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Accountants' Liability Newsletter

Number 29 Third Quarter 1992

ACCOUNTANTS LIABILITY IN THE 1990'S

By Dan L. Goldwasser
Vedder, Price, Kaufman,
Kammholz & Day
New York

1967-1992
AICPA Professional Liability Insurance Plan
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Lessons From Recent Accounting Firm Failures

There have been numerous accounting firm failures in recent years, perhaps the two most visible failures were those of Laventhol & Howarth and Spicer & Oppenheim, both national firms with offices located throughout the country. The demise of these two firms was quite different, although they do have certain elements in common.

Laventhol & Howarth

Laventhol & Howarth was the seventh largest accounting firm in the United States prior to its filing for bankruptcy in the fall of 1990. Laventhol had been extremely aggressive in its marketing practices and had grown rapidly throughout the 1980's, both as a result of its marketing efforts and through the acquisition of smaller accounting practices. Although Laventhol & Howarth tried to compete with the Big Six accounting firms, economically it was distinctly weaker and was unable to obtain the significant professional liability coverage which its larger competitors had been able to procure largely through

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WITH OUR COMPLIMENTS ...

Please accept this complimentary issue of the Accountants' Liability Newsletter. The newsletter is a quarterly publication mailed as a service to all AICPA Professional Liability Plan insureds. It can help reduce liability exposure and keep accountants up to date on current industry trends.

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AICPA Professional Liability Insurance Plan

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the London market.

While the quality of practice within Laventhol & Howarth was generally quite good, it had a few weak partners and weak offices. More importantly, however, it practiced in the public company arena and thereby subjected itself to the possibility of large professional liability claims. Moreover, Laventhol & Howarth had a very substantial practice in the real estate industry, which was hard hit by the slump in the real estate and construction industries starting in the mid 1980's. It was the weakness in partner earnings as a result of the decline in its practice, together with a number of serious liability claims which were only partially insured, that led to the ultimate decision on the part of Laventhol & Howarth's executive committee to seek the protection of the bankruptcy laws. Although there were a number of articles in the Wall Street Journal and in other major newspapers regarding the "shoddy practices" at Laventhol & Howarth, this was largely a rationalization rather than a reason for Laventhol's demise.

Spicer & Oppenheim

Spicer & Oppenheim had long enjoyed an impeccable reputation as being one of the nation's foremost accounting firms to the securities industry. Unlike Laventhol & Howarth, Spicer & Oppenheim was largely "a national boutique," with the great bulk of its revenues coming from the brokerage industry. Although Spicer & Oppenheim did have one major lawsuit against it, that claim was eventually settled for an amount well within its liability insurance coverage with little or no effect on the Spicer & Oppenheim partners' assets.

Spicer & Oppenheim's financial problems came as a result of unfortunate management decisions coupled with a severe downturn in the industry which it serviced. Beginning with the stock market crash in 1987, the brokerage industry underwent a severe contraction, with brokerage firms laying off literally thousands of employees and generally cutting their expenses to the bone. The contraction of the brokerage industry and the loss of Bear Stearns could not have come at a worse time for Spicer & Oppenheim since it had only recently moved out of two offices and consolidated into an even larger rented facility in New York City's World Trade Center. It had taken more than enough space to meet its needs at the peak of its practice, with the result that when the fall of the brokerage industry occurred, it found itself with not only twice as much space as it needed but also with continuing liability on its two earlier leases.

Unlike Laventhol & Howarth, Spicer & Oppenheim did not file for bankruptcy, but rather simply sought to work out its problems with creditors by stretching out and restructuring outstanding debt obligations.

The Ultimate Lesson

Perhaps the ultimate lesson in the collapse of these firms is the difficulty of managing a large business enterprise as a general partnership. As both firms began to suffer financial difficulty, they were unable to deal quickly and efficiently with their problems because of the necessity of obtaining approval of their many and dispersed partners. Spicer & Oppenheim came very close to working out an arrangement with its creditors which would have allowed for the partnership to survive; however, at the last minute this effort failed.

