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Accountant's Liability Newsletter, Number 25, Third Quarter 1991

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

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Investing In Recessionary Times

In today's economy, the news that the AICPA Accountants Professional Liability Insurance Plan has reduced rates, on average 20%, received great reviews.

The resultant premium savings to you can be used in a variety of ways. Based upon the nature of your risk tolerance, we would suggest that investing these savings may top your list and there exists a vast spectrum of investment options available to provide you with a fair return on your money. The one investment that we would strongly encourage you to consider is increasing your liability insurance protection.

In some cases, firms can double their insurance coverage for the same (or even lower) premiums than they "invested" in 1990! The following example illustrates the wisdom of choosing your liability insurance as the vehicle for this investment money:

Assumptions

- Firm carries a \$250,000 limit of liability and a \$3,000 deductible.

Premium	
1990	1991
\$3,109	\$2,458

- Cost to increase limit of liability to \$500,000 in 1991: \$651.
- Firm incurs a \$300,000 liability loss in 1991.

Investment Options

- A.** Firm invests \$651 at 10% (simple interest) for 12 months, or
B. Firm invests \$651 to purchase \$500,000 limit of liability.

To carry this illustration out, the firm chooses to invest the \$651 in an investment yielding 10% return rather than increase the limit of liability insurance.

*By Michael J. Chovanak,
Assistant Vice
President,
RBH Direct
Group*

The claim is \$300,000, of which the insurance company would pay \$250,000. The firm would be required to pay the remainder of the claim (\$50,000) from out-of-pocket funds. The 10% simple interest yield, minus the firm's claim payments (\$50,000) net the firm a negative \$49,935 return.

Conversely, investing the \$651 to double the limit of liability of the firm's liability insurance from \$250,000 to \$500,000 would give the firm a net gain of \$47,000. Again, the claim is \$300,000, of which the insurance company would pay \$297,000, which is in this case the claim minus the \$3,000 deductible. The only cost incurred by the firm would be the deductible, therefore the net gain on the \$651 investment would be \$47,000.

Granted, no one can predict a liability claim in any given year. You must consider, however, that there is a very strong correlation between a recessionary economy and the increased reporting of liability claims. So far, this year, over 10% of the AICPA Plan participants have elected to "invest" in increased limits to further protect themselves from potential equity-draining liability losses. Aren't protection and the resultant peace-of-mind the real reasons one purchases liability insurance in the first place?

Calculation

	10% Investment	Investment in Liability Insurance
Claim	\$300,000	\$300,000
Insurance Co. Payment	250,000	297,000
Insured's Deductible Payment	3,000	3,000
Insured's Payment Excess of Deductible	47,000	-0-
Investment Results	(49,935)	+ 47,000

It should be noted that, subject to policy exclusions, the AICPA Plan generally considers "financial planning" as activities that accountants have always conducted, but are now rolled-up in the term "financial planning."

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Fact Pattern 1:

A CPA has just completed a personal financial plan for Mr. and Mrs. Hunter. This financial plan covers income tax strategies, estate planning, insurance needs, and investments. After discussing their investment goals and objectives, the CPA suggests that they allocate their \$1 million investment portfolio as follows:

Percentage	Category
40%	Money Markets and Treasury Bills
30%	Intermediate-Term Municipal Bonds
20%	No-Load Domestic Equity Funds
10%	Real Estate
100%	

A. Mutual Fund Recommendation — A list of seven no-load mutual funds that have met the CPA's criteria for performance, cost, risk, and continuity of man-

agement is presented to the client and the CPA recommends that the client choose any three funds from that list.

B. Municipal Bond Recommendation — Before the client purchases bonds, the client wants the broker to call the CPA for approval when the broker finds an appropriate municipal bond.

C. Real Estate Recommendation — The client invests in a private placement real estate limited partnership. The general partner is also a client of the CPA firm, which provides accounting and tax services to the partnership. The initial introduction between the client and the general partner was made through the CPA. The CPA received no commission or referral fee from the general partner.

Questions Presented:

As a result of each of the CPA's actions evaluated together and individually, is the CPA covered under the AICPA Plan? Which recommendation would make the CPA excluded and why?

Coverage Discussion:

The pertinent AICPA Plan provision is Exclusion "J" which states that the policy does not apply "to any claim arising out of the promotion, solicitation, or sale of specific securities," (emphasis added).

There would appear to be no problem with the recommendation for the percentage allocation, by category, of the client's funds to be invested. At that point, it is generic, not "specific" as to a particular investment vehicle.

A. Mutual Fund Recommendation - The client is going to rely on the CPA to suggest criteria for performance, cost, risk, and continuity of management. Although it would be better if the CPA did not provide a list of "specific" funds, the fact that the client is being asked to choose three funds appears not to present a coverage problem.

