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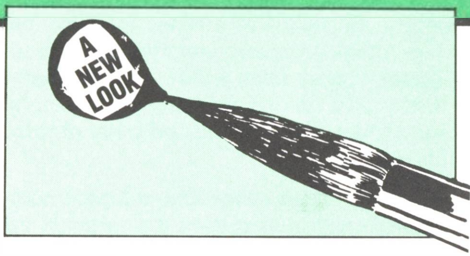
Accountant's Liability Newsletter, Number 12, May 1986

American Institute of Certified Public Accountants. Professional Liability Insurance Plan Committee

AICPA ACCOUNTANT'S LIABILITY NEWSLETTER

AICPA Professional Liability Insurance Plan Number 12: May 1986

REVISED FORMAT FOR "NEW AND IMPROVED" NEWSLETTER



GIVEN the recent explosive growth of claims against accountants and dramatic premium increases, the AICPA Professional Liability Insurance Plan Committee has decided to revise the format of the quarterly Newsletter. The Committee wants to provide to our insureds timely information about the nature of claims that are being filed; developments in the law of malpractice as applied to accountants; the efforts of the Professional Liability Insurance Plan Committee to keep our Plan viable; and the work being done by the AICPA and its recently appointed Special Committee on Accountants' Legal Liability. In order to make these changes, the Newsletter will be edited by Peter C. Kostant, who recently became Assistant General Counsel at the AICPA. This is the first issue of the Newsletter which will have the revised format.

Each issue of the Newsletter will contain actual case summaries of recent claims brought against our insureds. We believe that it will be helpful for our readers to have a clearer understanding of exactly what types of activities are generating liability. The reader will discover, we believe, that in certain cases the conduct of the accountant against whom a claim has been brought was so careless or incompetent as to be inexcusable. There will be other cases where a blameless accountant has been sued solely because he was insured, and therefore a "deep pocket," and our readers will think "there but for the grace of God go I." We intend to present both of these types of claims in our Newsletter, and more importantly, the numerous cases which fall in between.

In this issue, the article by Norman Batchelder, a member of the Professional Liability Insurance Plan Committee, provides a representative cross-section of recently filed claims. In the next issue, we will discuss recent tax claims. Future issues will deal with certain types of audits and other practice areas, depending on developments within the Plan.

In another article, Committee member Robert Geis discusses the appointment by the Chairman of the AICPA Board of Directors of a Special Committee on Account-

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AICPA APPOINTS SPECIAL COMMITTEE ON ACCOUNTANTS' LEGAL LIABILITY

BY ROBERT GEIS

THE AICPA recognizes that there is currently a crisis in accountants' professional liability. To help address this problem, the chairman of the AICPA Board of Directors has appointed a Special Committee on Accountants' Legal Liability, which is being chaired by Ray J. Groves, the immediate past chairman of the AICPA Board of Directors. The Special Committee's charge includes reviewing possible initiatives to reduce accountants' legal liability exposure to reasonable levels. The Special Committee has already made preliminary recommendations to the AICPA Board of Directors, and will continue to recommend specific actions.

The Special Committee first met on December 9, 1985, and because of the urgency of the situation, we have met four times, and are operating on an expedited basis. We believe that it is essential not to miss the "window of opportunity" that is opening because of the general awareness by both the public and legislators of the severity and widespread nature of the

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Mr. Geis is a member of both the AICPA Professional Liability Insurance Plan Committee and the Special Committee on Accountants' Legal Liability

This Newsletter is prepared by the AICPA Professional Liability Insurance Plan Committee and its staff 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. The Newsletter is furnished free to practice units insured under the AICPA Professional Liability Insurance Plan. Subscription information is available upon request.

AICPA APPOINTS SPECIAL COMMITTEE (Continued from page 1)

problem. Numerous state legislatures are currently considering or planning to consider a variety of changes to their tort laws in 1986. A number of states have already passed legislation to stem the growing tide of costly litigation, and other states currently have bills under consideration. Much of this activity arises from the significant difficulty that all entities, including state and local goverment units, are having in obtaining adequate liability insurance coverage. The activity is spurred on by active and vocal coalitions of local businessmen, professionals and public sector organizations, all of which face significant risks because of this societal problem. The Special Committee has prepared a package

of materials on proportionate liability, including draft legislation and supporting memoranda, which has already been distributed to state societies and legislators.

