systems audit. This is an example of the lack of reality which surrounds the present law relating to auditors, and explains why I said earlier that *I think the trend of the law will probably move towards a wider concept of liability in the future.*" (page 319, emphasis added)

The foregoing is not an encouraging comment.

Compliance with G.A.A.S.

The defence that the auditor complied with G.A.A.S. is not as successful a defence as it used to be. The Chief Justice in the **Revelstoke** case suggests that reasonable care is the test, not the standard of the profession.

Proceed with Caution

The substantial increases in both the number of claims and the value thereof suggests auditors should be extremely careful when performing credit union audits.

Auditors should pay particular attention to assessment of internal controls, investigation, and supervision of field work staff.

The widening scope of liability and the interpretation of reasonable care as the test, not the standard of the profession, further emphasize the need for caution.

7. Environmental Liabilities

Two decades ago, chartered accountants began their explorations into solving the many accounting issues inflicted by the rapid surge of the computer revolution. Today, the profession faces new challenges in tackling the many issues surrounding environmental costs, liabilities, and risks. Indeed for the profession, the effects of environmental issues could prove even more profound than those of the information age.

Bottom Line Issues

Clients expect their accountants to understand their businesses and to be aware of potential financial liabilities they may be facing. Today, responding to your clients' needs and expectations demands a heightened awareness of environmental issues and their impact on the bottom line.

Know the Client's Business

Knowledge of a client's business has never been so crucial where environmental liabilities are concerned. While all business activities may attract the possibility of liabilities, some are more environmentally sensitive than others.

For example, service industries can have a low sensitivity, although if they do handle substances, such as dry cleaning fluid that may harm the environment and attract liabilities, then the sensitivity level may increase. Medium sensitivity industries, representing the majority of activities, manage substances that may affect the environment, possibly for equipment lubrication, fertilizing or cleaning. High sensitivity industries either deploy environmentally harmful substances as part of their main activity or release harmful substances into the air or into water systems. These would include transportation companies, pulp and paper companies, chemical and oil producers. These industries may suffer an accidental spill which may be measurable and contained or may accidentally through leakage or emission release a toxic waste substance. Exposure to environmental liabilities is particularly an issue in the latter case because the time or the extent of the damage may be difficult to evaluate.

As Advisor to the Client

Liabilities for environmental misadventures may be minimized by a proactive stance on the part of all businesses. As their advisor, encourage management to develop an environmental focus, to monitor the treatment of all hazardous materials and to develop a specific, tested action plan to deal with any unexpected disaster.

Specifically, determine if the company has:

- assessed its environmental position
- identified potential environmental risks
- developed a system for managing those risks.

Consider also whether any neighbouring properties have reported significant environmental damage and if so, whether it may affect your client's property.

You also need to be cognizant of your client's awareness of and attention to environmental matters related to handling substances that may contaminate water systems or pollute the air or soil. This requires being not only up-to-date with developing attitudes towards environmental issues on the part of legislators but also of hazardous material handling methods which are continually changing.

Proceed with Caution

Purchasing business assets as opposed to shares once minimized the risk of exposure to unidentified liabilities. However, today's environmental liabilities are such that no immunity exists for the acquiror because responsibility for environmental damage lingers with current and prior owners of the tangible property.

For example, if your audit client plans to acquire a business, including facilities adjacent to a chemical handling plant, your knowledge of environmental issues is paramount. In this situation, the prudent practitioner would advise management to have an environmental site assessment, an increasingly normal practice in acquiring facilities.

This assessment would help the business:

- avoid business disruption upon financing or disposal;
- avoid further contamination; and
- attach responsibility to perpetrator for the purposes of compensation as early as possible.

An environmental assessment may also be recommended when the client's business activities vary with regards to handling hazardous products or when those of adjacent neighbours change. If a neighbouring business has reported significant environmental damage, it may affect the adjacent business' property and thus its exposure to environmental loss. Pollution can migrate and knows no boundaries, so that attaching responsibility for contaminating air, soil or water can often be evasive.

The implications of environmental issues are many and far reaching for both you and your clients. Most significantly, these issues could potentially result in more professional liability exposures. As a first step to protecting yourself and your firm, work to improve communications with clients, be informed about legal, industry and international developments, and keep up-to-date with emerging professional guidelines and standards.

III TAX PRACTICE

1. **Negligence and Standard of Care in Tax Practice**
2. **Tax Engagement Letters**
3. **Tax Return Preparation: Quality Control vs. Efficiency**
4. **Section 85 Rollovers**

1. Negligence and Standard of Care in Tax Practice

The services normally provided by a tax practitioner will be provided under an agreement. In the event of a failure to perform the services, the aggrieved client will claim against the practitioner, probably both in breach of contract and negligence.

In a negligence claim, the standard is that the practitioner must exercise the standard of care and due diligence of others ordinarily performing those services. If the practitioner falls below this level of performance and injures another, he or she may be found negligent and liable for the damages resulting from that negligence.

