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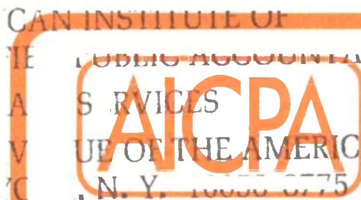
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accountant's liability newsletter

AICPA Professional Liability Insurance Plan

Number 11: January 1986

PLAN IMPACTED BY INSURANCE INDUSTRY TURMOIL

by Walter Stock,
Chairman, AICPA Professional Liability Insurance Plan Committee

As most readers know from reading my recent letter to participants in the AICPA Professional Liability Insurance Plan, our plan's underwriters have found it impossible to negotiate their year-end treaties with reinsurers at existing premium rates. Due to the severe claims experience of firms insured under the plan, it cannot continue without additional substantial increases in premiums.

The entire general insurance market has experienced extraordinary losses resulting in a withdrawal of capital from the insurance marketplace and a consequent restricted ability of insurers to write the same amount of coverage as in prior years. This has caused a retrenchment by insurers from what they consider to be high risk areas, such as professional liability. These conditions have resulted in sharply increased prices for all types of liability insurance coverage.

Professional liability has been among the hardest hit of any type of insurance. Increased costs and limited availability of professional liability insurance of all types have become a severe problem in this country. In addition to the losses which have caused many companies to leave this market, insurers are no longer confident that they can accurately predict future liability given the rapidly changing and increasingly threatening liability environment.

During the past year, the AICPA Professional Liability Insurance Plan Committee members began an intensive study of past claims in order to alert our insureds through this Newsletter about those areas of practice where members are most vulnerable to lawsuits, and to suggest ways to avoid such malpractice suits. Also, following an evaluation of several candidates with the committee, the plan's underwriters, Crum & Forster, engaged the consulting firm of Tillinghast, Nelson & Warren Inc. ("Tillinghast") to do an actuarial evaluation of our plan. The consultant's report which was recently completed makes clear that the plan requires a substantial increase in premiums to meet claims against CPAs which continue to increase both in frequency and severity. Based on the report, the committee authorized a new rate schedule which it anticipates the underwriters and reinsurers will accept as a basis for continuing to participate in the plan.

The chart on page 4, prepared by the plan administrator based upon the Tillinghast report, indicates earned premium and final settlement costs in the plan from 1978 through 1985 and shows graphically the inadequacy of present overall premiums to cover the plan's losses as currently reserved by the underwriters through 1985. Under the circumstances, underwriters and reinsurers cannot be expected to continue to write policies at present premium rates unless there is to be a radical reduction in claims, and knowledgeable people do not foresee that happening in the near future. Therefore, the Tillinghast report recommended, and the committee has authorized, a substantial premium increase overall. The last two columns on the chart show an approximate projection of earned premium and final settlement costs through 1986 based on the new premium increase which became effective on January 1, 1986. As the chart indicates, the plan overall will have to generate substantially more than the present premium volume to become actuarially sound.

The Tillinghast firm also was asked to evaluate the premium schedule as a whole to assure that firms were being fairly charged in relation to the historical losses for firms similar in staff size to themselves. The study concluded that the existing schedule is illogical, unfair and in need of substantial overhaul. As my recent letter to you pointed out with several examples, premiums are computed in the schedule with reference to staff size, and the cost per head bears little relation to losses for different sizes of firms. The size groups in the existing

(continued on page 4)

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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 or 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. Copyright © 1986 by American Institute of Certified Public Accountants.

USING ENGAGEMENT LETTERS TO DECREASE YOUR LIABILITY EXPOSURE

Most CPAs think engagement letters are "good." However, analysis of current practice reveals that many firms that use engagement letters do not adapt them so as to minimize liability. Others fail to use engagement letters altogether.[1] In view of the increasing cost and/or unavailability of malpractice insurance (especially for firms that have any claims history in the past several years), it is essential for you to review your firm's practices with your attorney if you have not done so. Here are a few ideas to consider as a starting point for developing your own loss-control program.