Also, at the February meeting of the AICPA Board of Directors, the Special Committee was authorized to coordinate and join with the large number of industry, trade and other professional groups which have formed similar committees to achieve legal reforms. We believe that such coalitions can forge the strongest possible efforts for legislation and other reforms.

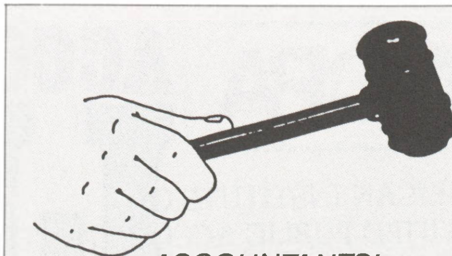
Various state CPA societies are or will be participating in these coalitions. The Special Committee has urged the state societies to initiate or participate in tort reform activities in their states as actively as possible. The Special Committee recognizes that initiatives at the state levels are crucial to the success of these reform programs, and the Special Committee is committed to assisting state efforts to the maximum extent possible. Efforts will be coordinated between the AICPA and the state societies, and the state societies will advise the Special Committee about local reform activities.

One area of tort law reform which the Special Committee has identified as being of special importance to CPAs is in the area of "proportionate liability." Errors and omissions in financial statements are often not solely the result of auditor malpractice. The client company and its senior management may bear equal, if not greater responsibility for misstated financials, sometimes aided by the collusion of third parties.

Although many states have adopted comparative negligence laws that provide for liability apportionment based on the parties' relative degree of fault, all but a few states continue to maintain the principle of "joint and several" liability. Under this rule, an auditor-defendant can be held liable for the full amount of damages assessed regardless of his relative degree of fault and, in seeking contribution from other tortfeasors, bears the risk that they may be judgment proof. The Special Committee favors the replacement of the "joint and several" liability rule with "several" liability alone, under which a defendant cannot be compelled to pay more than his proportionate share of the plaintiff's loss relative to other responsible persons. As I mentioned above, the Special Committee's materials on proportionate liability reform have been distributed, and the AICPA and the state societies are currently pressing for these reforms at the state level.

In future issues, I will discuss the Special Committee's efforts in connection with preserving the privity rule for malpractice actions against accountants by third parties; attempts to bar or reduce "frivolous suits;" the use of incorporation to reduce certain types of liability; and amending the federal RICO statute.

The Special Committee has been meeting every four weeks, and will continue to do so for as long as its services are needed to assist the profession in dealing with this crisis which affects us all. I will continue to provide updates to keep you informed as new developments arise. I welcome your comments or suggestions on this subject, addressed either to me, or to Peter C. Kostant at the AICPA. ■



ACCOUNTANTS' PROFESSIONAL LIABILITY: COMMENTS ON A CRISIS

BY NORMAN C. BATCHELDER
Member, AICPA Professional Liability Insurance Plan Committee

I RECENTLY gave a talk on this subject to the Connecticut Society of CPAs. I tried to make the talk graphic by including case summaries of recent representative claims made under the AICPA Professional Liability Insurance Plan. These were all actual claims, except that I changed certain facts to preserve confidentiality. Since my talk elicited a favorable response, I have expanded it into this article in which I am presenting representative case summaries, and offering some brief comments of my own about each case.

The summaries present a fair indication of current open claims in our Plan. In selecting these cases, I have chosen mostly cases of firms with staff of 25 or less, although I have included several brought against larger firms. During 1985, approximately 60%–70% of new claims were brought against firms with total staff sizes of 25 or less.

As you read these case summaries, notice some of the common threads. The use of accurate engagement letters was hardly universal. Most claims were brought against firms which had no prior claims history, and most of these claims were brought in connection with engagements which were performed deficiently in some way. Note that in one case a claim was brought as a counter-claim after our insured brought a lawsuit to collect his fee. This had happened to this insured on four previous occasions!

About 5% of claims actually go to trial, and the average cost of a trial is about $150,000 for legal and expert witness fees. The 11–25 person firms have consistently had by far the most severe loss experience.