Accounting firms are likely to continue to suffer the same type of economic problems as other businesses. If they are to weather economic storms, they must have an organizational structure which will allow their management to take the necessary steps for the survival of the firm, including power to assess firm members in order to accomplish the requisite restructuring. To have to negotiate such matters with one's partners, while at the same time trying to negotiate with a host of creditors, is virtually an impossible task, doomed to failure from the start.

The Laventhol & Howarth experience also points out the need for accounting firms to seek out new organizational structures which will better protect innocent partners from liability

LATE BREAKING NEWS!

When your AICPA Professional Liability Policy renews, you may notice a change in the carrier from The North River Insurance Company to International Insurance Company. (Except in Illinois, where International Insurance Company has been the carrier).

International Insurance Company, an Illinois based insurance company, has been in business for 20 years and is a member of the Crum & Forster family of insurance companies. It enjoys the same "Excellent" A.M. Best rating as The North River Insurance Company. The change is being implemented by Crum and Forster Managers Corp. (ILL) to recognize a tax benefit for using International Insurance Company.

claims. This might include dividing the organization into regulated and non-regulated parts, with the non-regulated operations being placed into a business corporation with no personal liability on the part of the firm's owners. Moreover, even those regulated parts of the firm should be divided up into a number of separate entities so that claims against any one of them will not necessarily affect the firm as a whole or impose personal liability on the firm members not associated with the entity which was the subject of the claim. Unfortunately, the quality control requirements of accounting firms makes such internal divisions difficult to sustain in the face of a legal challenge. Nevertheless, if mid-size accounting firms are to continue to survive in an atmosphere of constant liability claims, organizational structures more appropriately suited for this environment will have to be devised and approved by regulators of the profession.[1]

[1] The preceding discussion on this form of organization for CPA firms is under the review of a number of State Boards as to whether such revisions would be consistent with state laws as they now exist. Firms insured under the AICPA Plan are expected to adhere to Board Regulations and applicable codes of ethics.

Mr. Goldwasser is a Senior member of Vedder, Price, Kaufman, Kammolz & Day, a New York City Law Firm, which represents the New York State Society of CPAs and approximately 110 CPA firms. Mr. Goldwasser is actively involved in the development of Defensive Loss Prevention Techniques/Practices for CPAs. This article is the fourth of a series of articles that Mr. Goldwasser has contributed to this newsletter, portions of which may have previously appeared in other periodicals or presentations by the author.

THE POWER OF REVIEW AND OTHER QUALITY PRACTICE TECHNIQUES

By Brenda J. Poole
Senior Account Representative
Rollins Burdick Hunter Direct Group

Introduction

Quality review is a process used to encourage the application of the highest standards in a firm's accounting and auditing practice. The AICPA believes that all firms, regardless of size or scope of services, must have a system of quality control.

CPA firms generally embrace the notion that their operations be managed in adherence to the highest professional standards. Quality reviews, seen as a remedial (non-punitive) learning experience will lead to professional achievement and a uniform standard by which all firms are judged.

What is a Quality and Peer Review?

It is the goal of the AICPA, through its review programs, to help ensure that the general public is afforded quality performance from its members who are in public practice. The review programs are founded on the doctrine that "a systematic monitoring and educational process is the most effective way to attain high quality performance throughout the profession". The AICPA encourages State Societies to participate in its review process. State Society administered reviews must meet the requirements of the AICPA review program. State Society administered reviews are supervised by the AICPA Quality Review Executive Committee or the AICPA Quality Review Division. At least one partner, principal or proprietor of the firm must be a member of the AICPA to be reviewed under the AICPA review program. All reviews are performed every three years and last two to five days.

Moreover, an off-site quality review is administered to a firm rendering accounting services (compilations and reviews). The firm's degree of sophistication and documentation of its quality control system should at least meet minimum standards. The areas that should be documented are: Supervision, Professional Development and Inspection. This type of review provides only a limited assurance that review and compilation engagements meet professional standards.

