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Accountant's Liability Newsletter, Number 22, Fourth Quarter 1990

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

Accountants' Liability Newsletter

Number 22 Fourth Quarter 1990

Tax Engagements Risk Free — Don't Bet On It!

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Recently proposed changes in the current income tax laws, together with the passage of the Tax Reform Act of 1986 and the multitude of revisions of the tax law continue to put additional pressure on the tax accountant. It is noteworthy that tax-related claims under the AICPA Plan constitute over 40% of the total number of claims reported (refer to Chart 1).

Some readers at this point will volunteer that most of the tax errors must be advice errors and not a concern to the tax preparer. This response has some merit in that approximately 42% of the dollars paid for tax losses in the AICPA Plan are indeed advice errors, however, the remaining 58% are predominantly the basic bread-and-butter tax preparer type of error (refer to Chart 2). This fact coupled with the knowledge that the average claim (even if proven to be non-meritorious) includes tens of thousands of dollars of claims expenses, clearly illustrates the tax preparer's exposure to a catastrophic loss.

To combat these imposing odds, the tax accountant can use the following loss prevention techniques:

1. Use engagement letters on all engagements. Specify what you are to do for the client, time parameters, who is responsible for filing the tax return and the method of payment. Most claims handled by the AICPA Plan have

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Rate Reduction for 1990 — up to 20%

The AICPA Professional Liability Insurance Plan Committee is pleased to announce that the premium rates for the AICPA Accountants Professional Liability Plan will be reduced, on average, 20% in 1991.

The stable premium level of the last few years in conjunction with improved claim loss ratios of the AICPA Accountants Professional Liability Plan led to the decision to reduce rates for policies written during the 1991 calendar year.

AICPA Professional Liability Insurance Plan

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Tax Engagements
continued

one common element - lack of an engagement letter.

2. Select clients carefully. One must be cautious of taking on clients that continuously use different firms, are in poor financial condition, or after preliminary discussions your "gut feeling" is that you should not do business. You must be comfortable with your clients.

3. Do not sue for fees. Again, many claims experienced in the AICPA Plan stem from the firm suing to collect overdue fees, which prompt the client to countersue alleging an error or omission on the respective engagement. The firm should establish a reasonable fee schedule with the client and document this in the engagement letter. If difficulties later arise, the firm can attempt to work out a revised payment schedule or arrange to mediate or arbitrate a solution to the difference.

4. Do not accept an engagement for which your firm is not qualified. Stick to engagements that you (or your firm) have been trained to perform. The more complex engagement may command a higher fee, but may also create a serious error and a disastrous claim situation.

5. Keep current as to applicable accounting standards. From small subtle changes, to the Tax Reform Act of 1986, changes in the accounting profession are a constant challenge that an accountant must keep abreast of in his or her daily routine.

6. DOCUMENT - DOCUMENT - DOCUMENT. Accountants must practice what they preach! Clients are advised to maintain clear, concise tax records. Accountant's records (files) should likewise reflect a clear, concise written documentation of all client interactions - including telephone conversations.

7. Establish a workable fee and payment schedule with each client prior to accepting the engagement. This item goes hand-in-hand with Items 1 and 3 above. Gauge the ability of your client to pay his bill, and structure the fee schedule accordingly to avoid payment problems down the road.

8. Use caution when making representations and rendering advice whether verbal or written. Assure that your client is providing you with sufficient information to arrive at your conclusion and document such input. Use your judgment to consult with another partner in your firm (second impartial opinion) and/or your legal counsel when you deem necessary. Never render legal advice, but rather refer your client to an attorney.

