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## Accountant's Liability Newsletter, Number 15, November/ December 1988

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

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# ACCOUNTANT'S LIABILITY NEWSLETTER

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AICPA Professional Liability Insurance Plan

Number 15 • November/December 1988

## CLIENT AND ACCOUNTANT BENEFIT FROM USE OF ENGAGEMENT LETTERS

BY F. KYLE NIEMAN  
UNDERWRITING MANAGER,  
CRUM & FORSTER

Recent CPA publications have included articles on the use of engagement letters as a means to limit the accounting firm's liability. In spite of the publicity this issue has received, it is shocking to see the number of accountants insured through the AICPA Plan that do not use engagement letters even for audit and review engagements! While engagement letters will not make your firm immune to a lawsuit, their use has assisted greatly in the handling of claims reported. The following examples will help illustrate the value of the engagement letter.

An accounting firm was engaged to perform a compilation for a small manufacturing concern. The firm reviewed the monthly cash flow, checked out the bank reconciliation and compiled balance sheets and prepared financial statements on a quarterly basis. During the fourth year of their engagement, the firm experienced difficulties in securing the necessary information to complete the quarterly review. After discussing with management the difficulties in obtaining the information needed from the bookkeeper, the firm resigned from the engagement. The year following the firm's resignation, it was discovered by another accounting firm that the bookkeeper had been embezzling funds. The ex-client filed suit against the accountants alleging negligence in performing accounting service demanding \$100,000 in damages. The case was quickly settled prior to trial for \$10,000 in expenses.

The favorable outcome of this case hinged on the accountants' use of an engagement letter confirming the scope of the engagement and specifically stating that the services provided were not designed to detect fraud. The letter, which was signed by the client, properly documented the understanding between the client and

the accountants. Had an engagement letter not been secured, additional costs would have been incurred to defend the accountant and to prove that the client should not have expected the accountant to detect fraud, a very difficult endeavor in today's legal climate.

Difficulties with tax clients can also be limited with the use of engagement letters. A common scenario evolves out of an accountant receiving a phone call to assist a potential client in preparing taxes. The potential client is usually pressed for time and realizing this, the accountant verbally agrees to accept the engagement. The accountant soon finds out that the necessary information to complete the work is not available and experiences difficulties in obtaining the information needed to complete the tax forms on a timely basis. The accountant then hears from the client's attorney requesting payment for penalties, which have been assessed by the IRS.

(Continued on page 3.)

## RATE LEVELS FOR SECOND YEAR IN A ROW REMAIN UNCHANGED IN '89

The AICPA Professional Liability Insurance Plan Committee is pleased to announce that 1989 will mark the second consecutive year that Plan rates will remain unchanged. Independent actuaries concluded that the current rate levels are adequate based on their extensive analysis of the program. This means that the premium being charged for liability coverage at this time is thought to be commensurate with the exposure to loss on the program.

Better than 85% of the firms insured with the AICPA Plan last year renewed

their coverage. Insurance industry statistics indicate that professional liability plans usually renew about 65% of their insureds. We attribute this remarkable success to three things:

### Stability:

Contributing to the strength and stability of the Plan is the countrywide spread of risk and Crum & Forster's commitment to set an actuarially sound price for accountant's exposure. Crum & Forster has developed the largest and most experienced claims handling facility of any accountants professional liability underwriter. To control costs, Crum & Forster has implemented a litigation management program and a technical advisor program designed to allow claims specialists immediate technical accounting assistance.

### Service:

Rollins Burdick Hunter has 45 professionals dedicated to the administration of the Plan and insured related questions. Because of this team, 90% of the renewals are quoted 30 days prior to expiration. This allows the insured to review and discuss the program thoroughly with sales representatives in advance of the expiration date.

### Flexibility:

Premiums may either be paid in full or financed. Sensitive to both the necessity of securing insurance and the significant business expense represented by the purchase, premium financing is provided at a rate, which, at this writing, is below prime. Every insured is eligible for the same rate irrespective of firm or premium size.

