**Episode Title:**

The Cost of Liability Risk

**Episode Notes:**

In this podcast, you’ll hear from Rebecca Toffolon, JD from CNA’s Accountants Professional Liability Claims department. CNA provides insurance solutions that many CPA firms rely on to better manage their risks and grow profitably, and their extensive claim history reads like a roadmap of CPA firm liability risk areas on which to focus. Prior to joining CNA, Rebecca was in private law practice and in addition to her law degree, Ms. Toffolon has an M.S. in Negotiation and Conflict Resolution from Columbia University.

Rebecca and Steve will take listeners through some eye-opening numbers from claim data and will discuss key insights for CPA firms that can be gleaned from this information.

OUR GUEST

Rebecca Toffolon, JD, Assistant Vice President, Accountants Professional Liability Claims, CAN

INTERVIEWER

Steven A. Menges, Product Team – Assurance, CPA.com

HIGHLIGHTS INCLUDE:

• Lawsuits and claims and potential claims (oh my!)

• The “Pain Period” – a new statistic every firm should know

• Severity: How much, why, and who; key indicators for which to watch (and avoid)

**Transcript:**

The Cost of Liability Risk

**SUMMARY KEYWORDS**

claims, firms, engagement, CNA, liability, cpa firm, claim, audit, resolve, payouts, professional liability, accountants, cpa, podcast, client, engagement letter, risk

**SPEAKERS**

Steven Menges, Rebecca Toffolon

**Steven Menges**

Hello, and welcome to the Modernizing Your Practice podcast series brought to you by CPA.com. CPA.com is the technology subsidiary of the AICPA and is tasked with helping bring the profession forward into the digital age through relevant learning opportunities and technology solutions. I am your host, Steve Menges, and I lead the Modernizing Your Practice program at CPA com. Our goal with this podcast series is to bring relevant and actionable insight around ways that you can modernize your firm in the context of today's most common areas of liability and risk for public accounting firms. With me today is Rebecca Toffolon, JD from the Accountants Professional Liability Claims department at CNA. If you're not yet familiar with them, CNA is the underwriter for the liability insurance that many CPA firms rely on to better manage their risks and grow profitability. CNA's extensive experience and history in handling accountant’s malpractice matters provides a roadmap of CPA firm liability risk areas on which to focus, and CNA's claim professionals bring unique perspective and expertise in liability risk.

**Steven Menges**

Welcome to the podcast, Rebecca.

**Rebecca Toffolon**

Thank you Steve. I'm happy to be here.

**Steven Menges**

Rebecca, tell us a little bit about CNA, and what the company does for CPA firms.

**Rebecca Toffolon**

Sure, CNA is the market leader in providing accountants professional liability insurance. We insure firms of all sizes, and assist them with resolving claims and mitigating potential claims. We also have an active risk control team that helps firms improve risk management through a number of different educational forums, as well as a hotline that insureds can call with any questions that they have.

**Steven Menges**

Okay, so how long have you been there and what is your role there?

**Rebecca Toffolon**

I've been at CNA for 13 years. I've had various capacities handling professional liability claims during that time. In my current role, I am the Assistant Vice President overseeing the Accountants Malpractice Claim team, which consists of 14 claim professionals who are dedicated solely to handling accountants professional liability matters.

**Steven Menges**

Okay, so you're a lawyer and have a master's in negotiation and conflict resolution. So, your understanding of liability claims spans all the different ways that claims against CPA firms are ultimately resolved, correct?

**Rebecca Toffolon**

That is correct. When I started handling professional liability claims at CNA, it became apparent to me that most matters were resolved through mediation and negotiation instead of through trial. The claims that did resolve through alternative dispute resolution, or ADR, usually resolved earlier and with better results. I wanted to learn more and hone my skill set towards ADR to better serve our insureds. So, I went back to school at night, and I got a master's degree in negotiation and conflict resolution to round out my legal experience.