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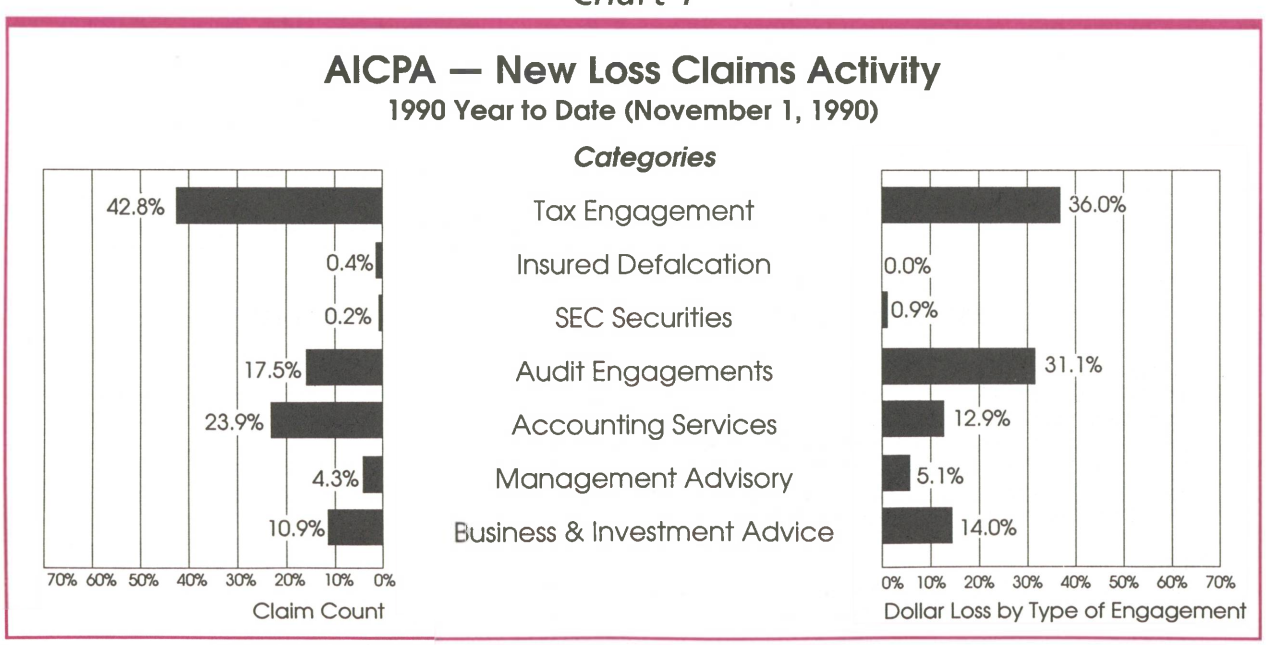
Chart 1



Tax Engagements *continued*

Remember your files can be used by the court in a legal proceeding, thus documentation as respects advices given and the input furnished to arrive at these advices can be extremely important to protect your firm's interests.

9. Maintain a balanced portfolio of clients. If an account comprises a substantial portion of your total billings, your objectivity in delivering bad news to that client could be impaired.

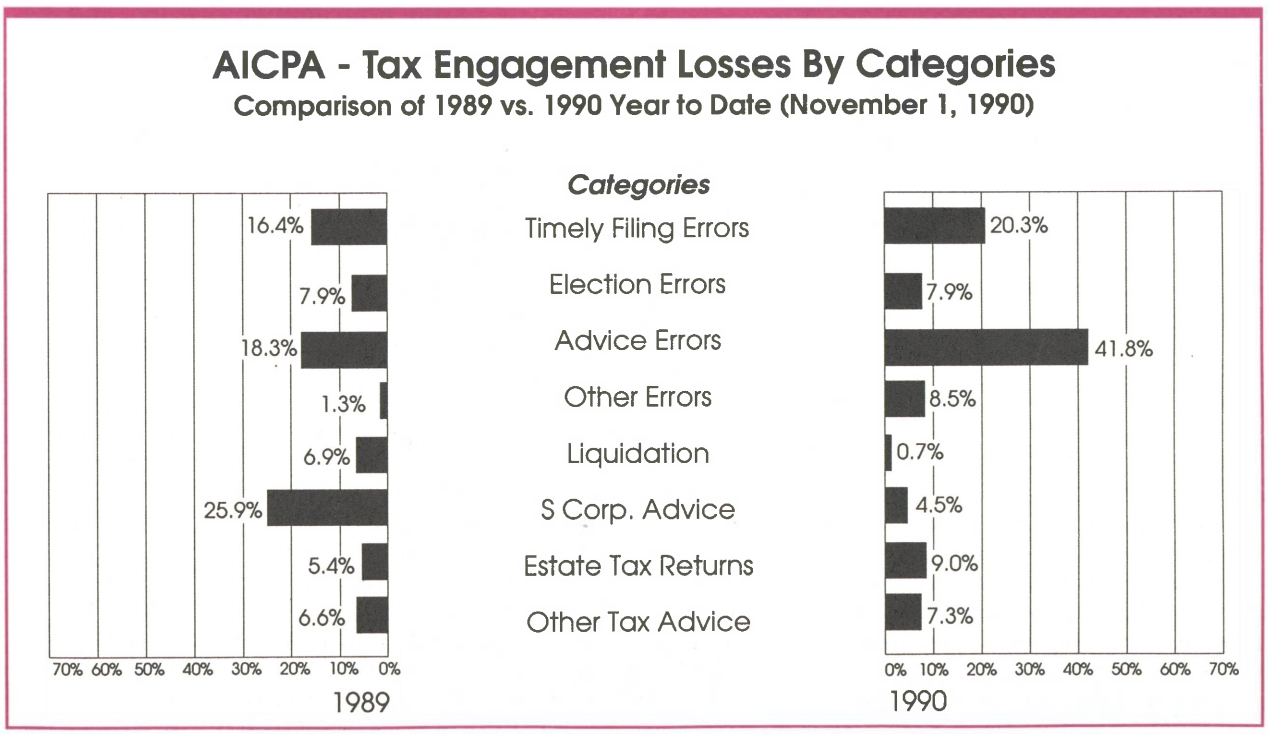
10. Purchase adequate liability insurance.