Since 1987 the Committee has been working with Crum & Forster to determine appropriate rate levels based on industry and individual AICPA account experience. Now that the Plan has a stable rate, it is important that every AICPA insured learns about the Plan's success. For additional information please contact the AICPA Professional Liability Insurance Plan administrator, Rollins Burdick Hunter at 1-800-221-3023.

# PREMIUM SURCHARGES — WHY THEY EXIST AND HOW THEY AFFECT YOUR PREMIUM

BY ROBERT M. PARKER  
VICE PRESIDENT,  
ROLLINS BURDICK HUNTER

Many accountants have asked us, when discussing their professional liability premium computation, whether they subsidize the premium for CPA's who engage in "more hazardous" types of practice than they do.

The AICPA Accountants Professional Liability Plan's premium scale does take into consideration the nature of the work performed by the individual firm and the individual firm's claim experience in an effort to assure all Plan participants of an equitable premium. Those firms that perform engagements that have proven over time to be less risky and/or those firms that have had no claims reported pay a premium commensurate with their individual risk. This is known in the Plan as the "standard rate," and it applies to over 95% of all questions issued to applicants.

Conversely, those firms that perform engagements that have been noted to produce a significant volume of claims (frequency) and/or high dollar value claims (severity), or those firms that have actually had claims activity are subject to a premium surcharge over and above the standard rate. A little over 47% of all quotes carry a surcharge. These surcharges may range in size from 5% to 100% of the standard rate.

In an effort to keep member firms aware of these surcharges so that they can do their own risk management as respects the types of engagements that they are willing to perform, the following list provides some of the accounting services for which a surcharge **may** be levied on a firm's premium:

- Claims activity
- Lack of engagement letters
- Percent of audit engagements
- S.E.C. engagements
- Business manager engagements
- Suits for fees
- Business consulting engagements
- Investment advice engagements
- Percent of billing from largest client.
- Tax shelter activity.

Ultimately, a firm must do the cost-benefit analysis of whether the revenues from a particular engagement outweigh the potential premium consequences from that engagement.

*"The Plan's premium scale does take into consideration the nature of the work performed and the individual firm's claim experience."*

According to the latest Plan statistics, three categories account for 76.8% of all surcharged quotations. The categories are as follows:

REASON FOR SURCHARGE	PERCENT OF TOTAL
Claims activity	36.9%
No engagement letters used	21.1%
Audit percentage	18.8%
All other	23.2%
	100.0%

## AICPA PROFESSIONAL LIABILITY PLAN CLAIMS STATISTICS

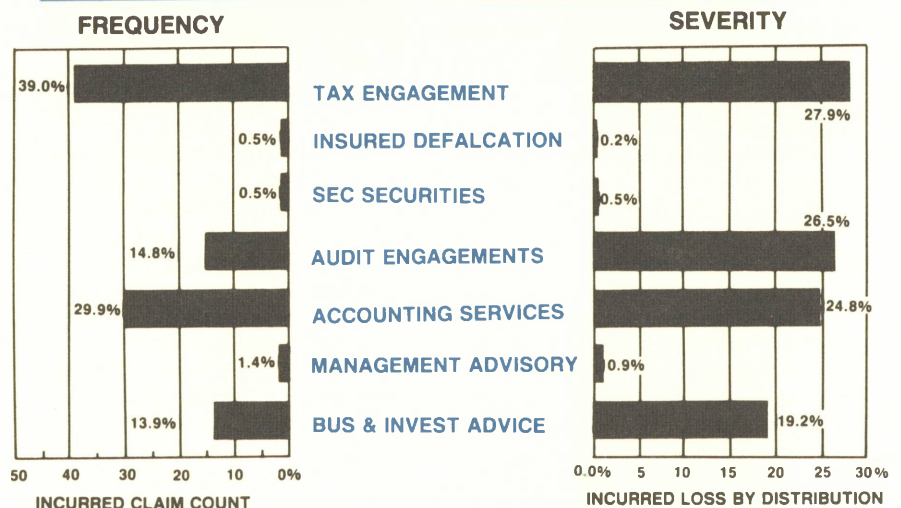
BY MIKE CHOVANCAK  
ASSISTANT VICE PRESIDENT,  
ROLLINS BURDICK HUNTER

The AICPA Professional Liability Insurance Plan Committee meets quarterly with Rollins Burdick Hunter, as broker/administrator, and the underwriters at Crum & Forster, to assess the health of the Plan and chart its direction for the future.