An on-site quality review is for firms that perform audits of financial statements. If a firm has ten (10) or fewer professionals, a partial system of quality control should be documented: Independence, Consultation, Inspection and Professional Development. On-site reviews for firms with more than ten (10) professionals require the maximum documentation of the

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quality control system. This type of review provides a more rigorous look at a firm's practice. All nine (9) elements are tested: Inspection, Acceptance and Continuance, Advancement, Hiring, Professional Development, Consultation, Supervision, Independence and Assigning Personnel.

In 1977, the AICPA established the Division of CPA Firms to "provide a new level of quality control by monitoring the performance of member firms". The Private Companies Practice Section (PCPS) peer review is designed for local firms servicing smaller, non public clients. There are 4,800 firms belonging to the PCPS Section. The AICPA requires that firms auditing SEC registrants belong to the SEC Practice Section (SECPS); there are currently about 500 such firms.

To prepare for a review, the firm acquires the appropriate questionnaires and requirements. It is important that the questionnaire reflect the policies and procedures of the firm since the review team will study, evaluate and test whether a firm is consistently complying with its quality control system. To alleviate any anxieties the firm may have, an entrance interview is recommended. There is also an exit interview discussing the findings and other concerns that the firm and the reviewer may have.

A report will follow from the reviewer within 30 days. The reviewed firm will have 30 days to respond to the report. The report is then submitted to the AICPA or State Society. The results of the quality review can only be made public by the reviewed firm. The results of the PCPS and SECPS are made available to the general public by the AICPA.

The report may be unqualified, qualified for non-compliance or adverse. If a firm receives a qualified opinion, the AICPA Review Committee will re-examine the nature of the report to decide if corrective action should be taken. If corrective action is warranted, normally the firm is revisited by the team captain 12 to 18 months after the initial report to ensure that the necessary corrective steps have been taken by the firm. If an adverse report is rendered, the revisitation may be accelerated. If a firm does not correct reported problems, then sanctions may be imposed. Under the Quality Assurance Review (QAR), there is no specific wording for sanctions. However, the AICPA may elect to terminate the firm from the program.

The inadequacies noted include a wide range of considerations. The most prevalent are documentation related errors and encompass the following: Performance of key procedures, professionals continuing education, lack of understanding with client on review and compilation or understanding the internal control structure.

Cost

Although understanding that the review process gives the firm a powerful marketing tool for client solicitation and helps to establish uniform standards, the biggest concern for most firms is still cost.

Cost should not be a deterrent for a firm to undergo a formal review. There are numerous ways a firm can control costs. For example, a sole proprietor doing audit work (requiring an on-site review) can take the necessary materials to the reviewer. Technically this is still an on-site review. Money is saved because the reviewer's travel time and other expenses are cut.

Not all State Societies participate in the AICPA peer review programs. For example, Massachusetts only administers the quality review. The cost for a quality review by the MACPA for a sole practitioner is $75 an hour. For firms with two or more members, the cost is $85 an hour. The number of hours needed to complete a review normally is from 12 to 20 hours. The fees in Massachusetts have remained stable for the past three years.

Firms may also look for a reviewer quoting a fixed fee. This approach can eliminate unforeseen expenses (keep in mind that no reviewer can be used more than twice). Rates for reviewers are monitored by the AICPA and state societies. The AICPA, ever mindful of costs, allows firms to hire member firms in The Association of CPAs or "qualified review firms". A list for each is available for firms considering reviews from the AICPA.

The AICPA will check the qualifications of the reviewers. If the reviewing firm is not deemed qualified, the AICPA will notify the reviewee.

If the AICPA is performing the review, a sole practitioner can expect to pay from $1,700 to $2,100. For two - five professionals with one partner, the average fee is $2,400 to $2,800. The fee structure is similar for two - five professionals with two partners. Fees for firms consisting of ten professionals average $3,400.

