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Accountant's Liability Newsletter, Number 10, September 1985

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

AICPA accountant's liability newsletter

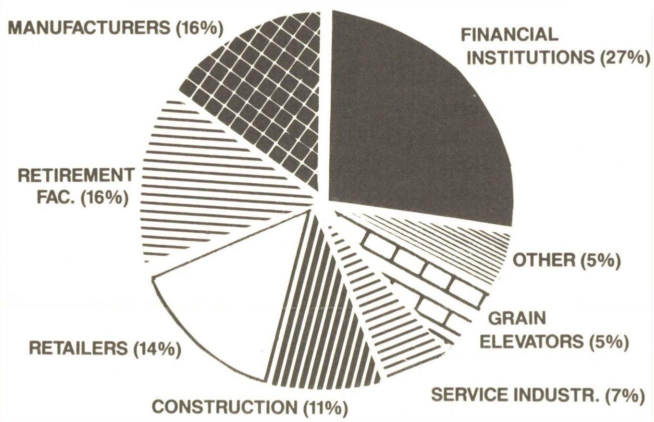
AICPA Professional Liability Plan

Number 10: September 1985

FINANCIAL INSTITUTIONS CAUSE 27 PERCENT OF AUDIT LOSSES

Recent analysis reveals that audit engagements result in 51 percent of all losses in your AICPA plan which insures only small or regional firms. The chart below reveals that financial institutions (banks, credit unions, and savings and loans) cause 27 percent of all audit losses. Retirement facilities and grain elevators together account for another 21 percent of all audit losses.

COMPOSITION OF AUDIT LOSSES



AICPA PROFESSIONAL LIABILITY INSURANCE PLAN

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J. B. DRESSELHAUS AVAILABLE TO EXPLAIN MALPRACTICE RISKS AND INSURANCE PROBLEMS TO YOUR GROUP

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Does your group want to know why malpractice insurance premiums are now increasing in 100 percent multiples? Do you want to know where the risks are and how to avoid them? J.B. Dresselhaus, one of the members of your AICPA PLIP Committee has volunteered to answer your questions. In addition to his knowledge obtained in committee service, J.B. has special knowledge about compilation and review, and directors' exams. We do request your group to reimburse J.B.'s expenses. If you would like CPE credit remember that you must reproduce an outline for those in attendance and keep records.

"AVOIDING MALPRACTICE" SEMINARS

For seminar materials for an 8-hour CPE program on "Avoiding Malpractice," call the AICPA CPE hotline (800) 242-7269. Defense Counsel for the AICPA plan are available as discussion leaders. Programs now scheduled include:

- Sept. 6, Buena Park, CA
  (California CPA Foundation)
- Oct. 9, Lanham, MD
  (Maryland Association of CPAs)

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This newsletter is prepared by Rollins Burdick Hunter Co. as broker and administrator of your AICPA Professional Liability Insurance Plan to alert you to loss-prevention/risk-management considerations in your accounting practice. It should not be regarded as a complete analysis applicable to your particular situation nor used for decision making without first consulting your own firm's legal counsel. Furnished free to practice units insured under the AICPA Professional Liability Insurance Plan. Subscription information is available upon request.

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Because of the significance of the losses from financial institution audits, it may become necessary in the future to surcharge your insurance rates based on the number of financial institution audits or the amount of financial institution assets that you audit.

ALLEGED ERRORS

Consider these allegations of errors that have been made by financial institutions against your fellow CPAs insured in the AICPA plan:

Credit Union A: (CPA staff size: 61)

(a) Failure to reveal delinquent loans including extensions recorded so as to make delinquent loans appear current and loans to officers without defined payback periods.
(b) Interest was improperly accrued on loans more than ninety days delinquent.
(c) Audit personnel were inexperienced in credit union audits.

Credit Union B (CPA staff size: 15)

When CPA could not locate 15 percent of loan files, a disclaimer was issued without follow up that would have disclosed fictitious loans; failure to disclose that loan officer's loan exceeded permissible limit.

Directors' Examination of a Bank: (CPA staff size: 14)

The FDIC claims over $10 million because of
(a) Failure to balance the bank's general ledger of investments (passing as immaterial a discrepancy in reconciliation).
(b) Failure to consider that the stockbroker safeguarding the bank's investments was the bank president's son.

Bank A: (CPA staff size: 63)

Failure to detect embezzlement by branch manager of a bank; a "textbook" example of auditor discovery of some evidence of an ongoing defalcation and then failing to follow up on this evidence.

