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Accountant's Liability Newsletter, Number 24, Second Quarter 1991

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

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Accountants' Liability Newsletter

Number 24 Second Quarter 1991

Quick Facts:

• Based upon statistics compiled by the AICPA Professional Liability Plan, over 20% of insured firms have incurred claims at some point during their last ten years in practice.

• A recent insurance industry survey by a leading insurance publication revealed that Crum & Forster Managers Corporation (the AICPA Plan's insurance carrier) was the second most responsive property/casualty insurance carrier with an outstanding 83% rating.

• Rates for the AICPA Plan have not risen for the last four years, and in fact have been reduced, on average, 6.7% for 1990 and 20% for 1991.

• Premium financing for AICPA Plan participants remains attractive at 8.80% A.P.R., down for the fourth consecutive year.

Risk Control Series

A Born Again Accountant and the Ten Commandments

Martin W. Terpstra
Altschuler, Melvoin and Glasser

After spending almost fifteen years as an auditor, I went through a career change a year ago and was reborn as a litigation services consultant specializing in accountants' liability litigation. The redundancy of auditing the same clients year after year has been replaced by the opportunity to analyze numerous liability claims for Crum & Forster.

My firm has provided excellent technical training through in-house seminars presented by leading trial attorneys and testifying experts. These specialized courses have been supplemented with AICPA and state society courses.

In recent months, we have assisted Crum & Forster adjusters investigating claims filed against accountants. This work has taken us throughout the

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AICPA Professional Liability Insurance Plan

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country, working with practitioners from small- and medium-sized firms. We have noted certain weaknesses in some from the practices of which I hope we can all learn and build.

The fundamentals we learned in our college classes are continuously reinforced. Adherence to the basic standards: generally accepted auditing standards (GAAS) and Statements of Standards for Accounting and Review Services (SSARS) provide the best defense for an accountant. Failure to apply these basic standards makes a plaintiff's attorney's work much easier and our work much harder.

Trial attorneys and our experience as testifying experts have taught us that juries are not made up of accountants (our peers), but rather persons with little or no knowledge of the alphabet soup of GAAP, GAAS, SSARS, FASB, and GASB. Technical presentations are Sominex for the masses, from which juries are selected.

The most successful testifying experts are those who can make accounting and auditing understandable to everyone. I recently attended a meeting at which a highly experienced expert witness explained his method of making GAAS juror friendly. The three general standards, the three fieldwork standards and the four standards of reporting are likened to the Ten Commandments. Failure to follow the Ten Commandments is a concept readily understood.

In today's increasingly litigious business environment, accountants are being used in all types of engagements, not just audits. We have seen claims against accountants in review, compilation,

Born Again
continued

tax return and bookkeeping engagements.

Frequently, in these nonaudit engagements, the accountant failed to obtain an engagement letter which clearly defined the scope of the engagement. This creates an opportunity for the plaintiff to define the scope of the engagement and forces the accountant to refute such claims. It is disheartening to see how the scope of a simple engagement can be expanded in a complaint prepared by a skilled accountants' liability attorney.

In this first article we want to emphasize one point: for every engagement the accountant should annually obtain an engagement letter which clearly defines the scope and limitations of the services to be performed.

In this series of articles we shall report on some of the most common weaknesses found in practitioners' procedures and documentation in audits, reviews and compilations, and discuss protective measures for the CPA. Speaking of the Ten Commandments, it is our hope that this series of articles will do for careless auditing what the movie "Fatal Attraction" did for adultery, make the parties involved think twice.

Mr. Terpstra is a Manager of Litigation Services Group of Altschuler, Melvoin and Glasser in Chicago. We plan to run Mr. Terpstra's series of articles in subsequent newsletters.

Errors in Judgment

Katherine M. Mezzanotte
Harvey, Pennington, Herting
& Renneisen, Ltd.

The recently announced bankruptcy of Laventhol & Horwath and the reason given in the press for that bankruptcy – an overwhelming number of malpractice claims against the firm – makes this a good time for all accountants to review their practices with an eye towards establishing safeguards to prevent anything similar from occurring in their firms.