I am including these actual case summaries to underscore that unfortunately, it *can* happen to you. An ever increasing number of accountants are learning to their surprise and acute displeasure that formerly dependable and loyal clients are quickly transformed into litigants when they are advised that they may have a claim against their accountants.

It is possible to greatly reduce your exposure to malpractice lawsuits if you follow these rules:

- Use engagement letters on every engagement and always amend them as engagements change.
- Be choosey about who you accept for a client, and steer clear of the suspicious-looking ones. We all want our practices to grow, but we have to be careful that growth is orderly and that we not take excessive risks.
- Recognize high-risk engagements that require unusual care, training and expertise to perform, such as those involving financial institutions, construction industry companies, SEC-filing companies and tax shelters.
- Don't accept engagements that you aren't qualified to do and haven't hired someone with the necessary expertise to help you perform.
- Never represent, or appear to represent, both sides of a transaction.
- Never sue for collection of a fee unless the suit is based on a promissory note, and then consider that a lawsuit may still be too risky.
- Use meaningful management letters, and repeat recommendations to eliminate uncorrected weaknesses in each subsequent engagement for the client.
- Deliver reports only to clients, include any restrictions on their use, and avoid relationships with third parties that might arise by discussing engagement arrangements with them prior to performing the work.
- Improve the quality of your practice. I personally believe that all practice units should seriously consider joining the AICPA Division for CPA Firms, because it requires formulating and documenting adequate policies for quality control, following them and obtaining independent verification that the policies are working. Short of this, a firm should, at least, get independent assistance in installing policies and procedures that are in accordance with these standards. Incidentally, I have found that one of the greatest values of the peer review system is the constructive and practical suggestions received in the Letter of Comment.

Also, be careful that your audit files contain working papers that record accurately and completely all work performed. Ideally, this should be confirmed in the opinion of a partner or practitioner unconnected to the engagement. Audit procedures and file notes should be adapted to the specific circumstances of each engagement. Sample sizes used in tests should be recorded, and accompanied by an explanation of how they were determined.

Now let's get to the gory details...

CASE SUMMARIES

Claim #1

Type of Alleged Error: Accounting Services/Audit
Firm Size: 8 in total personnel; No prior losses; No engagement letter
Amount of Claim: $1,337,985

Facts: Our insured was the accountant for a construction company which worked on public contracting projects. The company went bankrupt in 1981. The insured issued a compilation report for 1980 and later issued an unqualified opinion on an audit. Plaintiff bonding company claims reliance on the compilation and audit reports in having decided to bond the construction company and looks to the CPA for the entire amount of payment under the bond.

Liability Evaluation: Liability for at least a portion of the total losses appears probable. Preliminary review indicates that audit evidence available to our insured did not support the unqualified opinion issued in 1980. When a compilation engagement is replaced by an audit, it is essential that it be treated as a new engagement. A new engagement letter should be prepared, and no shortcuts should be taken based on the earlier work for the compilation. In this case, the insured did not view, price, test or confirm the inventory when it upgraded its report. Despite the lack of these procedures, our insured issued an unqualified opinion. This opinion was inappropriate under the circumstances and was not in accordance with GAAS. Also, it appears that the company's books were in such disarray at the time, that it may have been impossible to perform an audit based on these records. Recovery from the company is unlikely due to insufficient assets and the large number of creditor claims.

Engagement letters should have been used for both the compilation and the audit. When the scope of the engagement changed, the insured did not change his work program and did not perform the required audit procedures. He also failed to recognize that the records were inadequate for an audit, and he should not have accepted the audit engagement.

This claim is still pending. A substantial settlement has been offered but not accepted.

Claim #2

Type of Alleged Error: Audit; Firm Size: 3;
No prior losses; Engagement Letter: Yes; Amount of Claim: $500,000

Facts: Insured for years, including 1981 and 1982, provided accounting and audit services for a family-owned business controlled by a single individual. When this individual died, the assets were placed in trust for his wife and children, and the trustee decided to sell all assets. Insured discovered overstatement of inventories in both 1981 and 1982, withdrew the financial statements and issued corrected ones. Trustee's sale of assets was not consummated and sale was not completed for another year, and at a reduced price. Trustee claims professional fees of $30,000; tax penalties of $15,000; and a loss of $455,000 in the sales price.