Bank B: (CPA staff size: 40)

Shareholders and FDIC allege loan loss reserves that were $100,000 should have been $600,000; failure to reveal the financial condition eliminated the opportunity to minimize losses.

Bank C: (CPA staff size: 41)

Stockholders claim $153,000 loss of investment plus treble damages as a result of demise of bank; alleged failure to evaluate collateral in an industry with a history of economic instability.

Savings and Loan Associaton A: (CPA staff size: 11)

Failure to consider weaknesses in internal control; failure to disclose investment policies in Association Minutes violated by employees controlling investments; failure to disclose speculative investments that were prohibited by Federal Regulations.

Savings and Loan Association B: (CPA staff size: 59)

Failure to disclose speculation in GNMA securities without board authorization; failure to disclose outstanding mortgage commitments and their market value; failure to recognize the difference between market value and commitment cost as a current loss.

Loan Company: (CPA staff size: 25)

Court appointed receiver for a loan company claims our audit should have revealed individual loans in excess of the statutory limit; it is also alleged that the auditor is in default on a loan secured by his home and accounting-firm receivables.

Finance Company A: (CPA staff size: 12)

At persuasion of client the auditor failed to confirm leases that were collateral for financing by the client.

Finance Company B: (CPA staff size: 5)

Failure to adequately reserve for bad debts despite evidence revealed by testing; failure to reveal inadequacies in the client's computerized aging program.

LOSS PREVENTION

Here are some ideas for designing your own loss-prevention/risk-management program.

Financial Institutions

1. Does our staff have the knowledge of specialized industry practices to undertake an engagement for banks, credit unions, or savings and loan firms?
2. Do we have special programs designed to detect the embezzlement schemes that are often found in these firms?
3. Do our practices and procedures provide assurance as to the adequacy of loan loss reserves?
4. Do we perform a special study of procedures, authorization, and disclosure of any speculation on Fannie Mae's or Ginny Mae's?

Grain Elevators

Are internal controls adequate to account with assurance for all quantities of grain for the period and all liabilities to farmers or should we limit our engagement to a compilation with special disclosures of weaknesses and uncertainties?

Retirement Facilities

1. What is the history and track record of management?
2. Are there customer complaints or dissatisfaction?
3. Is there a present ability to carry out all contract commitments?
4. Has the client's attorney given us a full and complete response indicating that there are no pending or potential lawsuits or claims?

FOUR NEWSLETTERS FOR 1986

Starting with our next issue, January 1986, we will publish four issues a year: January, April, July and October. Watch for this story in January: "U.S. Supreme Court deals blow to accounting profession: Sedima v. Imrex Co."

COMMENTS FROM A COMMITTEEMAN

Written by
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This open letter to you my fellow CPAs is to share some of my impressions gained while serving you on the AICPA Professional Liability Insurance Plan Committee.

THE PROBLEM

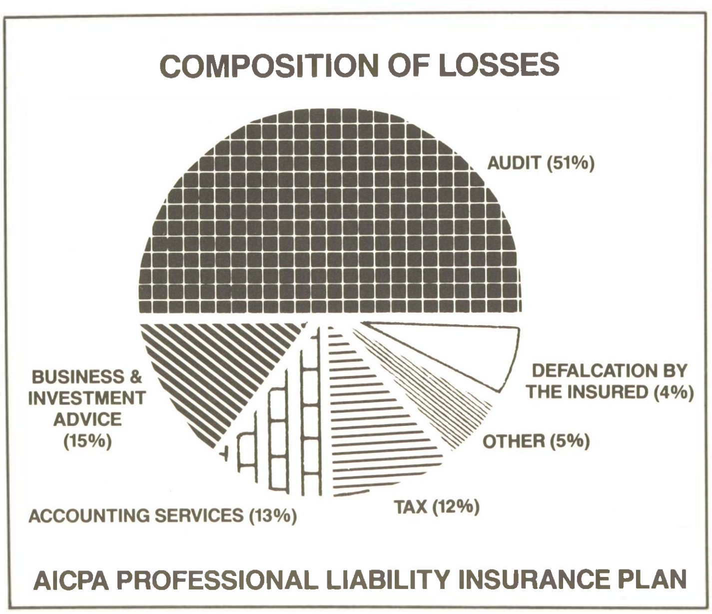
You already know that something is amiss in the world of professional liability insurance if your policy has been renewed recently and, if it hasn't, prepare yourself for an unpleasant shock. Most premiums and deductibles have doubled since November 1984, on top of an earlier rate increase. There are two aspects of this problem to consider:
- Our litigious society
- Our own failures in public accounting practice