The standard does not require infallibility. Rather, the standard requires a proper exercise of skill and judgment. A practitioner can act reasonably, make a mistake and not be negligent. But the practitioner who falls below the minimum level of conduct may be found negligent.

Your engagement letter defines this standard of care. It is your duty to perform up to your contract. Experts or individuals who hold themselves out as having a particular expertise will be held to a higher standard of care.

Preventive Tax Practice

The best defence is an offence: do not make a mistake. Do your work thoroughly and competently. Some items to consider include:

- Be selective in accepting new clients. Avoid new clients that have long running disputes with Revenue Canada or are in financial difficulty.
- Don't accept a client if you are not confident that you can provide the needed services in a timely fashion.
- Use information sheets. Have these sheets initialled by the taxpayer. Inquire about all facts. You do not have to be perform a full investigation; however, do inquire as to facts.
- Maintain written documentation. Keep records of conversations and advice given to clients.

- Use a tickler system or other reminder system to remind you of deadlines.
- Conduct research when it is needed and document the research.
- Use third parties to confirm your research and filing positions that you recommend.
- Avoid conflicts of interest. Don't act for both parties of a divorce proceeding. Don't act for both partners in a business split-up.
- Don't discuss with clients the possibility of their returns being selected for audit.
- Collect accounts as they become due.
- Complete an engagement letter for every engagement.
- Keep your professional liability insurance up-to-date and review limits of coverage annually.
- Play by the rules. In advising clients to minimize tax, ensure the position taken is realistic.
- Be an advisor, not a decision maker. The practitioner who becomes the decision maker is heading for controversy in his decisions. Make recommendations to a client. Put them in writing but have the client make the final decision.
- Maintain permanent files.
- Keep time and practice records. In the event of litigation or controversy, well documented client files and work papers can be the practitioner's best defence.
- Report to the client. The practitioner should make a practice of reporting to a client on services performed. Written communication is paramount in establishing good client relationships. It also prevents misunderstandings. Written documentation can be of great use if litigation arises.

- Honour your engagements. One of the leading sources of claims is the aggrieved client. If you have not performed according to the terms of your engagement, then you can anticipate a lawsuit.

- Honour your commitments and contracts. If you must terminate a relationship with the client, do so properly.

- Stay in touch with clients. Clear communications are fundamental in preventing misunderstandings. Proper documentation and timely communication will increase client satisfaction. Frequent contact with your clients indicates your genuine interest.

- Bill and collect promptly. A significant portion of litigation stems from fee disputes. Frequently, malpractice claims come in the form of counterclaims from clients who have been sued for past due fees. If clients are fully informed about fee expectations and fee arrangements, this knowledge will serve to head off problems at an early stage.

- Maintain professional competence. Keep yourself up to date. Attend CICA and other professional development courses. When in doubt, consult.

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2. Tax Engagement Letters

Engagement letters should be used for every tax engagement. They are the start of the relationship with the client and allow you the opportunity to focus on the positive aspects of the engagement while discussing all of the terms of it. If problems develop later, reference can be made to the engagement letter. Most importantly, the engagement letter helps reduce the likelihood of misunderstandings occurring between you and your clients.

Here are some tips about tax engagement letters:

- State how your fees are determined and when payment is due. Outline your policy regarding additional fees in the event that a tax return is reviewed by Revenue Canada.

- Spell out your duties in precise language. Avoid generalities such as "prepare all necessary tax returns."

- Identify information that the client will be providing. State how it is to be provided. In a worksheet, schedule? Verbally? In writing? Deadlines?

- State the duration of your engagement. Is it for this year's tax returns or is it an ongoing engagement?

- Point out that Revenue Canada views tax returns as the taxpayers's responsibility. Warn the client that you are hired not to verify information but to accept information from the client as being correct.

- Refer to the risks that apply in taking aggressive tax return positions and as to the possibilities and consequences from those filing positions.

- Warn the client about penalties for inaccurate, late, or underpaid returns. Inform the client of his or her responsibility to submit quarterly instalments or other payments.

- Counsel the client to retain supporting documentation for all transactions, for example, entertainment expenses, appraisals, barter transactions, and logs for business use of vehicles.

- State that you are not responsible for the disallowance of any deductions or exclusions or the taxation of any unreported income, or any resulting taxes, interest or penalties.

- Periodically review your engagement letter with a lawyer.

- Have the client acknowledge receiving the engagement letter by signing a copy.

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3. Tax Return Preparation: Quality Control vs. Efficiency

As a tax practitioner, you must constantly strive to balance the quality control measures necessary to produce a complete and accurate tax return with the need to prepare the return as efficiently as possible. With too little quality control, i.e., reviews, cross checks, etc., returns will contain unacceptable errors which will require expensive reworking. Clients will be agitated and the potential for costly litigation will rise. On the other hand, if the tax return process takes too much time and it is inefficient, i.e., too many reviews, cross checks, etc., then the engagements will require far too much professional and clerical time. The result will be either costly breakdowns or losses. Again, clients will be agitated as client service will suffer.