Liability Evaluation: Insured admitted making substantial errors in observation and valuation of both the 1981 and 1982 inventories. Plaintiff may have difficulty proving that our insured's conduct caused the aborted sale of the assets originally. Insured recognized that he lacked the necessary expertise to perform the engagement but unfortunately the accounting professor that he hired as an expert consultant to assist him in evaluating and revising the inventory cost system also failed to perform adequately.

The insured was correct in withdrawing the original statements and replacing them with corrected ones. He was also correct in hiring an expert when he recognized his lack of necessary expertise, but he made an unfortunate selection. This claim was eventually settled for $20,000.

Claim #3

Type of Alleged Error: Audit and Tax Services
Firm Size: 7; No prior losses; Engagement Letter: Yes
Amount of Claim: $250,000

Facts: Insured prepared federal and state tax returns for plaintiff for 1977-1982, a balance sheet audit for 1978, and full audits for 1979-1982. Plaintiff's claims include overpayment of state taxes because additional warehouse expenses were not included on state returns; penalties for failure to advise on county withholding taxes; attorney fees to defend state income tax audit assessments for 1978-1980; lost investment opportunity; failure to discover an employee's embezzlement; and for the return of all audit fees paid.

Liability Evaluation: There appeared to be little merit to most of the claims. There was possible slight exposure for the warehouse expenses, but plaintiff could have filed amended tax returns, and failed to do so. There may have been some exposure on the embezzlement issue because the embezzler had commited suicide, making it more difficult to corroborate evidence that insured could not have detected the embezzlement by following GAAS.

Despite the weaknesses of plaintiff's case, defendant was unlikely to get summary judgment on all the claims. It would be expensive to try the case, and risky to have it submitted to a jury, so the claim was settled for $35,000.

The insured should have advised his former client in writing about the time period to amend the tax returns, thereby possibly obligating him to mitigate his damages. Because the insured did not know the proper practice for withholding county taxes, it appears that he had insufficient expertise to take on this engagement. If he did know, he acted carelessly.

Claim #4

Type of Alleged Error: Accounting and Auditing Services
Firm Size: 4; No prior losses; Engagement Letter: Yes
Amount of Claim: $2,000,000

Facts: Insured served as accountant and auditor in 1983 for a company which services members of a large organization of credit card holders. Plaintiff purchased the company in October 1983, and claims fraud and negligence against three majority shareholders, attorneys and our insured. Plaintiff alleges that our insured understated liabilities, understated cancellation and refund expenses to members, and overstated members' renewals. Plaintiff also demands punitive damages of $6,000,000 as to all defendants.

Liability Evaluation: Counsel believes that our insured made errors in calculating refund amounts due to customers, and did not use a proper method of accounting for deferred costs. Insured should have accelerated the amortization because of the company's questionable ability to continue as a going concern, and should have disclaimed an opinion on the January 1983 Income Statement because of the lack of adequate testing to issue an audit opinion. Despite these errors, it will be difficult for plaintiff to prove reliance on the financial statements in purchasing the company. Apparently, plaintiff closed on the purchase prior to reviewing insured's opinion and had at least one of his own people on the purchased company's board who had the opportunity to review the company prior to purchase.

It appears that the insured did not have the technical competence necessary for the engagement. In accounting for the deferred costs, he should have recognized the "going concern question," and this should have been addressed in the engagement. In cases like this, it can be very important that the accountant not be lulled into a false sense of security because the client knows the accountant's concerns and is on friendly terms with him. Working papers must reflect what is actually known and the work that has been done.

Claim #5

Type of Alleged Error: Accounting Services/Bookkeeping
Firm Size: 31; Four prior losses (all on counter-claims)
Engagement Letter: Yes; Amount of Claim: $500,000

Facts: Our insured sued for fees against the client. In response, the client counterclaims and alleges that insured was retained to trace and cross-reference payments received by client's husband. Client alleges insured failed to perform and, as a result, she received substantially less in her divorce proceeding than she would have if the tracing and cross-referencing had been performed by our insured.

Liability Evaluation: The key issue in this case is whether our insured was in fact retained to perform the tracing and cross-referencing tasks. Although the insured had an engagement letter, it was silent on this point. Therefore, this case will come down to a factual dispute, with oral evidence and credibility of the witnesses being the primary factors. It should be mentioned that, since the client is a former wife of a well-known personality, this may affect the jury's decision in this matter.