**Steven Menges**

Wow. That's great. So, what size of firms are you seeing reporting claims?

**Rebecca Toffolon**

I guess I should first clarify what we consider an actual claim. We define a claim as a demand for money or services. And while I think everyone anticipates claims against large firms, the bulk of actual claims that we see that were reported to us in 2018 were from mid-sized and small firms. One third of all the actual claims were actually from firms with three or less practitioners.

**Steve Menges**

They're interesting numbers, especially how many claims or what percentage of claims are coming against smaller firms. What other types of matters does your team assist with?

**Rebecca Toffolon**

I think one thing that tends to surprise CPAs, especially at smaller firms, is that the bulk of what is reported to CNA on a yearly basis, at least in recent years, is not actual claims, but potential claims and subpoena assistance matters. Only about 20% of what was reported to us in 2018. were actual claims at the time the matter was reported.

**Steven Menges**

Okay, so I'm guessing it's very helpful for a firm to let their insurance company know about a potential claim, so as to get ahead of it.

**Rebecca Toffolon**

Definitely. The benefit to reporting a potential claim is that we may be able to prevent the claim or mitigate any damages. Similarly, if a CPA is served with a subpoena for records or testimony, we can provide an attorney to help them respond, to make sure that they don't turn over any documents that they shouldn't, or say anything that may cause a claim to be made against them in the future.

**Steven Menges**

Right, right. Okay, so just responding to and dealing with claims has to be a resource burden on the firm. So, what is the average length of time from a claim filing until it's finally resolved?

**Rebecca Toffolon**

The average in 2018 was 14 months to completely resolve and close out a claim. It definitely can be a burden on a firm. You’re right, both from a time and resource perspective, as well as from a psychological perspective. It can mentally be draining and stressful worrying about the outcome, and even to potentially be deposed or go to trial.

**Steven Menges**

Wow, 14 months is the average? Well, I think that statistic deserves attention and a name so I'm going to call it the "pain period" because of all the pain and work disruption at the firm that is dealing with the claim. I’m going to give it that name, I like that, the pain period. So, if the overall average is 14 months, what do the numbers say about audit claims in particular?

**Rebecca Toffolon**

Audit claims can definitely have a significantly longer pain period. They usually involve extensive discovery and complex, sometimes multi party litigation, so it can be several years before an audit claim will resolve.

**Steven Menges**

Okay, wait, so you're saying they can be multiple years long?

**Rebecca Toffolon**

I am.

**Steven Menges**

Well, clearly then, firms need to focus on minimizing liability risk for audit engagements, and that includes using best practices for engagement letters. And it means really understanding privity in third party audit claims. Other interviews in this Modernizing Your Practice Podcast series do cover those two topics, so I encourage folks to check them out at CPA.com/myp to check out those other podcasts in this series on those two topics.

**Rebecca Toffolon**

Those interviews with Stan Sterna and Sarah Ference were excellent. I definitely would recommend them.

**Steven Menges**

Great. So, what did the payouts look like for the different types of liability claims?

**Rebecca Toffolon**

That's a good question. It's hard to provide a general guideline for what payouts look like, as they tend to be very fact specific. Claims from large insureds also tend to skew numbers up drastically. So, to give you an idea of average payouts, we looked at small to midsize claims at CNA that closed from 2007 to 2016. And based on that, the average payouts for a tax claim were $29,000, for a consulting professional liability claim was $60,000, and for an audit professional liability claim was $138,000.

**Steven Menges**

$138.000 dollars average to resolve audit claims. Wow. So, audit claims are both the largest and have the longest pain period then?

**Rebecca Toffolon**

That's right.

**Steven Menges**

Okay. So, we mentioned the importance of engagement letters to reduce liability risk earlier. So, I'm curious, is there any link between not having an engagement letter and liability claims?