In that role, the Committee is constantly monitoring what causes insureds to have loss activity, what accounting services cause the greatest number of claims (frequency) and which claims activities are producing the highest dollar loss (severity).

The following graphs show some of the more significant information concerning losses resulting from professional liability claims.

### AICPA - NEW LOSS CLAIMS ACTIVITY January 1, 1987 through June 30, 1988



NOTE: The percentages above relate to a claim count of 798.

NOTE: The percentages above relate to an incurred dollar distribution of \$30,236,957.

## INSURER RECOMMENDS AGAINST USE OF BINDING ARBITRATION AGREEMENTS

BY DENNIS L. BISSETT  
ASSISTANT VICE PRESIDENT,  
CRUM & FORSTER MANAGERS CORP.

The increased cost of professional liability coverage has caused many practitioners to re-evaluate their practice, searching for practical ways to control the cost of doing business. One area under consideration has been the use of a "Binding Arbitration Clause" in engagement letters. There recently have been a number of reports in various publications of disputes being settled quickly at minimal costs by the use of the arbitration proceedings. Accountants should understand, however, that having a binding arbitration agreement can be a significant disadvantage in many cases.

Initially, by agreeing to binding arbitration before the nature of the dispute is known, the accountant could be subjecting himself and his firm to an insurance coverage dispute. Such unilateral action by an accountant, no matter how well intended, could be interpreted as a compromise of a claim.

Additionally, arbitration proceedings can involve several negative aspects from the accountant's perspective. By design, arbitration limits discovery into legal liability and damages. It is, moreover, oftentimes difficult to limit the arbitrators' decision to relevant case and statutory law. As a profession, this should be of concern to accountants. Privity, engagement letter issues, as well as other defenses, can become clouded in arbitration proceedings.

After much consideration and study, it is our recommendation that accountants not use binding arbitration clauses in engagement letters. While the potential exists for reduced expenses and time to resolution, there are aspects which, if not controlled, can be detrimental to an individual case, as well as to the profession.

As your insurer, we share practitioners' concerns over increased legal costs. While arbitration can be a viable alternative, we recommend that cases be chosen selectively. If a claim

is made against you and/or your firm, discuss the arbitration alternative with your claims representative. Do not be hesitant to discuss any alternative to long-term litigation. Remember, you as the insured and we as the insurer have the same objective, i.e. timely and

proper resolution of claims.

If you have questions regarding arbitration, or other claim issues, please feel free to call Dennis L. Bissett, Assistant Vice President, Crum & Forster Managers Corporation, (312) 993-6343.

## ENGAGEMENT LETTERS

*(Continued from page 1.)*

Clearly, there is a misunderstanding between the client and the CPA. The client expected the accountant to straighten out the tax mess and to file the return. Had the accountant issued an engagement letter confirming that the client had the obligation to furnish specific information by a certain date to enable the CPA to complete the return in time for filing, there would not have been a problem. These cases are difficult to handle in that the accountant must prove that the client

in fact did not cooperate.

Through the use of engagement letters, the firm attempts to reduce the possibility of a misunderstanding between themselves and their client. Firms that do not take this precautionary step find themselves in a difficult position in the event a claim is made. It is important that the accountant and the client reach an understanding as to what is expected in performing specific accountant functions. It is in both parties' interest to execute a signed letter of engagement.

## CLAIM REPORT

The following claims are abstracted from claims filed in the program. They are claims against small firms, big firms and medium size firms. There are claims against firms just like yours, no matter how big or small your firm may be. Any of us can make mistakes or put ourselves in a position where someone believes they have a valid claim against us. Settling a claim costs money, big money, even if there isn't much merit in the claim.

The best thing to do is BE CAREFUL in all of your work. Remember that almost half of the claims brought against accountants have to do with tax work. Hopefully these claim reports will help to remind you of the kind of mistakes any of us can make.