Management Advisory Services

A growing line of court decisions including California[2] and Florida[3] generally uphold contractual limitation of liability clauses in both breach of contract and negligence actions between the contracting parties, provided there is no personal injury. These clauses are upheld in contracts for services as well as in contracts for goods. This approach may be pertinent to your business consulting services because (1) liability to third parties is unlikely, and (2) there is good precedent for limiting liability in this particular type of engagement. For example, at least one national accounting firm has a limitation of liability clause in its MAS engagement letter. Reproduced here is a limitation of liability clause approved by one court decision:

> Limitation of liability
>
> The Customer agrees that [the Company's] liability hereunder for damages, regardless of the form of action, shall not exceed the total amount paid for services under the applicable Service Estimate or in the authorization for the particular service if no Service Estimate is made. This shall be the Customer's exclusive remedy.
>
> The Customer further agrees that [the Company] will not be liable for any lost profits, or for any claim or demand against the Customer by any other party.
>
> No action, regardless of form, arising out of the services under this Agreement, may be brought by either party more than one year after the cause of action has accrued, except that an action for non-payment may be brought within one year of the date of last payment.
>
> [The Company] does not make any express or implied warranties, including, but not limited to, the implied warranties of merchantability and fitness for a particular purpose.
>
> In no event will [the Company] be liable for consequential damages even if [the Company] has been advised of the possibility of such damages.[4]

Audit

Two important aspects to consider when drafting the audit engagement letter:

- You must provide for progress billings or else you have an "entire contract" so that you cannot collect or withdraw until after the audit is complete.
- You should delineate the division of responsibility between you and your client. Just prior to the clause explaining that your audit may not reveal defalcations, state: "An audit is not a guarantee of the accuracy of the financial statements." Then explain the sampling nature and the fact that you are not doing a special or detailed investigation to detect embezzlement.

While most firms use engagement letters for audits, the need for engagement letters is greater for the non-audit engagement to prove that you do *not* have audit responsibility. Small firms tend to ignore this distinction and to make less use of engagement letters in non-audit engagements than the larger firms.

Compilation and Review

In order to reduce liability for compilation and review of financial statements:

- Consider using the Compilation of Financial Statements and the Review of Financial Statements Illustrative Engagement Letters which are appendices B and C to Statements on Standards for Accounting and Review Services AR §§ 100.53 and 100.54 published by the AICPA.
- Consider including in the engagement letter, for your clients having inadequate segregation of duties, a warning about the same person handling cash receipts and receivables and suggest a "lock box" procedure whereby remittances go to a post office box controlled by the bank and the bank forwards a list of remittances.

Tax

There are four important aspects of your tax engagement letters:

- Limit the scope of the engagement to the specific undertaking and explain that the engagement does not include any aspects that are not covered such as internal control review, preparation of financial statements, or IRS' audit or question of the return.
- Provide that the client certifies that there is substantiation for travel, entertainment and "listed property," (as explained on the reverse of your letter) and require the client to answer the tax return questions concerning listed property.
- Always warn about inherent uncertainties in tax advice and specific uncertainties in the particular situation (e.g., no interpretative court decision or a court decision only from another circuit).
- Where the situation is complex, explain that your letter is for preliminary planning purposes and that if the client desires to implement the advice, it will be necessary for the accounting firm to monitor the implementation stages for other conditions that must be met.

Conclusion

The engagement letter is under your control and you can use this control to materially lessen your exposure and to structure the engagement along lines which are comfortable to you. However, engagement letters are legal contracts. Never adopt the suggestions you read here or elsewhere before checking with your attorney for your particular legal setting and factual situation.

---

[1] "Engagement Letters: What Practice Shows," *Journal of Accountancy*, June 1982, pp. 72-79.

[2] Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965). Accord: Boone Valley Cooperative Processing Ass'n v. French Oil Mill Machinery Co., 383 F. Supp. 606 (N.D. Iowa 1974); Flintkote Company v. W. W. Wilkinson, Inc., 260 S.E.2d 229 (Va. 1979).

[3] Radiation Technology, Inc. v. Ware Construction Co., 455 So. 2d 329 (Fla. 1983). Also see "Enforcing Contract Limitation Clauses in Negligence Actions," *Florida Bar Journal*, July-August 1984, pp. 457-460.