**Rebecca Toffolon**

Well, only 69% of actual claims reported to CNA in 2018 had an engagement letter. A strong engagement letter can probably help avoid a number of claims, especially ones where there just isn't clarity as to the CPA’s roles and responsibilities. And then taking it one step further, if a claim does come, it helps with the defense in explaining the scope of the engagement and potentially in limiting damages. So, on the flip of that, not having an engagement letter can definitely hurt the defense in the scenarios specifically where there is a dispute as to whether it was the CPAs responsibility to do something. Those scenarios then turn into a sort of "he said, she said" scenario that can be difficult to defend.

**Steven Menges**

Wow, so if 31% had no engagement letter, then I'll again recommend folks listen to our podcast on engagement letter best practices. Okay, so to finish things off for today, what can you share about the “why” and the “who” in the claims data, for the big money claims, that can help firms assess potential risk?

**Rebecca Toffolon**

I can. I can give some leading indicators of severity from a review of closed CNA claims in 2017, where we made an indemnity payment of $1 million dollars or more. This dataset covers claims from 2008 to 2014. Speaking of that pain period for audit, specifically, what we found most often in these million dollars plus payouts, the fact pattern involves the failure to detect a large embezzlement or a fraud. Another scenario that was common was an audit of a sale, or distressed company. And I should mention the 2008 to 2014 time period that also included some claims, a good number of claims, after the financial crisis, so that audit of failed distressed companies was probably pretty relevant in that timeframe, due to that as well. And the third scenario was a lack of independence, either in fact, or just in appearance.

**Steven Menges**

Very interesting, seeing that that lack of independence makes the list. What about the other firm practice areas?

**Rebecca Toffolon**

Sure, for non-audit engagements, some of the recurring red flags that we saw were the client was a wealthy client or a celebrity. We also saw engagement creep, an over reliance on the CPA firm. Often those three would go together. And then the fourth pattern we saw was investment advice was given. And just generally speaking, that themes that we see that span across all types of claims, is really the size and the severity of the underlying loss, regardless of liability. Knowing if you have 100-million-dollar damage model, even with a 1% - 2% liability, you know that would still be a pretty large loss. We also saw underlying matters involving fraud or embezzlement, regardless of the type of engagement. Very typically any sort of a fraudulent scheme, anyone that was involved, any professional involved gets pointed to, that they should have seen it, regardless of really what their role and responsibility was. Another overarching indicator we saw was the client was a financial institution. Again, some of this probably because of the timeframe of the claims we’re looking at, failed banks were a big result coming out of that financial crisis. So that particular financial institution being a client may have a little bit of timing from the claims we were looking at. And the last one that we saw, regardless of the type of engagement, when the CPA firm was alleged to be involved in improper activity, that was a pretty big red flag and severity driver.

**Steven Menges**

Wow. Okay. So that that last one was that the CPA firm was alleged to be involved in improper activity. That's interesting. It's also fascinating that wealthy clients and celebrities being risky as clients makes sense. And again, we see engagement scope creep as an issue for firms to address, including being careful to not be seen as providing investment advice in other engagements. Okay, so Rebecca, any final thoughts for firms before we wrap up this podcast?

**Rebecca Toffolon**

I have a couple Steve. First, I'd urge firms to take note if any of their engagements have any of the potential severity indicators we talked about. If so, I would encourage them to review their processes and procedures around that engagement as well, as you mentioned to ensure they have a strong engagement letter for that client. My second thought would be to encourage firms to account for and have a plan in place for dealing with a claim, as it's likely one is going to be made at some point, and the better educated and prepared the firm is, the easier the claims process will be for them.

**Steven Menges**

Great. I'd like to thank Rebecca Toffolon for joining us today and helping firms as they innovate and digitally transform. So, a reminder, the show notes provide links to great additional content from CNA and AON related to today's topic, so check them out, along with CPA.com/myp. We hope you gleaned some useful actionable insights from today's podcast. Check out CPA.com for more useful information to help you and your firm win in the digital age. I'm Steve Menges with CPA.com, and I want to thank you all for listening today.

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