In the provision of all services, you must strive to balance quality control and efficiency. As each tax return is a separate engagement that is relatively small, the practitioner has little room for an inefficient process. However, with the increasing complexity and frequent changes in tax legislation, the tax return preparation process is a never ending challenge.

Most of the work associated with tax return preparation is performed in February, March, and April. This seasonable pattern requires a maximum effort in a short period of time; the pressure is intense. To run a profitable and efficient tax practice, you need to develop a system for approaching these engagements.

Some Common Tax Return Preparation Errors

As part of your preparation for the busy tax season, review this list of common tax return preparation errors and then set up controls for avoiding these pitfalls:

- Failure to review prior years' returns. This can result in a failure to take into account certain items such as claiming loss carry forwards.
- Ignoring benefits from employment resulting in an understatement of taxable income.
- Not verifying interest expense to ascertain that it is fully deductible.
- Lack of supporting documentation including charitable donation receipts and RRSP receipts.

- Failure to inquire about prior audits that may highlight issues in controversy with Revenue Canada.
- Not verifying dependency status.
- Failure to calculate alternative minimum tax.
- Failure to report all capital dispositions even where there is no tax payable because of the capital gains exemption.
- Omitted rental or royalty income or expenses.
- Omitted health care expenses.
- Mathematical errors.

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4. Section 85 Rollovers

Section 85 of the Income Tax Act provides the means whereby certain assets can be transferred to a corporation at an amount less than fair market value. The assets that can be transferred under Section 85 are defined in Section 85(1.1) and provide that the transferee must be a taxable Canadian corporation pursuant to Subsection 89(1)(i) and the transferor's consideration **must include shares**. Assets such as receivables **cannot** be transferred under Section 85. When transferring assets, sales and other transfer tax implications must be reviewed.

Section 85 can be used to accomplish various objectives such as:

- Deferring inventory gains, recapture and/or capital gains transfer of qualifying assets from an individual or partnership to a Canadian corporation or from one corporation to another.
- Estate planning.
- Removing non-active business assets or non-farming assets from a company in order to be a qualified small business corporation or a family farm corporation for purposes of the additional $400,000 personal capital gains deduction.

Avoiding the Pitfalls of Section 85

Claims against chartered accountants for their failure to file election forms following rollover transactions are frequent and often result in unnecessary costs. In addition to the financial and legal implications of failing to follow the requirements of Section 85, the chartered accountant's professional reputation and credibility can be severely damaged.

The common pitfalls of rollover transactions that inevitably contribute to a claim include:

- Lack of an effective diary (reminder) system
- Work delegated to employees not checked
- Absence or failure to follow up
- Improper valuation
- Improper classification of real property

- Transfer of shares from an individual to a non-arm's length corporation and receiving non-share consideration in excess of the adjusted cost base of the shares disposed of

- Failure to designate the order of disposition of depreciable property under Section 85(1)(e.1)

- Failure to file the prescribed form (T2057 or T2058) within the required time period

- Failure to elect on goodwill or other intangible assets

- Electing as the agreed amount the V-Day value of depreciable property

- Failure to properly compute adjusted cost base of shares (eg. failure to deduct tax paid undistributed surplus (TPUS) or capital surplus on hand (CSOH)).

Loss Prevention Strategies

To avoid these common pitfalls:

- Establish an effective diary system. This could include a simple checklist outlining:

    - the transaction date
    - the name of the corporation and the corporate year end, and
    - the identity of all individual shareholders and the date that they should file their next tax returns.

- Consider filing both corporate and personal income tax returns immediately upon completion of a rollover transaction as there is no need to wait until the next income tax return is filed. This method is the most productive for avoiding the omission of filing the required election form.

- Place a copy of the election form in the corporate and personal tax file of each affected shareholder.

- Advise each shareholder in writing that the election form must be filed prior to the filing deadline of the personal income tax return or the corporation income tax return, whichever comes first. In addition, be sure to outline the consequences of failing to file the election within the required time period.

- Ideally, try to assign one individual in the firm to review and initial each recorded transaction involving the rollover of assets under any section of the Income Tax Act. It is recommended that the assigned individual should be a partner who is reasonably well versed in income tax matters. In the event that multiple offices are involved in the partnership, it may be prudent to assign this responsibility to one individual in each office so that adequate technical review and some measure of control are achieved. Coupled with an effective diary system, making an individual responsible for assuring each rollover is complete and filed within the prescribed time should eliminate this common failure.

- The appointed individual in the firm should be responsible for ensuring that the election forms are filed within the required time period. Ideally, the diary system should allow a grace period of perhaps one week in order to prevent the deadline passing without filing the election form.