Today there are a variety of sources to procure liability insurance. Several companies offer a tax preparer policy at extremely low premium levels, but remember these policies may have severe policy restrictions and will not cover losses for any work outside of tax preparation. Therefore, it is important for you to review the policy wording carefully before you purchase your insurance protection, as the policy may not cover other losses you may incur aside from preparing a client's tax return - whether these services include other accounting work or even tax advice. The AICPA now offers two distinct Plans for your protection - the "Basic" Accountants Professional Liability Policy, which offers broader coverage than the so-called tax-only policies, and the "Standard" Accountants Professional Liability Policy (the Basic policy is discussed in greater detail in another article in this issue).

Another area of your review should be the stability of the carrier and the carriers' commitment to the accountants' professional liability insurance market. Many carriers come and go in the marketplace, leaving their insureds scrambling to replace coverage (often at inopportune times). Select a carrier that has continued to service the accounting profession for a good length of time and recognizes the accountant's needs and concerns.

Tax engagements, like other accounting functions, necessitate that the accountant be properly prepared and careful. As we have found in the AICPA Plan, tax engagements can and do produce significant liability exposures. The tax accountant should acknowledge these exposures and take heed to the risk control measures adopted by other prudent practitioners.

Chart 2



Case Study: Assumptions and Dangers of Projected Financials

John R. Barker
Senior Partner
Bittner and Barker, P.C.

John R. Barker is a senior partner in the law firm of Bittner and Barker, P.C., with offices in Portland, Oregon and Seattle, Washington. Mr. Barker is experienced in the defense of accountants' malpractice litigation.

The Fredericks were a farm family in the rural mid-west, which had developed a highly successful line of purebred cattle. These cattle regularly won top prizes at national shows, and were regarded as the top of their breed.

In the latter part of 1984, the Fredericks decided to form a limited partnership to capitalize on the genetics they had developed in their herd. They intended to use embryo transplant technology to transplant fertilized embryos from prized donor cows into recipient commercial cows, then sell the offspring.

Accountants were retained to prepare projections for inclusion in the offering memorandum. They were unaware that Lance Fredericks, a son, had a serious drug problem. He was to be the operating general partner.

The accountants read literally hundreds of pages of material on embryo transplant technology, the particular breed involved, and the Fredericks' operations in order to gain general familiarity with the industry and the general partners.

The accountants' projections for the offering were based on assumed sales prices and a certain level of production (*e.g.*, the number of offspring which would be born and sold, etc.). The offering memorandum made it clear that the Fredericks were the source of the assumptions. The offering was expected to close in the spring of 1985. However, at the last minute, a source of financing for the investors withdrew its commitment. This caused a delay of six to eight months in closing the offering. The projections were not adjusted to take into account the delay or the change in the financing scheme. The accountants were involved in trying to resolve problems that arose during this delay, but took no steps to revise their projections. The delay made the projections outdated primarily because of changes in timing of biologically-driven events.

The partnership was in trouble right from the start after the late December closing. Among other things in the litigation that followed, it was learned that the Fredericks had induced a veterinarian to falsify records of embryo transplants made just prior to year-end.

Next came the bitterly-contested divorce of the Fredericks two months after closing. The partnership floundered after the divorce. The son, Lance played too large a role in partnership operations given his experience and personal qualities. During this time, he was having problems with alcohol and drugs. The market for the partnership's products declined and the tax

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At Last! Short Form Renewal Application Arrives

The AICPA, listening to input from member firms, has worked with Rollins Burdick Hunter and Crum & Forster to take some of the sting out of completing the annual renewal application by introducing a new shorter renewal form. The new format will be used for two consecutive renewals, with the standard application necessary only every third year.

As a friendly reminder, whether it be the short form or the standard form - the application does become an actual part of the insurance policy and must be completed in its entirety. Should you have any questions on completing the application, please call Rollins Burdick Hunter toll free at 800/221-3023.