Our Litigious Society

We have an oversupply of attorneys who encourage their clients to believe that the element of normal risk can be replaced by the guarantee against loss provided by professional liability insurance. The public does not understand the difference between business failure and professional failure. Most malpractice claims are settled, even when the insured CPA may not have done anything materially wrong, because the high costs of defense would exceed the settlement offer. Many of the cases that do go to trial result in defense verdicts followed by appeals by the plaintiff in order to exact some concession from the insurance carrier and some suits seek multiple and punitive damages.

Our Failures in Public Accounting

The most recent analysis of losses in your AICPA plan covering some 14,000 practice units are summarized in the following chart:



One of the most shocking things that I have learned as a member of the AICPA Professional Liability Insurance Plan Committee is that the defalcations by our insured CPAs account for 4 percent of our total plan losses. We also find frequent violation of basic good practices such as:
- Using engagement letters.
- Acquiring special expertise or associating a specialist before engaging in specialized areas, such as financial institutions, grain elevators, estate tax returns, etc.
- Not handling client funds.
- Maintaining an effective system of quality control.
- Never suing for collection of fees unless suit is based on a promissory note.

OUR PLAN

A word of background about how the insurance industry operates. In order to spread the risk of loss as much as possible and still make a profit, underwriters purchase insurance on their policies, called "reinsurance." These reinsurance treaties are individually negotiated, vary as to layers of liability (or portion of the risk assumed) and premium charged. A professional liability specialist representing various syndicates at Lloyd's in London calls the shots as to what terms of these coverages he will reinsure. Even he must carry protection against the catastrophe in the form of "retrocession" agreements, perhaps with an investor in Munich, and so forth.

Approximately 85 percent of the firms insured in the AICPA plan have a staff of ten or less. NO BIG EIGHT FIRM IS INSURED IN THE PLAN. So why should an Arthur Andersen & Co. loss exceeding $65 million (*Wall Street Journal*, November 8, 1984) have an effect on you, the little guy? Because the fellow in Munich gasps "Mein Gott" and his clients in London say "Blimey, that won't do at all" and the underwriter on the 100th floor of Sears Tower in Chicago says "@##!?*-¢#." When the dust settles, the little guy, along with everybody else that buys insurance, finds that his premium has skyrocketed, his coverage shrunk and, if he was insured in the New York plan in April of 1985, discovers that his insurance company had decided to get out of the professional liability insurance business altogether.

WHAT WE CAN DO

Considering the frivolous claims that the Plan has defended and paid, as well as those where our insured CPA has erred, the AICPA plan has had surprising success in maintaining a stable malpractice insurance market for our members. In reviewing recent loss reserve increases, I counted twelve out of thirty-two cases that involved firms with partners and staff of three to nine. These claims had total loss reserves of $1,330,000 and paid expenses of $113,975. Your firm's chance of being sued in any one year runs between 5 percent and 10 percent.

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Things may get worse for the small CPA firm before they get better, but there are some things that you can do:

- Keep informed. Read Newton K. Minnow's article in the September 1984 *Journal of Accountancy* titled "Accountants' Liability and the Litigation Explosion." Read the *AICPA Accountant's Liability Newsletter* on a regular basis.
- Join the AICPA Division of Firms. This will ensure that you formulate, document and follow good practices, and an independent, outside source will verify that you do so.
- Develop special expertise for yourself and your staff in those areas that call for special knowledge, such as financial institutions, grain elevators, construction industry, etc. The chart on page 1 will illustrate the point.
- Inform your local political representatives at all levels of the situation and recommend such things as making attorneys liable for negligence in bringing frivolous suits, making punitive damages unavailable (because there are criminal penalties for punishing the guilty), reducing the statute of limitations to three years from time of performance, eliminating joint liability of innocent professional persons for acts of their partners, and establishing dollar limits on liability.
- Strive to improve the quality of your performance, keep current technically, keep the CPA's normal confidence from becoming overconfidence. Practice as if a smart and hostile lawyer with the benefit of hindsight and your workpapers were going to question you on the witness stand (he may).

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CLAIMS?
CALL L. W. BIEGLER INC.
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