- If you do not have the expertise in your firm, you should have the transaction reviewed by someone who does. The fee may or may not be "nominal", but would, in any event, be cheaper than the potential penalties, in terms of financial loss, damage to your professional reputation, and loss of clients. The recognition and treatment of a potential problem which may affect your client is truly a measure of professional service which your client will appreciate.

- It is imperative that consideration (shares, notes) equal the fair market value of the property transferred and that properly prepared valuations and/or appraisals be obtained in order to complete the election forms. Transfer agreements should contain fair market value price adjustment clauses. The election cannot be considered as valid if shares are not taken back on the transfer.

- Fair market value of non-share consideration received from the company being of greater value than the agreed amount results in increased agreed amounts and, possible recapture, capital gains and/or income gains. If the fair market value of the total consideration exceeds the fair market value of the assets transferred, a Subsection 15(1) benefit can arise.

- Ensure that a sale agreement has been prepared and that the provisions of the sale

as they relate to a transaction under Section 85 are reflected in the agreement. Ensure that the election form agrees with the provisions of the sale agreement and is signed by all parties to the transaction.

- Whenever real property is transferred under Section 85, it is essential that you document your position that the property is capital and **not** inventory. Transferring of shares from an individual to a non-arm's length corporation in return for non-share consideration in excess of the adjusted cost base of the disposed shares will create an immediate taxable dividend pursuant to Subsection 84.1. This is a **dangerous** section of the Income Tax Act, giving rise to claims more serious than those in which there is a failure to file the election form at all or failing to file the election form within the required time period. It is suggested that **careful** review should be undertaken whenever shares are transferred to a corporation, even if Section 85 is not being used.

- It is recommended that you elect at least $1.00 for goodwill and other intangibles on disposition of a business to a corporation, even if you consider their fair market value to be nil.

- Consideration for the difference between agreed amounts and fair market value should be taken in shares in order to avoid an increase in elected amounts by Revenue Canada.

- Ensure that any Company Act requirements, respecting issuance of shares for non-cash consideration, and any other legislative requirements (i.e. bulk sales, transfer taxes, sales taxes, appraisals) are followed.

- Retain all working papers as long as possible. If your file indicates that the election was filed, the onus is on Revenue Canada to disprove it.

If, in spite of your precautions, you learn that a client has been assessed/reassessed as a result of late filed or non-filed election forms, you should give notice immediately to your insurer. ***Time is of the essence.*** With the help of your insurer, the situation may be repaired and damage minimized, or it may be possible to challenge the assessment/reassessment by the retaining of tax experts who will make the necessary representations and/or file the required appeal.

IV BUSINESS ADVISORY SERVICES

1. **Claims Involving Chartered Accountants in Business Advisory Services**
2. **Personal Financial Planning**
3. **Investment and Other Advice**

1. Claims Involving Chartered Accountants In Business Advisory Services

Today's owner/managers view the chartered accountants as an important source of advice and needed assistance. But with this expanding role of the chartered accountants as business advisor (and the resultant potential for maintaining and building practices), come potential exposures, especially in providing less formal, general business advice.

Four business advisory services which have caused claims to date include:

- computer systems and programming,
- profitability studies,
- mergers and acquisitions, and
- purchase and sale of companies.

This update focuses on these areas and provides some general recommendations for loss control in providing business advisory services.

Computer Systems and Programming

The information revolution is now well upon us. Clients want to harness the power of information technology and look to their chartered accountants for advice on evaluating, acquiring and then successfully using and implementing information systems.

Most claims arise from problems which were neither expected nor discussed with the client. Frequently what the client understands the system will do and what in fact this system is capable of doing are two different things. Clashes can develop when the frustrated client sees the period of debugging stretching longer than anticipated and the costs escalating beyond what was initially discussed. At this point, the client may refuse to pay the fees. The practitioner who has invested far too many hours to forego collection of the account may proceed to sue for the fees. The client, in turn, files a counterclaim and alleges that the chartered accountant is not entitled to his fees because he was negligent. The counterclaim is often related to costs of having another party explore the system problems, overtime costs for employees working on the problems, and perhaps the cost of disposing of the system found to be incapable of performing to the client's expectations. Add to this prejudgment interest, legal costs, and such, and costs of corrective action often soar far beyond the original estimates.

Generally, when a claim arises as a result of a counterclaim in the computer systems area, the cost of obtaining experts and defending the counterclaim can easily become disproportionate to the true exposure. Once a claim is made, logic suggests there should be a saw-off between the chartered accountant and the client with both sides withdrawing the claims against each other and bearing their own costs. No one is a winner in this situation. The chartered accountant usually loses the client and, in addition to the fees not recovered, has had to put in additional time to meet with the adjusters, experts and legal counsel to prepare a defence. The client experiences frustration in not only the problems he has encountered, but also in the internal resources diverted to deal with these problems.