### 1. TAXES: FAILURE TO FILE S CORPORATION ELECTION

The I.R.S. alleges a \$293,000 deficiency in taxes as a result of failure to file the S Corporation Election in this claim. This plus interest, penalties and possible treble damages under state corrupt practice laws could well push this claim over a million dollars! The problem is a common one where the CPA claims he was told the attorney had filed the election and the attorney

claims he told the CPA to do it.

The lesson is "Get Everything in Writing." There is an overlap in the tax area between CPA's and lawyers. The thing to do is prepare a written agreement between the client, the attorney and you, specifying who is to do what.

### 2. AUDITS: FAILURE TO EVALUATE THE POTENTIAL LOSS FROM A PENDING LAWSUIT

The CPA firm had done unaudited statements for several years for this independent petroleum operator. Now they were engaged to perform an audit to be used in a private offering. The CPA discovered the pending lawsuit, but he made the mistake of accepting too readily the assertions by the company's attorney and the management that there was little merit in the lawsuit. The lawsuit resulted in a \$4,000,000 judgement and caused bankruptcy of the company. Now the investors are suing the CPA firm.

The lesson is "Be Very Careful When a Company Has a Large Lawsuit Pending Against It." The GAAP standards don't say that the CPA is automatically safe just because the attorney and management say there is little merit in a case.

## "ACCOUNTANTS ON TRIAL" VIDEO AND WORKBOOK NOW AVAILABLE

The "Accountants on Trial" Video Tape, prepared by Crum & Forster Managers Corporation in conjunction with the AICPA Professional Liability Insurance Plan Committee, is now available for your review.

The 69 minute video gives an inside look at a trial representing a malpractice suit against an accounting firm. The issues addressed in the tape are consistent with claims reported in the AICPA Plan and are presented to illustrate the impact your actions as a practitioner have on you in the courtroom.

Learn about the importance of complete record keeping and how organized work papers and documentation can help you win your case.

Attendees of AICPA and State Society Sponsored Conferences (where the tape has been shown) have found the contents of the tape to be interesting and pertinent to their practices.

The video and accompanying workbook are available through your State Society Office or by contacting the AICPA Order Department, 1-800-334-6961 (U.S.A.), New York residents call 1-800-248-0445.



Are you subjecting yourself and your firm to a possible insurance dispute? Viewing the video, "Accountants on Trial," should help to analyze your own risks. Shown here (left to right), Art Quern, President, Rollins Burdick Hunter Company, Norman Batchelder, Chairman, AICPA Professional Liability Insurance Plan Committee and David Thompson, President, Crum & Forster Managers Corporation.

## THE LATEST ON AMERINST

BY NORMAN C. BATCHELDER, CPA  
CHAIRMAN, AICPA PROFESSIONAL LIABILITY  
INSURANCE PLAN COMMITTEE

Many shareholders have had questions about what AmerInst has been doing since the offering. The offering of shares of AmerInst Insurance Group, Inc. was completed in late February of this year. Since that time, the directors of AmerInst Company have been occupied in finalizing details relating to the establishment of AmerInst's operating subsidiary, AmerInst Insurance Company, obtaining the necessary licenses to operate, selecting and contracting with an investment advisor, and completing reinsurance agreements and management agreements. These tasks have been substantially completed and on April 19, 1988, the insurance subsidiary obtained its certificate of authority from the state of Illinois. This enabled the subsidiary to accept a ten percent quota share of the AICPA Professional Liability Insurance Plan underwritten by Crum & Forster.

AmerInst has been informally advised, it already has had a stabilizing effect on the basic AICPA Professional Liability Insurance Plan rating structure and the directors hope to expand that role as one of the basic objectives. AmerInst is fulfilling its role as a reinsurer of the AICPA Plan. Future plans call for AmerInst to build its reserves so that it will be financially strong. Then it will be a real factor in providing stability for its stockholders.

### AICPA PROFESSIONAL LIABILITY INSURANCE PLAN COMMITTEE

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### AICPA Professional Liability Insurance Plan Committee

c/o Newsletter Editor  
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*The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.*