B. Municipal Bond Recommendation - Rather than have the CPA's "approval" of the broker's selection of an "appropriate" municipal bond, it would be better for the CPA, again, to merely establish whether the bonds in question meet the

Components continued from page 1

The Carrier - Crum & Forster Managers Corporation has been the carrier on the Plan since 1974. Crum & Forster maintains a definite commitment to the accounting profession through this longevity, unmatched in the marketplace for a nationally sponsored program. Crum & Forster continues to earn a BEST rating of "Excellent".

The Reinsurance - AmerInst is an insurance company organized and owned by AICPA members to participate in the reinsurance of the AICPA Plan.

The Broker/Administrator - Rollins Burdick Hunter has served in this role for the AICPA Plan since 1974. RBH is part of Aon Corporation, an insurance conglomerate with over \$10 billion in assets. RBH's commitment to the Plan is quite apparent in the financial and personnel resources it devotes exclusively to the Plan.

As you can see, the success of the Plan is dependant upon many sources - with you as the critical element of this success.

criteria for performance, cost, risk, and continuity of management.

Coverage
continued

C. Real Estate Recommendation - On its face, there appears to be no coverage concern here. The fact that the general partner and the limited partnership are clients of the CPA should not prevent an introduction with other clients who have funds to invest and where real estate is a logical diversification of asset allocation. It would be prudent for the CPA to disclose fully to his client the relationship between himself and the general partner and limited partnership entity, including whether or not the CPA is also an investor in this partnership. If the CPA is an owner/investor in this partnership, Exclusion "K" may be applicable, which currently eliminates coverage for the "professional accounting services" to the partnership if the CPA is an "officer, trustee, director, partner, manager, or more than 5% shareholder." This exclusion is currently being reviewed and may be amended to only exclude attest function engagements for the relationship described above.

Fact Pattern 2:

A CPA firm has a number of employees who provide financial planning services as part of their accounting practice. The firm:

- A. Charges fees based on an hourly billing rate.
- B. Has no discretionary authority over client funds for investment purposes.
- C. Does not sell or recommend any specific investment or insurance products.
- D. Does not receive any direct or indirect compensation for the purchase of products by its clients.
- E. Provides generic investment recommendations.
- F. Recommends the use of a specific investment advisor or fund manager.
- G. Provides generic non-specific investment planning recommendations of general asset categories such as purchase insurance, mutual funds, stocks, real estate, etc.
- H. Suggests a specific portfolio mix of general asset categories (such as assets should be 15% liquid, 20% income producing, and 65% growth-oriented investments.).

- I. Evaluates whether specific investments selected by the client or the client's broker are suitable.
- J. Manages and disburses client's funds, but investment selections are made by an investment advisor.
- K. Has registered as an investment advisor under the Investment Advisors Act of 1940 and the state securities statutes.
- L. Has established a separate entity to handle its financial planning practice whose name is not the same as the accounting firm.

Questions Presented:

As a result of each of the CPA firm's actions evaluated together and individually, is the firm covered under the AICPA Plan? Which point(s) would make the firm excluded and why?

Coverage Discussion:

The services provided in categories "A" through "E" and "G" through "I" all appear to fall within the scope of coverage.

Category "F" bears some discussion. Although recommending a specific investment advisor or fund manager is not clearly within any policy exclusion(s), the practice can be problematic. There is a cause of action in tort law known as "negligent referral." This requires the CPA to be certain that the people he is recommending will not only conduct themselves professionally, but also work within the CPA'S investment criteria for performance, cost, risk, and continuity of management. Further, if an investment advisor or fund manager is known by the CPA to favor certain specific investment vehicles, the recommendation could be tantamount to specific investment advice pursuant to policy Exclusion "J."

Category "J" raises the question as to what control the CPA has over the funds "managed and disbursed." If this is pursuant to precise, written client instructions, then there is no coverage concern. The insurer's focus is on fraud or embezzlement which is not covered for the guilty party. The "innocent partner" aspects of the policy will provide coverage for those insureds having no knowledge of or participation in the alleged criminal misconduct. It would be prudent for the

CPA firm to be covered by a fidelity bond as respects management and disbursement of client funds. The AICPA Plan is a professional liability product covering alleged acts, errors or omissions in "professional accounting services" and not employee dishonesty.

Category "K" by itself presents no coverage questions as long as the CPAs conduct themselves appropriately with regard to the policy provisions already discussed.

Category "L" suggests that the separate entity needs to be named as an "additional insured" under the CPA firm's professional liability policy but, otherwise, this separate entity needs to conduct itself as described above.