The key to carrying out these engagements is communication. Both the client and the practitioner must understand the client's needs and expectations clearly. If a system cannot meet all of the client's expectations, then the chartered accountant should carefully explain this to the client, and follow up in writing. Secondly, recognize when to seek technical advice and support when making certain decisions or controlling certain activities.

Profitability Studies, Mergers and Acquisitions, and Purchase and Sale of Companies

Frequently, a practitioner becomes involved in valuation of shares and companies or is engaged to comment on the potential profitability of a business. Not only may the clients rely, to their detriment, on advice given but also third parties, such as banks or other lending institutions, may rely on this advice. In other words, the exposure in this area can go beyond that of the client. The key is to adhere to the reasonable standard of care but, to date, in Canada, there is not enough legal jurisprudence to clearly define what constitutes a reasonable standard of care. The very simple allegation behind many of the problems is that the client and/or some third party relied to their detriment on studies, a report and/or advice given by the chartered accountant.

In one case, the chartered accountant represented to the plaintiff, in writing, that the gross sales of the business would be a minimum of $100,000 annually, with a maximum of $150,000. The latter figure was suggested to the plaintiff's banker. At trial, the chartered accountant testified he had projected that the client's sales would be $120,000, notwithstanding that over the last twelve-month period the sales for this particular company had only been $50,000. The judge, in rendering his decision, found that there was no reasonable basis for advising the plaintiff that he could expect sales of $100,000 to $150,000 per year. Given the absence of any reliable previous history of income and expenses for the company, the figures advanced by the chartered accountant were found to be speculative, but the client was found entitled to rely on them.

Many claims advanced by third parties go against the auditor of the business. Banks, other lending institutions and purchasers have found it to their advantage to have another auditor review the previous audited statements in order to determine whether the first auditor was in a position to express an unqualified opinion on the statements. Such claims may also involve

advice given with respect to valuations or projections of profits as well as the quality of the audit and the appropriateness of the audit opinion.

Other types of business advisory services, frequently performed by practitioners, which can give rise to claims include: Corporate Planning, Feasibility Studies, Financial Planning and Control, Inventory Control Systems, Long Range Planning, Management Accounting, Market Surveys, Production Planning and Control, Project Control Systems and Project Management and Critical Path Studies.

A Strategy for Loss Control

The most important loss control in providing business advisory services is effective communication. Your strategy should also include:

- **Investigation** — Investigate the client's needs and problems thoroughly at the start. Do not assume that you understand the client's problems without confirming them through independent investigation. If you decide to delegate responsibility to others within the firm for the preliminary investigation, make certain they also understand the client's requirements and the reason for doing their aspect of the assignment.

- **Proposal** — Make sure an engagement letter, signed by the client, clearly sets out the objectives of the assignment, the approach to be used, the results to be expected, the personnel to be assigned, the probable time required and the estimated cost to complete the assignment.

- **Supervision** — During the assignment, ensure work is completed with due care and provide progress reports for constant communication with the client. Staff must be properly supervised and the assigned personnel must be appropriate for the work.

- **Report** — Make certain that the report at the conclusion of the assignment is comprehensive and clearly sets out the scope, objectives, restrictions, conclusions and recommendations. Set out the recommendations clearly and provide supporting data. Give full descriptions of costs, benefits, methods of implementation and time frames.

- **Follow Up** — Keep in touch with the client and review the progress in implementing the recommendations. A client appreciates this follow up and it can lead to further assignments.

- **Documentation** Document your work and all contacts with the client. When discussing important matters with the client over the telephone, make notes and file them. Should you be asked for some "off the cuff" advice while providing other ancillary services, formalize the advice with a follow up letter.

Whether the objective is to improve a company's performance or meet the challenges of increasingly complex business, financial and regulatory environments, business advice is considered to be one of the most valuable services a chartered accountant can offer. With professional knowledge of their clients' organizations, finances, information systems, personnel and tax situation, chartered accountants can offer business advice that is cost-effective, independent and objective. Protect yourself and your firm. Make sure your firm implements effective loss control measures for all business advisory engagements.

2. Personal Financial Planning

Personal Financial Planning services (including tax advice and analysis) are considered public accounting and therefore subject to the professional conduct rules for a public chartered accounting practice. If you are presently providing personal financial planning services, make sure the engagement is properly conducted or you may be held responsible for losses that the client may incur.

A client's loss and your failure to exercise due care may constitute grounds for legal action; however, the client would have to prove damages were suffered and that such damages arose from your failure to exercise due care. What constitutes due care in a particular situation will depend in part on the terms of the engagement.

Before you commence any engagement, set out the terms in an engagement letter. This letter should cover:

- the objective of the engagement,
- the approach to be taken,
- the report to be produced,
- the schedule or timetable,
- the fees to be paid by the client to the practitioner and any billing arrangements, and
- the client's responsibility for the disclosure of the assumptions, plans, expectations and information required to prepare the projections.