One of the major problems you, as accountants, face is that the professional service you provide is beyond the comprehension of the great majority of lay people, even those who are intelligent and relatively sophisticated. The other problem is that your findings on a review, audit or compiled financial statement greatly impact a company's ability to obtain financing, sell stock, etc. As a result, there may be a strong impetus on the part of your client to provide you with inaccurate or misleading information in order to obtain a favorable result.

That leads to a third problem, and that is that you, as accountants, are subject to attack not only from the clients with whom you have contracted but also a secondary group of individuals with whom you have no direct contact or relationship who may rely on your findings in determining whether they should loan money to a particular company, invest in the company's stock, or even purchase the company. Although there is some argument that privity to some extent still exists, there is no question that it is not an absolute bar and recent case law has significantly eroded that defense and has greatly expanded the scope of an accountant's liability to unknown and, quite likely, unintended recipients of their professional advice.

There are many things an accountant can do to prevent problems. One suggestion is to always prepare an engagement letter for the services performed. Often times a question will arise concerning the scope of the engagement. Obviously, regardless of what an engagement letter states, a plaintiff may always testify that the scope of the engagement was greater than what was set forth in the engagement letter. Documentary evidence in the form of an engagement letter, as to the scope of the engagement will, however, go a long way towards supporting your position.

Our office recently handled a case where the scope of the engagement was the key issue in the case. That matter involved a defalcation by a bookkeeper employed by the plaintiff. The plaintiffs in that particular case were a small firm of plaintiff's attorneys. Plaintiffs alleged in that case that they had previously had one defalcation by a bookkeeper that had been employed with them for many years. Thereafter, they contacted our clients, the accounting firm, and interviewed and engaged them to provide accounting services for their firm. Plaintiffs alleged that they specifically advised our client that they wanted our client to do whatever was necessary to prevent that type of problem (embezzlement) from occurring again.

Obviously, it is impossible to institute a fail safe system to prevent

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an embezzlement. If there were, whoever invented that system would be a millionaire. Unfortunately none exists. That fact, coupled with the limited funds that many businesses have available to them, does not allow them the luxury of spending endless dollars on accounting services. Despite that, when an embezzlement or any problem occurs, the clients seek a deep pocket from whom to recover their losses. In this particular case, our clients did send an engagement letter to plaintiffs outlining the scope of the engagement which essentially involved preparing compiled financial statements. There was no audit or review to be done by our clients. Unfortunately, the engagement letter was not signed by the client and in addition, the accountant undertook to provide additional services not set forth in the letter. On this basis, the plaintiff alleged that there had been an oral agreement to amend the engagement letter subsequent to the date that engagement letter was received by the client.

Although it is doubtful that this lawsuit could have been prevented under any circumstances in light of the cast of characters involved, had the engagement letter been signed by the client, and had the accountant not provided additional service without an amended engagement letter, there would certainly have been a stronger basis to doubt the veracity of the plaintiff's statements that they intended the scope of the engagement to be much broader than that set forth in the letter.

In this particular case, the issues were compounded by the fact that the plaintiff and the accountant were friends prior to the engagement. I can assure you there were no pleasant feelings on the part of my client towards the plaintiff by the end of the litigation. However, I

Errors *continued*

believe the friendly relationship at the outset between the plaintiff and the accountant prevented my client from insisting that plaintiff return the signed engagement letter or even following up to request that the signed letter be returned.

I believe the truth of what occurred was that the plaintiff simply neglected to return the signed engagement letter and because of the pre-existing relationship, my client felt disinclined to call the client or make an issue of it. I recognize that the nature of your business as accountants is that many of your clients are individuals with whom you are friendly or have met in connection with some sort of social gathering, or through a recommendation from a friend, club or organization to which you belong. However, you should make it a practice not to allow personal relationships between you and your client to in any way relax the cooperation you would insist upon from any other client with whom you do not have such a relationship.

In reviewing the many cases that our office has handled, it has been my experience that more often than not there is a personal relationship between the accountant and the plaintiff at least prior to the date the lawsuit is filed. The accountant is always shocked at the filing of the lawsuit. The accountant has often gone out of his or her way and extended him or herself for that particular client. Unfortunately, things went awry for the client plaintiff for whatever reason, bad business practices, poor management, bad financial cycle, embezzlement, etc., and he then turned to his accountant.