[4] IBM v. Catamore Enterprises, Inc., 548 F.2d 1065 (1st Cir. 1976).

CURRENT COURT DECISIONS

by Denzil Y. Causey, Jr.
Professor of Accountancy
Mississippi State University

Federal Courts

Potentially one of the most important court decisions to affect accountants' liability is the 1985 five-to-four decision of the U.S. Supreme Court in *Sedima v. Imrex Co*.[1] It holds that legitimate businesses, including accounting firms, can be sued for treble damages plus court costs and attorneys' fees under RICO (a federal statute aimed at racketeering). These suits need not be conditioned on any proof of "racketeering" and can be based on allegations over a ten-year period of two or more instances of wire fraud (including interstate telephone calls), mail fraud, or fraud in the sale of securities (including limited partnerships). There are twenty-two RICO suits now pending against small CPAs insured in the AICPA liability insurance plan. Losses can be expected to get worse unless RICO is amended because treble damages will raise the stakes causing higher settlements and verdicts.

Following the Supreme Court decision, corrective legislation was introduced by Representative Rick Boucher (D.-VA). The bill provides that civil RICO actions can only be initiated against businesses and individuals who have been convicted of certain criminal violations. The AICPA has been active in mobilizing support for this legislation. Currently, there are 106 congressional co-sponsors for this bill. The AICPA urges its members to contact their congressional representatives and stress the great importance of limiting RICO to its initially intended purpose.

State Courts

Perhaps the most important common-law court decision for the accounting profession since the 1931 *Ultramares* case is the 1985 court decision of *Credit Alliance Corp. v. Arthur Andersen & Co*.[2] This case was decided by the New York Court of Appeals, New York's highest court, and the same court that decided *Ultramares* over 50 years ago. In reaffirming and restating the *Ultramares* decision, the court held that "[b]efore accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance."

This decision can be expected to have a major impact on the future direction of state courts. Nevertheless, some states find liability for negligence contrary to the holding in *Credit Alliance*. Courts in New Jersey[3], Minnesota[4], Wisconsin[5] and Ohio[6] have held that accountants are liable for negligence to foreseeable classes of users of their reports with respect to foreseeable types of transactions. Legislation is needed to align these states with the *Credit Alliance* rule.

[1]Sedima v. Imrex Co., 53 LW 5034 (1985).
[2]Credit Alliance Corp. v. Arthur Andersen & Co. (Court of Appeals of N.Y. July 2, 1985).
[3]H. Rosenblum, Inc. v. Adler, 461 A.2d 138 (N.J. 1983).
[4]Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976).
[5]Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2D 361 (Wis. 1983).
[6]Haddon View Investment Co. v. Coopers & Lybrand, 436 N.E.2d 212 (Ohio 1982).

STUMPED ON A TECHNICAL PROBLEM?

Occasionally, a CPA firm is confronted with a technical problem it cannot satisfactorily solve. CPAs in national firms can call the technical department at their *national* headquarters for help. A similar function is available to all AICPA members through the AICPA Technical Information Service.

The primary responsibility of the eleven people who staff the Institute's Technical Information Service is to answer members' questions on technical matters. They respond to 20,000 inquiries per year on accounting principles, financial statement presentation, auditing and reporting standards and certain aspects of professional practice, but do not answer questions on tax, professional liability insurance, or legal matters. John Graves, the Director of the Technical Information Division, stated:

> "Most questions can be immediately answered at the time the member calls. We also answer questions that involve extensive research and consultation with others."

If you would like assistance, we encourage you to call the Technical Information Service's toll-free numbers: Except New York: (800) 223-4158; New York only: (800) 522-5430.

AICPA PROFESSIONAL LIABILITY CONFERENCE TO FLESH OUT ISSUES ON RISKS, LOSSES, AND INSURANCE

Are you upset about the current course of events for accountants' professional responsibility? Here is your chance to direct questions to speakers who know the most about it. The AICPA Malpractice Prevention and Risk Management Conference set for April 21-22, 1986 in New York will give you an opportunity to hear from and direct questions to these speakers:

- Representatives of the AICPA Professional Liability Insurance Plan Committee.
- New York State Society of CPAs outside legal counsel.
- AICPA General Counsel.
- Defense counsel and claims manager for L.W. Biegler Inc., underwriter for the AICPA liability insurance plan.