To ensure that the client and, more importantly, any third party users are made aware of the inherent limitations of personal financial statements, you may wish to place a Notice to Reader on all such statements. Where a Notice to Reader is not used, consider placing restrictions on use in the engagement letter.

Assure yourself that the basis of valuations of the assets, i.e. costs, market value, replacement costs, etc., are properly evaluated to arrive at a fair net worth. Do not forget deferred taxes.

Prepare a personal financial planning checklist as well as a personal financial planning questionnaire to be reviewed with the client.

Obtain a letter of representation which notes:

- that the assumptions are considered reasonable,
- that all relevant information has been supplied,
- that information supplied is relevant, appropriate and accurate,
- that projections may not be realized,
- the basis that was used for valuations, and
- that the document is not permanent and should be reviewed and updated at least annually.

Document all the necessary information in your files.

Prepare a list of advisors whom the client consults, such as the stockbroker, life insurance agent, lawyer, banker, etc.

The information related to personal financial planning is very broad and constantly changing. Make sure you keep current with standards for personal financial planning and relevant legislation.

3. Investment and Other Advice

When giving investment advice or providing services in other non-core areas such as personal financial planning and counselling, make sure you are aware of the potential pitfalls. Such engagements, provided they are carried out by a chartered accountant with the required training and experience, are often considered by clients as having greater value than the services in the core areas of accounting, auditing and taxation. For the chartered accountant, engagements in non-core areas can be riskier because there is less jurisprudence over what is expected.

Some Facts

- Some chartered accountants believe that they are exempt from legal recourse as a result of giving investment and other business advice. This is incorrect. Lawsuits against chartered accountants do arise in the non-core areas.

- Many chartered accountants are not as versed in the non-core areas as in the traditional areas of accounting, auditing and taxation.

- The member's professional liability insurance policy will not cover services given which the insurer considers to be outside the usual field of public practice.

Some Practical Precautions

Insureds are strongly recommended to take the following precautions:

- Restrict the advice to subject matters with which you as a chartered accountant are familiar. Few chartered accountants are qualified to give investment advice *per se* but if they do they are required to do so with the same degree of expertise expected of them in core area work.

- Obtain a signed engagement letter from the client in advance of starting the assignment.

- Ensure that all advice given over the telephone is recorded in writing, including the time and date. This information should be properly filed in the working papers.

- If the client plans to hand out written information about a venture, a third party may sue the chartered accountant if the information is incorrect. Therefore, there should be attached to the information a disclaimer stating that the Chartered Accountant is not giving an opinion on the investment viability of the venture

- When giving advice regarding the purchase or sale of a business, it is almost always unwise for the chartered accountant to act for both parties to the transaction. However, chartered accountants who do act for both parties are required by law to divulge to each party all knowledge they have of the transaction, no matter what the source of that knowledge. When chartered accountants are acting only for one party, they should advise the other party to obtain a separate counsellor. Failure to so inform the second party could lead to a situation where the chartered accountant is found by the court to be acting for both parties.

Before You Start

Before commencing any type of assignment referred to in this Loss Control Bulletin, check with your AICA program representative to ensure that your professional liability insurance policy covers the work to be performed.

V INSOLVENCY

1. Claims Involving Receiver/Managers

1. Claims Involving Receiver/Managers

Although claims against receiver/managers were a rarity in the 70s, this area of practice generated numerous claims in the early 80s, particularly in British Columbia where, at one point, 20% of all claims resulted from receivership problems. This stabilized in the later 80s at which time claims against receivers and trustees in bankruptcy together accounted for only 4% of all claims across Canada in volume, but approximately 8% of the total dollar value of all claims. The cost per claim against receiver/managers is only half of the cost of an average claim, most of which is spent on defence costs as opposed to claim payments.

An analysis of the claims activity demonstrates, beyond any doubt, that problems with the economic climate in general affect the public attitude to receivers, receiver/managers and trustees in bankruptcy. In the last few years, claims against receiver/managers in Ontario have increased due to the severe recession and the attitude that receiver/managers are the tools of the lending institutions, working only for their benefit and to the detriment of troubled businessmen.

Claims can generally be classified into nine categories. Each is discussed in detail as follows:

(i) Information to creditors and other interested parties
(ii) Legal opinion on security documents
(iii) Stalling and negotiating tactics
(iv) Commercially reasonable manner and due care
(v) Revenue Canada claims
(vi) Court appointments
(vii) Indemnification
(viii) Conflicts of interest
(ix) Environmental liability

(i) Information to creditors and other interested parties

Receiver/managers are still being accused of not providing information to all concerned and in taking steps to realize on assets solely for the benefit of the banks and to the detriment of the unsecured creditors as it is unlikely that there will be any funds available for unsecured creditors.

The revisions to the Bankruptcy and Insolvency Act with respect to reporting requirements which now include receivers should do much to eliminate this type of claim.