Client retained an accounting firm as its outside auditor. Later, to raise capital necessary for funding continued growth, the corporation decided to offer shares publicly. In the interim, corporate management sought bridge financing from a bank, and in turn obtained security for the loans by entering warrant purchase agreements with a group of investors. The warrant investors provided security mainly in the form of irrevocable standby letters of credit. Additional capital was raised through the sale of stock by major shareholders of the corporation.

Later that year, the corporation filed for relief in bankruptcy, the bridge lender called in the letters of credit, and the warrants became worthless. The stock purchasers and warrant investors then filed suit against the accounting firm alleging fraud, negligent misrepresentation, and professional negligence. The complaint alleged the stock purchasers and warrant investors had relied on an unqualified audit opinion issued by the accounting firm. According to facts related by the court, the corporation's financial statements were too optimistic as a result of weaknesses in the internal accounting procedures for the corporation. Following a lengthy jury trial, the jury rejected the claims of fraud and negligent misrepresentation, but returned a verdict against the firm on the theory of professional negligence. The accounting firm was found liable for a total amount exceeding $3 million. The firm appealed, and the court affirmed the verdict against the accounting firm with the exception of an award of damages to one stock purchaser. The court addressed several issues raised by the facts.

Case Brief

The Standard of Care

The firm argued that the jury should have been instructed that if the firm had complied with GAAP and GAAS, then such compliance established that the firm had met the required standard of care. The court rejected this argument noting that neither GAAP nor GAAS provides a definition of an auditor's standard of care. "Certified public accountants, like other professionals, must meet the standards of expertise and diligence common to their profession as proved with respect to the facts of particular cases by the testimony of suitably qualified expert witnesses."

The Scope of Duty

The accounting firm argued that it owed no duty to the plaintiffs because the firm had no contractual relationship with the plaintiffs. Rather, the firm argued that third-party liability occurs only if: 1)a contractual relationship existed, or if a relationship which equates with contractual privity existed; or 2) the information was intended for the benefit of the third party and that party relied on it in a transaction, or a substantially similar transaction, which the information was intended to influence.

The court rejected the firm's argument noting that California negligence law holds that a defendant may be liable to others who were reasonably foreseeable to the defendant at the time of the negligent act. Under the reasonably foreseeable rule, the determination of whether a duty was owed to a plaintiff not in privity involves balancing such factors as the extent to which the parties intended to affect the plaintiff, foreseeability of harm to the plaintiff, whether plaintiff's injury has been established with certainty, the probability of the defendant's conduct causing the plaintiff's injury, any moral blame on the part of the defendant, and the policy of preventing future harm. The court noted further that a public accountant must act independently. When certifying corporate financial reports, the accountant owes an allegiance to stockholders and creditors of a corporation as well as to the investing public.

$3 million verdict against accounting firm; Third-party liability extends to reasonably foreseeable third parties.

The firm also argued that application of a foreseeability rule would result in unlimited potential liability similar to strict liability. The court did note that some factual situations might require limiting the reasonably foreseeable rule. "Given a breach of the duty of care, the foreseeability rule would extend liability for the breach only to those persons and entities who reasonably relied on the negligently-prepared unqualified opinion and whose reliance was reasonably foreseeable by the professionally sophisticated auditor." The court explained that this rule limits the class to parties who are interested in the auditor's client: "To those who may reasonably be expected to consider doing something to, for, with, or about the client."

Internal accounting controls

The trial court had allowed the jury to consider evidence as to the firm's alleged nondisclosure of material weaknesses in the internal accounting controls of the client. On appeal, the firm argued that the evidence should not have been allowed because any failure to report the internal accounting control weaknesses could not have been the proximate cause of the plaintiffs' damages.

According to the court, however, the client's lack of adequate internal accounting controls was undisputed; evidence supported the conclusions that the lack of controls was serious and amounted to material weaknesses. The court also noted the firm did advise the client of weaknesses, but did not characterize the weaknesses as material, and did not report them to senior management, the board, or the board's audit committee as required by AICPA Professional Standards, AU §323.01. The court reasoned that, as auditor, the firm's responsibility was to determine whether the client's financial statements accurately reflected the company's financial condition. To do this, the firm was first required to determine whether the client had adequate internal accounting controls, and if not, to test the financial statements more carefully than if adequate internal controls had been in place. Evidence as to the firm's alleged failure to report the lack of internal controls was relevant to the disputed issue of whether the firm had not discovered, or had discovered but disregarded, the undisputed material weaknesses. Therefore, the evidence regarding the firm's alleged failure to report the accounting weaknesses to its client was properly considered by the jury. Accordingly, the $3+ million verdict against the accounting firm was affirmed.

Coming Attractions

Future editions of the newsletter will feature an "Underwriter's Corner."