Additional Committee Question:

In addition, the Committee would appreciate it if you could describe actions relating to the promotion, solicitation or sale of a specific security. For example, if a CPA manages and disburses client's funds and has discretionary authority to evaluate whether excess funds should be invested, but relies upon the client's investment advisor to select the specific investment product, is that action excluded? If that same CPA has discretionary authority over the client's funds for investment purposes and recommends specific securities or investment

Coverage
continued

products, but does not sell them to the client, is that action excluded?

Coverage Discussion:

The CPA's discretionary authority appears irrelevant as the scenario describes the client's investment advisor as selecting the specific investment product. In order to clarify the situation, the investment advisor and client should have a clearly drafted agreement. This agreement should be incorporated by reference into an engagement letter between the CPA and the client whereby the CPA is explicitly held harmless for implementing advice given by the investment advisor.

Should the CPA actually recommend specific investment products or securities, Exclusion "J" would be triggered and coverage not provided.

Conclusion:

In closing, the above discussion deals with hypothetical situations. The actual services provided by Personal Financial Planners are not hypothetical. Discussing whether coverage is afforded for a particular service, to a particular client, under a unique set of circumstances is difficult for the underwriter to evaluate until an actual, concrete claim situation is presented. We trust that readers of this article will take this perspective into consideration.

AmerInst President's Report

The following presentation was made by AmerInst President Norman C. Batchelder at the Annual Meeting of Stockholders, May 23, 1991, reflecting on the first three year's of AmerInst's existence and future prospects.

I believe that AmerInst has made great strides toward achieving the goals established when AmerInst was formed. In this, the third full year of operation, AmerInst's participation in the AICPA Plan has reached 12 1/2% of the first million of coverage, with subsequent increases likely as AmerInst gathers strength. The Directors have not yet deter-

*Norman C.
Batchelder,
President,
AmerInst
Insurance
Group, Inc.*

mined the optimum participation level, but AmerInst should be well prepared to help stabilize the Plan when the next crisis in professional liability insurance arrives.

One of the near-term goals that AmerInst hopes to achieve within the next year is to receive a favorable rating from A.M. Best & Company, an organization that issues ratings of insurance companies. Best may issue a temporary numerical rating after an insurance company has been in business for three full years, which, for AmerInst, will be at the close of 1991. After five years, a company may receive a letter rating. Best does not like to change ratings without signifi-

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Liability Insurance, How Much Is Enough?

We are often asked by accounting firms what limit of liability insurance that they should purchase to adequately protect themselves. Our response is "It depends."

Some of the factors that we encourage accounting firms to consider in determining their liability insurance limits are:

1. Area of practice. All things being equal, a firm specializing in tax work would probably opt for lower limits than an audit firm.

2. Client demographics. If you are performing engagements for extremely affluent clients, their potential losses are greater. Thus your potential liability exposure is greater.

3. Local judicial climate. Certain states and/or individual cities have courts that have been known for awarding larger settlements, which again can impact your potential liability exposure.

4. Client volume. The greater the number of clients per accountant, the greater the chance of an error or omission and thus a claim.

5. Defense costs. Even if a claim made against your firm is deemed non-meritorious, your liability insurance could be required to pay these expenses.

By Michael J. Chovancak, Assistant Vice President, RBH Direct Group

Couple this with the annual aggregate nature of the policy and the fact that defense costs have historically amounted to almost 40% of all paid losses - a higher limit of liability is a prudent investment. *

Many AICPA Plan participants have recognized these factors as noted in the marked movement by member firms to elect to purchase higher limits of liability at renewal time. Whereas the number of firms purchasing limits of liability at the minimum level of \$250,000 has declined almost 20% within the last three years, the number of firms purchasing limits of liability of \$1,000,000 or greater has risen over 20%.

The following chart discloses the percentage distribution of professional liability insurance limits by staff size of firms in the AICPA Plan. Our recommendation is to purchase the amount of liability insurance for your firm based upon your knowledge of your firm, the factors discussed above, and in an amount that offers you the "peace-of-mind" that you require.

*Some states now require that claims expenses be paid outside the policy limit of liability.

AICPA PROFESSIONAL LIABILITY PLAN Percentage Distribution of Limits by Staff Size 1991

Staff Size	Limit of Liability						
	\$250 M	\$500 M	\$1 MM	\$2 MM	\$3 MM	\$4 MM	\$5 MM
1 - 2	51.0%	22.4%	25.2%	.9%	.5%	----	----
3 - 4	51.8%	22.5%	24.1%	1.1%	.5%	----	----
5 - 10	32.7%	24.9%	38.7%	2.5%	1.2%	----	----
11 - 25	.8%	23.3%	67.3%	6.2%	2.4%	----	----
26 - 50	----	----	75.5%	13.2%	5.9%	1.2%	4.2%
51 - 100	----	----	61.3%	20.7%	14.4%	.9%	2.7%
101 - 150	----	----	44.0%	24.0%	8.0%	4.0%	20.0%
151 & up	----	----	21.4%	----	42.9%	7.1%	28.6%

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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Engagement Letters

I recently began my own practice and was told by my underwriter that I need to implement the use of Engagement Letters or face surcharges on future renewals. Why such a concern with Engagement Letters? How do I implement such a practice? What are the basics that must be in such letters?