Mark your calendar now! This conference is a must! For further information call 1-800-AICPANY. In New York State call (212) 575-5696.

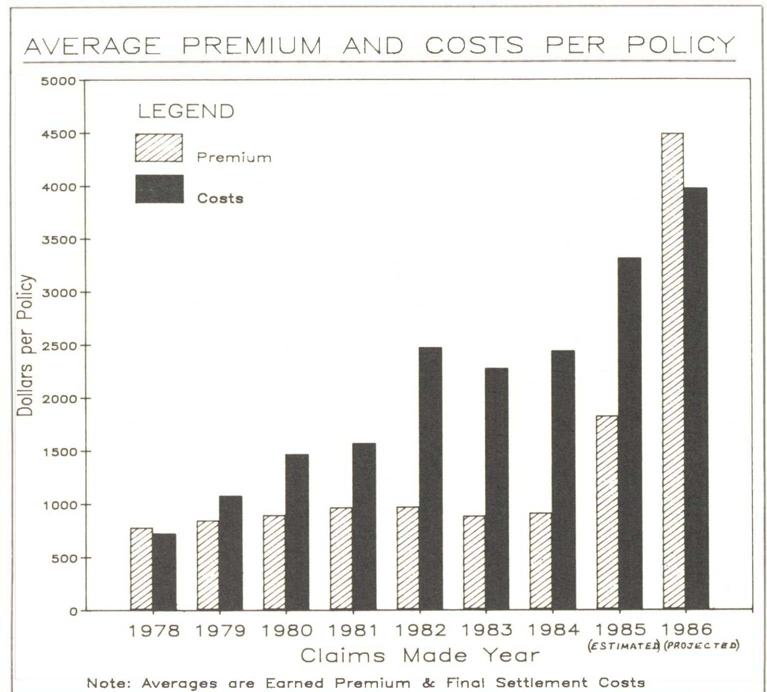
(continued from page 1)
schedule are stratified in such a way that the addition of one staff person could raise premiums far in excess of the risk a single new employee would add. Therefore, a new rate schedule has been developed to reflect risk as shown by historic losses in the plan by firm size and to smooth out progressions so that added personnel do not cause abrupt increases.

Because the plan needs substantially more revenue than it is currently generating to remain viable, the new schedule calls for premium increases for all practice units. These increases as a percentage of the current schedule will have to be greater for some firms than for others. Those who have been paying relatively more in proportion to their overall losses (generally the very smallest firms) will increase the least; those whose premiums have been substantially below their group losses will experience the greatest increases.

The committee, whose members come from firms of the size of those insured in the plan, regrets the need for another rate increase at this time as much as our readers do. However, we are convinced that the independent actuarial study of Tillinghast is credible; that underwriters and reinsurers will not remain with the plan unless premiums are actuarially sound; and that after probing the market throughout the past year there is no viable alternative.

At a time when most professional liability insurance plans have suffered frequent turnover of underwriters with resulting uncertainties of coverage, our plan has been remarkably stable. We have had one lead underwriter, Crum & Forster, since 1974; a level of stability virtually unprecedented for this type of insurance. Moreover, our plan continues to offer liability insurance to firms up to 250 in size, while many others have restricted coverage to firms with staff sizes below 20, and some even below 10.

In conclusion, the bad news is that liability insurance premiums must be substantially increased. The good news is that our plan will continue to be available and remain viable in 1986 and hopefully beyond. Crum & Forster has reiterated its commitment to our plan and its willingness to remain with it so long as it is priced with actuarial credibility. The committee believes that, with these most recent changes the plan will be on a sound footing that will be attractive to the insurance and reinsurance markets. We believe we have achieved our goal of continuing to provide a stable program of liability insurance to the profession at a price reflective of the plan's current losses and overall market costs. We will continue to direct our efforts to seeking reinsurance commitments in order to be able to provide the higher limits of coverage we had provided in the past, and at defining the causes of our losses in order to control costs and the resulting premiums paid by our members.



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