The Underwriter's Corner will consist of responses to questions submitted to us for publication, as well as various policy interpretations and other underwriting issues.

Should you have a question that you would like a response to, please send to:

Underwriter's Corner
c/o Rollins Burdick Hunter Direct Group
4870 Street Road
Trevose, PA 19049-0005
Attn: Michael J. Chovancak

An accounting firm performed audits for its client, a company manufacturing and wholesaling gifts, for several years. Unaudited financial statements were furnished for some years, and audited financial statements were provided for the period between June 1980 and March 1983. The company dissolved in 1983. Subsequently, shareholders and creditors of the company filed suit against the accounting firm alleging negligence and fraud. The trial judge found no basis for the claims of fraud, but found the accounting firm liable in damages on the negligence claims. The liability was based on qualified audit opinions issued by the firm on the company's financial statements for 1979, 1980 and 1981. The judge ruled that the financial statements did not conform to generally accepted accounting principles, and that the audits were not performed in accordance with generally accepted auditing standards.

The accounting firm appealed arguing that the plaintiffs should not recover because they had contributed to their own losses by negligently making loans to the company without obtaining security for the loans, and by paying more for the shares of stock than was reasonable. The court, however, rejected this argument, noting a client's negligence is a defense to an accounting malpractice case only if the client's negligence contributed to the accountant's failure to perform the accounting work. While a client does have a duty to avoid acting negligently in the context of a negligent misrepresentation action, the client's in this case were found to have reasonably relied on the audited financial reports provided by the accounting firm.

The firm also argued it had no duty to the plaintiffs as shareholders and creditors of the company because the plaintiffs were not reasonably foreseeable third parties. According to the firm's argument, third-party liability extends only to third parties who are reasonably foreseen as those who will rely on an accountant's work. The court, however, found the firm knew the audited financial reports would be used by the company to convince potential lenders and investors to invest in the company. Therefore, the shareholders and creditors were reasonably foreseeable under these facts. An accounting firm can be held liable to third parties who can reasonably be foreseen as parties who will rely on the financial statements prepared by the firm. Therefore, the court affirmed the trial court's ruling that the firm was liable in damages for negligent performance of the audits and upheld the award of damages to the plaintiffs.

Case Brief

Accountants found liable for damages where trial judge ruled audit not performed in accordance with generally accepted auditing standards.

New "Basic" Accountants Professional Liability Policy Unveiled

In an effort to offer professional liability protection to small firms that have historically gone without insurance because of cost, the AICPA, working together with Rollins Burdick Hunter and Crum & Forster Managers Corporation have created the "Basic" Accountants Professional Liability Policy.

This new policy will be available exclusively for firms that have:
1. Annual billings of less than $250,000.
2. Staff size of 5 or less.

The basic policy will cover losses for tax, write-ups, bookkeeping, compilation, and MAS - only. The Basic Policy will be available to firms that limit their engagements to these five areas of practice exclusively and will only be offered with a $100,000 limit of liability and a $500 deductible. As it is narrower in scope of coverage than the "Standard" AICPA endorsed professional liability insurance plan, it is priced accordingly.

The AICPA has thus made available liability insurance protection at a price competitive with the "tax preparers" policies, but with broader coverage. For further information, please contact Rollins Burdick Hunter at their toll-free number 800/221-3023 or your State Society.

Case Study *continued*

laws changed in a way that seriously impaired the ability of the partnership to market its products. The limited partners started bickering with the Fredericks and relations degenerated.

A lawsuit followed alleging the accountants had participated in a securities fraud because they failed to update the projections and did not disclose the inflated prices assumed for the partnership's products. The applicable state securities law placed the burden of proof on the accountants to prove they were unaware of the unreasonable assumptions.

The lack of integrity of the general partners hung like a millstone around the accountants' necks in defending the case. Lance Fredericks failed to appear for deposition because he was in jail on drug charges. The elder Fredericks testified that the limited partnership was formed to give Lance something productive to do. "He was spending too much time in jail."

The case was settled after extensive depositions and other discovery.

Prospective financial statements, whether projections or forecasts, present a very high litigation risk for accountants. The risk is in the assumptions. The best insurance against litigation is a good understanding of the responsible parties' knowledge. The accountants should have a general understanding of the industry sufficient to assess whether the assumptions have a reasonable objective basis where the prospective financial statements are examined. Finally, the accountants should carefully avoid any activity that might be construed as promoting the investment to clients or others, if, for no other reason, such activity can cause insurance coverage problems.

8.8% Premium Financing Rate for 1991!

AICPA Professional Liability Insurance Plan Committee
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