The importance of Engagement Letters from an insurance company perspective is quite simple - many serious claims reported under the AICPA plan begin with an Engagement undertaken without an Engagement Letter! Whether you perform a full audit for a major corporation or a tax return for your second cousin, you should use an Engagement Letter for every Engagement.

After you have carefully screened your client and established the nature of the Engagement, summarize the understanding of what is to be done, by whom, and when, in writing for your firm and the client. Without this key written ingredient, both you and your client could have two very diverse interpretations of the scope (and other variables) of the Engagement. Thus, to be effective, prior to beginning the Engagement you should compose the Engagement Letter and have the client read, agree and sign the letter.

The letter itself should contain:

- Client Name
- Firm Name
- Specific services to be performed
- Limitations of services to be performed
- Client's responsibilities
- Firm's responsibilities
- Time frames
- Bill Amounts
- Method of Payment
- Who will perform Engagement (staff assignment)
- Performance criteria
- Legal review
- Dispute resolutions
- Client signature

As you can see, the elements of the Engagement Letter can be rather exhaustive. However a simple rule of thumb is: The Engagement Letter - samples of which can be obtained by contacting the AICPA- should identify the "who, what, where, how and why" of the Engagement.

Financial Institution Engagements

Our firm has been approached from time-to-time to perform financial institution engagements - audits, directors examinations, loan reviews, even an invitation to bid on RTC work. We have been reluctant to take on such engagements as we were led to believe that such work is excluded from our liability insurance, is this correct?

Since the savings and loan crisis began, many accountants have become more concerned with how professional liability insurance applies to and would be affected by financial institution engagements. Financial institution engagements are not covered by all professional liability insurance carriers, however they are covered by the AICPA Plan. Crum & Forster Managers Corporation, the AICPA Plan's insurance carrier, considers these engagements to be a greater exposure than most standard accounting services. Under current underwriting guidelines, surcharges are often applied with regard to audits and directors examinations of financial institutions. However, since each accounting firm is reviewed on an individual basis and many criteria examined (such as the volume of work performed in this area, the financial condition of the institutions involved, the firm's expertise in financial institution work, etc.), surcharges may or may not be applied.

The savings and loan crisis also brought with it the formation of the Resolution Trust Corporation (RTC) and thus a whole new area of financial institution engagements was created. It has been our experience that many accountants are confused about how professional liability insurance will apply to RTC engagements. The Plan believes that RTC engagements carry far less exposure than the traditional audit or directors examination of a financial institution since most of the damage (liability) has already been incurred by the time the RTC becomes involved. Therefore, the premium rating is computed with this lesser exposure in mind.

Firms planning to solicit and/or bid on RTC engagements should be aware that the RTC generally requires a minimum \$1,000,000 limit of liability on your accountants liability policy. You should also be aware that policy limits and deductibles can only be amended at the renewal date - thus firms planning to entertain taking on a RTC engagement should also review their liability policy to assure adequacy of coverage before hand.

cant reasons, so the importance of the initial rating becomes apparent. A Committee of the Directors met with representatives of A.M. Best & Company in February to begin preparations for the rating process later this year. Best was very positive and encouraging about our progress so far and gave us several suggestions that will enhance these preparations. Having a good rating from Best will allow the other underwriters of the AICPA Plan more flexibility in dealing with AmerInst and the Directors are hoping that AmerInst will be able to take custody of its own reserves at that time, which will noticeably increase our investment income.

As I mentioned in my Report to Stockholders, the Directors have been engaged in several areas of planning, includ-

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ing annual budgeting and developing projections extending five years into the future. The ever-present question, "what if?" includes consideration of legislative developments, changes in the litigation and claims environment and changes in the way AmerInst participates in accountants professional liability insurance for the benefit of its stockholders and the profession.

The Directors continually address some of the problems inherent in our unique organization, such as the necessity of retaining earnings and the lack of liquidity in share ownership, but remain optimistic that the ultimate goals established at the outset will be met in a timely fashion to deal with the next hard market in professional liability insurance.

UP TO A 20% RATE REDUCTION IN 1991

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

AICPA Professional Liability Insurance Plan Committee

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