(ii) Legal opinion on security documents

It is often alleged that the security documentation has not been properly registered.

In most cases, the receiver/manager has obtained a legal opinion on the validity of the security documentation and whether or not such documentation has been properly registered pursuant to Personal Property Security Acts which may apply. It serves to emphasize that it is good business practice for a receiver to ensure in all appointments that the security documents supporting the appointment are valid.

(iii) Stalling and negotiating tactics

The allegations brought in many lawsuits are primarily a stalling tactic or are a negotiating tactic brought in anticipation of a claim against a principal under a personal guarantee for corporate indebtedness. The usual allegations are that the receiver was incompetent, showed preference, was too hasty or negligent in the process of disposition of the assets, or there was wrongful dismissal.

These actions are later found to be frivolous, vexatious and nothing more than a ploy by the plaintiff to delay an inevitable judgement or reduce a settlement due to a counterclaim.

(iv) Commercially reasonable manner and due care

It has also been argued that the receiver/manager did not exercise all due care and acted in a commercially unreasonable manner in liquidating the assets of companies with the result that assets were sold at prices much lower than could have been realized and other general creditors were left with no recovery on their claims.

Many creditors and principals often fail to understand that asset sales in distress situations such as receivership or bankruptcy will rarely achieve their perception of market value. Receivers and trustees can deflect such criticism by explaining that sales are usually made with no warranty as to condition or reliability; there is usually no after sales service or ability to return unsuitable or faulty merchandise; and that it is generally not cost-effective to hold out for better prices because of the cost of storage, administration, etc.

It is also not unusual to see an allegation that a receiver/manager's actions were malicious, capricious and high-handed without due or any regard for the position of the plaintiffs as creditors and with the intent of defeating the plaintiffs' claims as such creditors. Unfortunately, when such allegations arise, the insurance coverage applies only for the negligent acts of the receiver/managers and not for the other allegations of malicious intent, capriciousness and acting in a high-handed manner.

Such allegations may be based on the perceptions of the guarantors, principals or creditors rather than the true intent or manner of the receiver or trustee. In general, insolvency practitioners can often diffuse such claims by remembering that the people they are dealing with are under a high level of stress and therefore may react adversely or unreasonably.

(v) Revenue Canada claims

Occasionally claims are made by government tax departments alleging that taxes collected but not remitted by the debtor are trust funds for the Crown. The argument is that such taxes form a secured lien and charge on the entire assets of the debtor with priority over all other claims, including debenture holders.

Such actions are essentially a priority issue, but receivers and trustees can become personally liable if tax claims and filing requirements are not properly dealt with.

(vi) Court appointments

In some situations it is apparent that the officers, directors and shareholders of the company in arrears are hostile and unwilling to co-operate with the receiver/manager. It may be very helpful to have the appointment of the receiver/manager sanctioned by the court in such circumstances. This may make it more difficult to subsequently attack the receiver.

If the adjuster is consulted prior to an actual claim being made against the receiver/manager, it is often suggested that legal counsel acting on behalf of the debenture holder be consulted, to consider the merits of a court appointment. Once court approval has been obtained, the common perception is that the receiver/manager enjoys a more insulated position. However, the disadvantages include additional expense and the secured lender may have to relinquish some degree of control over the receiver. Similarly, the receiver will have much wider responsibilities to the creditors in general.

(vii) Indemnification

It is common practice for receiver/managers to obtain letters of engagement which include a clause pertaining to the indemnification in favour of the receiver/manager. Fortunately, in many instances, the receiver/manager who has been afforded such protection is able to get the bank or debenture holder to defend and indemnify the receiver/manager.

Most indemnification clauses contain a provision that such agreements will be in effect only if the receiver/manager carries out his/her engagement properly. In other words, the banks are attempting to spell out that they owe no indemnity if there is evidence that the receiver/manager was negligent.

It is possible to ensure the receiver/manager's ordinary negligence is protected in any event if the engagement letter is prepared properly by the receiver or independent counsel. It would be preferable to have it protected by the terms of the appointment but, even if this is not possible, the Insuring agreement of the standard professional errors and omissions policy will ordinarily afford such coverage provided the receiver/manager is not guilty of intentional wrongdoing.

Recently, it has been more difficult to obtain letters of indemnity, particularly in parts of the country where the volume of work has decreased. In such cases, practitioners may only be able to rely on the contractual relationship as agent of the lender.

(viii) Conflicts of interest

Claims have arisen where insolvency practitioners have been involved with a debtor in different capacities; for example:

- Appointment as receiver and also as trustee in bankruptcy.
- Appointment as receiver following an engagement for a viability assessment and/or monitoring engagement.
- Appointment as a receiver or trustee in bankruptcy where the firm has acted as an auditor for the debtor in the recent past.
- Appointment as a receiver or trustee in bankruptcy where the firm acts as an auditor for a creditor.