Please note that it is always dangerous to sue for a fee.

Claim #6

Type of Alleged Error: Accounting and Review Services
Firm Size: 95; Two prior losses; Engagement Letter: Yes
Amount of Claim: $750,000

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"NEW AND IMPROVED"

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ants' Legal Liability which will be actively engaged in formulating a program seeking to change state and federal laws in order to bring accountants' legal liability exposure within reasonable limits. Case summaries in the Newsletter will often contain issues relevant to the reforms which the Special Committee is trying to help implement, such as "several" rather than "joint and several" liability and the preservation of the privity requirement in negligence suits brought against accountants by third parties. Each issue of the Newsletter will summarize and update what the Special Committee is doing, and we will keep our readers apprised of developments which relate to accountants' legal liability and liability insurance.

The Professional Liability Insurance Plan Committee has worked diligently to keep our Plan viable. We now intend to outline in each issue of the Newsletter the actions taken by the Committee at its quarterly meetings, and the topics that are being explored to strengthen and improve our Plan. We will also advise our insureds about what they can do to help reduce costs.

Finally, the Committee and the editor of the Newsletter welcome letters from readers. If you have any suggestions about ways to make the Newsletter more responsive to your needs, let us know. We will be happy to keep experimenting and adapting the Newsletter as circumstances dictate. We would also like to introduce a "Letters To The Editor" column which can serve as a forum for our insureds to be able to communicate with the over 15,000 practice units which are covered by our Plan.

We look forward to hearing from you. ■

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Facts: Our insured performed SSARS reviews as of June 30, 1982 and January 31, 1983. Company was sold to buyer, who alleges that there was a $200,000 error in accounts payable as of June 30, 1982, and that he would not have purchased the company had he known of this. The basis of sale was the book value of the company's stock.

Liability Evaluation: Our insured admitted that the June 30, 1982 financial statements were in error. The book value error was due to miscalculations by our insured and misrepresentations by management. Although our insured performed a review and was justified in relying on management's representations, counsel indicates that our insured had "too much information" not to call the financial information into question. When an accountant does a review and becomes aware of a material departure from GAAP, he should recommend that the financial statements be revised to conform with GAAP. If the financial statements are not revised, the review report should contain a separate paragraph disclosing this GAAP departure, or the CPA should refuse to issue his report. The estimated cost to defend this lawsuit would be in excess of $100,000. There is possible third party liability of 50% from seller and 25% from the attorney who handled this transaction.

In this case, the accountant's technical performance was inadequate, and he also did not act properly on his knowledge.

Claim #7

Type of Alleged Error: Audit; Firm Size: 25; No prior losses
Engagement Letter: Yes; Amount of Claim: $3,000,000

Facts: Insured performed audits of a manufacturing company for five years. Plaintiff bank concluded a loan agreement with the company prior to the beginning of the engagement to extend maximum credit based on accounts receivable and inventory levels. This amount was $5,200,000 when the bank discovered that inventory was overvalued by $1,800,000 and receivables by $1,540,000. The bank took possession of the collateral upon the company's default. The bank alleges reliance on insured's reports in granting the loan and alleges that the misrepresentations were fraudulent.

Liability Evaluation: While observing inventory, insured allowed management to retain physical control of summary sheets. Between observation and completion of inventory, the company added items to the inventory list and changed pricing factors to overstate substantially the value of the inventory. The company also created false invoices to overstate receivables. Our insured admitted serious deficiencies in inventory testing procedures. The adequacy of receivables testing has not yet been determined, but overvaluation was approximately $5,000,000. Investigation by a competing bank in March 1983 disclosed "hundreds of thousands of dollars" of discrepancies, but insured could offer no explanation. Three months later, our insured issued an unqualified opinion at even higher inventory and receivables levels. The bank is also claiming lost profits and punitive damages.

The insured was technically incompetent in valuing the inventory and receivables. Although these types of frauds often are difficult to detect, the insured nevertheless should have discovered them. It is important not to take shortcuts, and particularly not to ignore the warnings from the other bank.