Perhaps equally as important as not allowing your personal relationship with your client to lessen the obligations that you place on them, you must also be sensitive

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to the importance of written confirmation. We as attorneys are quite accustomed to confirming in a letter, statements, conversations, agreements or requests. Unfortunately, you as accountants may not be as sensitized to the importance of this. However, when two people testify to diametrically opposed statements of what occurred, a few line letter confirming a conversation, which supports your position is more valuable than a thousand words recollected several years later.

The net result of the case which I referenced earlier was a resolution of that matter for a relatively small payment on behalf of our client to eliminate the potential of an adverse jury award in Philadelphia which is a notoriously plaintiff oriented city. Unfortunately for you as practitioners, accountant liability cases are expensive and time consuming to bring to trial. If you are the defendant in a lawsuit and the matter is settled, you should not feel as though it is an acknowledgment on your part that there has been any wrongdoing. Generally, there is a confidentiality clause inserted in the settlement agreement and if we as your attorneys advise or recommend a settlement, it does not mean that we believe you are wrong, it is only a balancing of the costs and the risks involved.

Errors *continued*

Ms. Mezzanotte is a member of the law firm of Harvey, Pennington, Herting & Renneisen, Ltd., Philadelphia, Penn.

The Limitless Statute

Thomas J. Shroyer
Moss & Barnett

Accountants often wonder how long they face claim exposure after they perform services. It is impossible to answer this question, in the abstract, since the statute of limitations varies between the states (anywhere from two to six years) and is subject to differing interpretations on when the limitation period starts to "tick." One recent claim illustrates just how limitless the statute can be, in certain settings:

The CPA prepared tax returns for a finance company, using the cash method, in 1972. The next year, the client began to accrue certain types of interest income on its internal books. The accountant was unaware of the change and inadvertently caused the return to overstate taxable income. As a result, the client paid excess income tax, starting in 1974 (the year of filing of the 1973 return).

This occurrence was repeated in each succeeding year, until 1982. At that time the CPA discovered the overstatement. He did not seek to amend any of the earlier years' returns (on the grounds that this would trigger IRS scrutiny), but instead eliminated accrual income from the 1982 return, filed in 1983. The same procedure was followed in each subsequent year.

In 1990, the client commenced suit against the CPA for the overpayment of taxes, beginning with the 1973 return. The trial court refused to dismiss this claim, under a six year statute of limitations, in the face of arguments by the client that the statute was tolled because the CPA failed to affirmatively disclose the overpayment. Thus, the CPA faces exposure to litigation

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Statute *continued*

costs (including inconvenience and lost time) for work performed 16 years earlier!

Teaching Point: The statute of limitations can be "tolled" under certain circumstances, especially where the claimant can establish that the CPA had a fiduciary duty to "blow the whistle" on himself. Although the CPA in this case claimed that he had told his client about the overpayment in 1983 — the client denied it. In the absence of written confirmation of the advice, the case will turn on a jury's measure of the credibility of the parties.

To avoid this result the CPA should have sent his client a letter, in 1983, describing the events of 1973-81, along with an explanation that it was the client's undisclosed and unilateral change in accounting methods that gave rise to the tax overpayment.

Mr. Shroyer is a member of the law firm of Moss & Barnett, Minneapolis, Minn.

Case Brief
Accounting Advice

An accounting firm agreed to advise its clients regarding a plan to reorganize several businesses. The reorganization plan included the liquidation of a corporation which, in turn, had the effect of defeating the tax exempt status of industrial revenue bonds that were to be issued to finance the expansion of a clinic building owned by the clients.

A group of medical doctors practicing medicine as a partnership were experiencing organizational problems relating to the cost of buying into the partnership and the cost of expanding their clinic. The partnership also controlled a corporation which owned the building in which the doctors practiced medicine, and a realty company (a partnership) which owned other realty. The doctors retained a law firm to study and recommend solutions to the various organizational problems they were experiencing. The law firm recommended that the doctors liquidate the corporation pursuant to the Internal Revenue Code.

The doctors then delivered the report prepared by the law firm to an accounting firm which reviewed the report, and (according to facts related by the court) wrote three letters to the clients recommending they proceed with the reorganization. The clients proceeded with the reorganization, selling their shares in the corporation that owned the clinic building to the realty partnership, and liquidating the corporation.