As a result, there are now a growing number of statutory and professional rules, regulations and guidelines which cover such instances. It is always difficult to apply general rules to specific situations and sound professional consideration, judgement,

documentation and disclosure have become more and more essential.

This topic is discussed in greater detail in the paper entitled **"Legal Liability Issues"** prepared by Mindy Paskell-Mede and Robert Emblem for the 1993 Canadian Insolvency Practitioners Association Continuing Education Seminar entitled "Retreat, Restructure & Rehabilitate". Practitioners are recommended to review this article.

(ix) Environmental liability

Much has been written about this new problem area for insolvency practitioners and the paper referred to above discusses the current status of the law. Again, practitioners are recommended to the article and to the suggested procedures which are also summarized below.

Avoiding Insolvency Practice Pitfalls

The best way to deal with a potential claim is to prevent the claim from ever arising. This is easy to say but much more difficult to do, particularly in the insolvency field where so much is at stake. Personal assets, livelihoods and pride often drive debtors and creditors to bring actions which may or may not have any foundation in fact.

Good business practices, if consistently followed, will often help the insolvency practitioner to avoid, or least reduce the potential liability.

Such practices should include:

- Adequate consideration of all parties' positions and the provision of adequate information so that such parties can understand the position and actions taken by the receiver or trustee.
- Adequate supervision of junior staff.
- Documentation of all relevant discussions, decisions. etc.
- Regular and appropriate reporting to interested parties.
- Use of standard procedures supported by programs and checklists as the engagement proceeds.

- Adequate exposure of assets for sale to the marketplace through appropriate advertising and sales techniques.

- Timely advice from legal counsel and other professionals where necessary.

Conflicts of interest

In respect of conflicts of interest, it is recommended that*:

- A system for detecting and dealing with actual and potential conflicts of interest should be established.

- Where a potential conflict is discovered but the firm feels that it can nevertheless accept the engagement, disclosure in writing of the circumstances of the engagement should be made to the affected parties (which in certain circumstances may include an appointing judge), and an acknowledgement of their acceptance in writing (or confirmation in writing by the professional) should be obtained; and,

- A well-documented system to prevent any future inadvertent conflicts of interest must be established from the outset.

Environmentally-sensitive issues

The receiver/manager should also consider the following steps when dealing with environmentally-sensitive issues*:

- Arrange or ensure appropriate environmental audits or due diligence procedures before deciding on exercising control or taking possession of the property or operation in question;

- Seek directions from the court as to the extent of potential liability (both personally and as a representative of the secured creditor(s)) and as to the priority of the receiver/manager's fees and disbursements relative to environmental remediation costs; and

- Where appropriate, seek indemnification from the secured creditors at least in respect of personal liability for damage caused by acts of the debtor prior to the receiver/manager taking possession or exercising control.

And if a claim arises....

In the event that a claim is made or the receiver/manager becomes aware of circumstances which could expose him/her to a claim either by the debtor or some third party, he/she should:

- Immediately notify AICA and cooperate fully.

- Immediately notify the principal who appointed him/her and refer to the letter of engagement and responsibilities regarding defence and indemnification.

- Immediately request the identity of the principal's lawyers and seek confirmation from them that they have been instructed by that principal to defend and indemnify the receiver/manager.

- Consider if there should be further involvement by the insurer. If the principal refuses to defend and refuses to indemnify the receiver/manager, the insurer may advise the principals that if the insurer has to appoint counsel, it may proceed by way of warranty proceedings against the appointing principal under the terms and conditions of the letter of engagement between the appointor and the receiver/manager.

  There have been a number of situations where the principal has reconsidered and agreed to undertake the defence of the claim. After discussions with its legal counsel, the adjuster is often able to convince the principal and its legal counsel that it is to their advantage to look after this because they will then control the litigation. Once the litigation is in progress, it becomes more difficult for the principal to take the position that the receiver is guilty of negligence because that would be a true conflict that would require the bank to appoint new solicitors because the current solicitors could no longer act for either the bank or the receiver.

- Review all relevant files to ensure that all discussions are adequately documented and that such correspondence and documents are properly filed.

- Where an engagement is still proceeding, ensure that staffing and supervision are appropriate for the level of risk involved and that firm procedures are being properly followed.

- Ensure that ongoing correspondence, reports and decisions are reviewed by appropriate counsel.

- Have experienced senior personnel field all media enquiries and make sure comments to the media are supported by written statements previously reviewed by the appropriate counsel.

- Review problems encountered and determine the need for changes to standard practice to avoid future occurrences.

* *These recommendations are reprinted from the paper entitled* ***"Legal Liability Issues"*** *prepared by Mindy Paskell-Mede and Robert Emblem for the 1993 Canadian Insolvency Practitioners Association Continuing Education Seminar, "Retreat, Restructure & Rehabilitate". They are included here with the kind permission of the authors and the Canadian Insolvency Practitioners Association.*