Claim #8

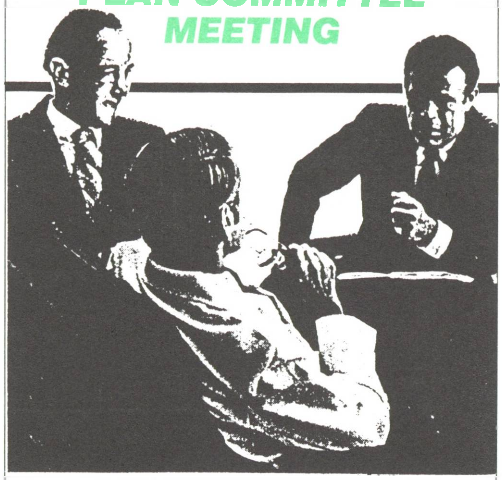
Type of Alleged Error: Audit; Firm Size: 17; One prior loss ($2,100)
Engagement Letter: Yes; Amount of Claim: $1,000,000

Facts: Insured performed audit of small equipment distributor as of September 30, 1983. It was subsequently discovered that the company's bookkeeper had not recorded some $400,000 of payables, thus the monthly statements were in error. Subsequent examination disclosed additional unrecorded payables. Claimant alleges that due to this understatement, taxes were overpaid, cash discounts were lost, available capital was decreased, and other consequential damages were claimed. Actual damages appear to be in the $100,000–$150,000 range.

Liability Evaluation: For the most part, our insured's audit procedures were in accordance with GAAP and GAAS, but the procedure performed on recorded vouchers and cash disbursements was substandard. The insured should have been alerted to this problem by the large decrease in accounts payable at year end. Our insured ignored this "red flag" and did not do further testing in this area. In this respect, the audit was inadequate. Management must share at least 50% of fault in this matter, because of their improper supervision of the bookkeeper and their inattentiveness to our auditor's suggested changes in the internal control system and other accounting areas.

The insured either ignored the required analytical review procedures, or performed them in a perfunctory manner. Subsequent review procedures should have disclosed the payables omissions, even if other procedures did not. Workpaper and report review appear to have been inadequate. ■

AICPA PROFESSIONAL LIABILITY INSURANCE PLAN COMMITTEE MEETING



BY WALTER STOCK, CHAIRMAN
AICPA Professional Liability Insurance Plan Committee

THE PROFESSIONAL LIABILITY INSURANCE PLAN COMMITTEE held its quarterly meeting with representatives of Rollins Burdick Hunter, the Plan broker/administrator and Crum & Forster Managers Corporation (formerly L.W. Biegler, Inc.), the lead underwriter, on January 30–31, 1986. The underwriter assured the Committee that they remain committed to keeping our Plan viable, even at the present time when so many other carriers are leaving this market. The broker/administrator and underwriter are actively seeking to add quality reinsurers to our Plan, and they remain optimistic about being able to offer again coverage in the Plan in excess of $1,000,000.

The Committee raised the question whether offering optional higher deductibles could materially reduce the cost of premiums for insureds in the Plan. While the underwriter said that they do not believe that this would have a significant beneficial impact, they agreed to study this option and report back to the Committee at the next quarterly meeting. The Committee also learned that many carriers have recently left the accountants' liability insurance market and that only six state societies continue to sponsor their own plans.

One of the Committee's goals is to evaluate possible alternatives to the current premium pricing structure which is currently based on staff size. Accordingly, an actuarial consulting firm will perform an in-depth risk analysis of various criteria that could be used to develop an alternative premium schedule. The Committee is especially interested in investigating the feasibility of establishing a pricing structure in which a basic policy would be purchased and additional coverage options

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COMMITTEE MEETING

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could be added at prices that would reflect the additional risks. The Committee hopes to receive a preliminary report at our next quarterly meeting in April, and a final report in August. The Committee will provide information to you about these developments in the next two issues of the Newsletter.

The Committee heard the status reports of the Plan prepared by the broker/administrator and underwriter for the fourth quarter of 1985, and discussed recent substantial claims made against insureds in our Plan during the quarter. The Committee noted that 90% of these claims were against insureds who had no prior claims history. The Committee also observed that tax shelters have sharply increased as an area of liability exposure, and plans to offer some practical advice about the problem in our next Newsletter. ■

The contents of this Newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.

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