In addition to the reorganization, the clients were planning a major addition to the clinic building to be financed by industrial revenue bonds. In connection with that project, a different law firm had been retained to prepare an application for the industrial revenue bonds. Later, counsel hired by the mortgage company that had offered to purchase the bonds learned of the earlier reorganization and determined that the purchase of the corporation shares constituted a capital expenditure. The capital expenditure of the reorganization together with the $7.5 million bond issue totalled more than the $10 million limit required for industrial revenue bonds. Therefore, the bonds would not qualify for income-tax exempt treatment of interest earned on the bonds. As a result, the bonds were not issued. Because construction had already begun, the clients obtained financing through a

Underwriter's Corner

The Underwriter's Corner was developed as a service to provide AICPA Plan insureds with answers to frequently asked questions. Should you have any questions which you would like answered in the publication, please address your questions to:

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Limits of Liability

Q. I am just starting out my practice this year with another CPA. Our focus will be on compilations and reviews with perhaps one or two governmental audits. Your application indicates several choices for limits of liability. What would you recommend for a firm in our situation?

A. *This is probably one of the most difficult questions that we receive. Some firms just starting out without any past services have individually determined that their claim exposure is somewhat limited. This theory is based upon statistics that indicated that most claims do not arise for two to three years after services were rendered. Further, the limit of liability which applies to a claim is the limit carried when the claim is reported, not necessarily when the actual services were rendered. Therefore, this particular approach allows the firm to save some much needed capital by purchasing lower limits the first year, then increasing the limits in the second and third years in response to the exposure generated by the services you have rendered. However, one must also take into account the financial size of each of your clients and the dollar amount of potential liability of damages that you could incur if your work is deemed to include errors or omissions.*

We would suggest that you consider all of these factors and make your limits of liability choice in a way that provides you with what you consider adequate protection and piece of mind for your particular firm.

Case Brief
continued

conventional loan.

The clients later filed suit against the law firms and the accounting firm, seeking damages for the loss of the benefits they would have realized if the industrial revenue bonds had been issued, and for the expenses incurred in connection with the conventional loan. The law firms settled with the clients for a total of $1,475,000. Following trial of the claims against the accounting firm, the jury returned a verdict against the firm and awarded the clients damages of $4,775,000. The court deducted the amounts paid in the earlier settlements, and entered judgment against the firm for $3,300,000.

When the accounting firm appealed, the court ruled that the extent of the firm's professional duty included an obligation to assess the tax consequences of the reorganization, and affirmed the award of damages to the clients. The firm argued that no express contract existed between the firm and the clients, and that the firm's duty was defined by the firm's conduct and the client's acceptance of that conduct. According to the firm, this conclusion was supported by several factors: the clients had asked the firm for guidance as to the reorgani-

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zation plan proposed by the law firm, but did not ask the firm to comment on the effect of the proposed reorganization on the issuance of industrial revenue bonds to finance the construction project; the clients wanted the firm to advise them on the effect of the reorganization on personal income taxes; the firm's expert at trial testified the firm had been given no indication that it was responsible for advising the clients regarding the issuance of industrial revenue bonds; the clients had relied on other experts with regard to the bond issue; and the firm had virtually no involvement with the bond issue. The firm also argued that an accountant has no duty to warn of unknown hazards outside the scope of the engagement. Since others more closely associated with the client and the reorganization failed to note that the reorganization would qualify as a capital expenditure and that it would prevent the bonds from qualifying for tax exempt status, the firm had no duty to discover and report that fact.

On the other hand, the clients argued that the letters written by the firm to the clients indicated the reorganization report had been reviewed by the firm for both accounting and tax considerations. The clients' expert witness testified that the firm's duty under the circumstances included a complete review of the reorganization report, and that the firm should have investigated the effect of the reorganization plan on the issuance of the industrial revenue bonds.

The court affirmed the jury's verdict against the accounting firm noting the evidence indicated the firm had not been completely isolated from the bond financing project; the reorganization report referred to the bond financing; the firm had performed audit work relating to the reorganization for the clients; the minutes of the realty partnership and the corporation referred to the reorganization and were available to the firm. Therefore, the court upheld the jury's findings of breach of duty by the firm.

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