For 11 - 19 professionals (PCPS) the review fees range upward from $5,900. For CART reviews, (in which a state society participates in the quality review program), fees vary. Contact your state society for specific fees and other information.

Only the AICPA Quality Review Division or State Society can administer quality off-site reviews. The Association of CPAs is not authorized to administer these reviews.

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AmerInst President's Report

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

The following is an excerpt of the President's report to shareholders by Norman C. Batchelder.

Over four years ago, on April 19, 1988, AmerInst began operations as a reinsurer of the AICPA Professional Liability Insurance Plan. AmerInst was formed to exert a stabilizing influence on the design, pricing and availability of accountants professional liability insurance. The hard insurance market and coverage shortages of the mid-eighties saw the AICPA Plan survive by only five days, in spite of massive rate increases, underwriting and coverage restrictions. During the past four years, the accountants professional liability market has stabilized. AICPA Plan rates are more than 20% lower and available limits have increased from one million to five million dollars. We continue to believe that AmerInst has been a factor in bringing these improvements about.

AmerInst increased its participation in the Plan by 25% effective in 1991 and anticipates that the lower rate levels of the Plan will continue to attract new insureds to the Plan. AmerInst has not yet achieved the financial strength to permit the payment of dividends, but the book value per share continues to grow, from $26.99 at December 31, 1990 to $29.03 at December 31, 1991.

BOOK VALUE PER SHARE
30
28
26
24
22
20
88 89 90 91

Presently, adequate underwriting capacity and competitive rating structures among insurance companies make a crisis in accountants professional liability insurance seem only a distant possibility. However, although opinions in the insurance industry vary, most believe that another coverage shortage is inevitable. Companies belonging to the Coalition of Independent Casualty Companies of America (CICCA), including AmerInst, have told many members of Congress that this crisis could occur in the next six to thirty months. Most of the CICCA member companies were born, like AmerInst, as a result of the coverage shortages of the mid - eighties. In that crisis a major source of reinsurance capacity, the underwriters at Lloyds in London, withdrew essentially all reinsurance of accountants professional liability insurance. Lloyds today faces many problems, from weathering catastrophic losses to internal issues that may lead to a major reorganization of their system that has been operating for centuries. Already the total underwriting capacity of the Lloyds underwriters has diminished by approximately thirty percent. AmerInst continues to prepare for the possibility of another crisis, and to maintain underwriting capacity, to protect the assets of our stockholders' firms and their owners.

During 1991, the Board of Directors commissioned AmerInst's consulting actuary, Liscord, Ward & Roy, Inc. to perform an analysis of the Company's loss reserves. By obtaining independent assurance that conservative provision for the payment of losses has been made, AmerInst maintains its financial strength and positions itself for obtaining a favorable rating from one of the industry's prime insurance company rating organizations, A.M. Best & Company. A favorable rating will provide AmerInst much more flexibility in negotiating terms of reinsurance treaties and agreements.

We believe that by resolutely pursuing these goals, AmerInst will be in an increasingly strong position to support our stockholders particularly and the accounting professional in general as the future unfolds.

What Has Quality Review Taught Me?

By Gene E. Ginoli

Over the past few years, the AICPA has developed and made available through State Societies a comprehensive program of quality reviews. Such reviews are mandatory for AICPA members and some State Societies have adopted similar standards.

When I heard about quality review, I realized I didn't know enough about it. So through my State Society and a lot of publications that started putting out information, I developed a file. When I started to feel somewhat comfortable, I talked to one of the partners at a large CPA firm that serves our area and told him I would like to have lunch with him and discuss quality review. I felt very comfortable with the firm even though they were a competitor in town. They are a very high class outfit and I felt good about dealing with them.

Reviews are relatively expensive. You don't necessarily have to use a reviewer in your home town, but adding the cost of per diem on top of the price of the review can be costly. However, there are other reasons you want to get someone from your immediate area.

Quality review, to a certain extent, is subjective. I think the philosophies of people in local areas are more compatible than for example, someone from Chicago coming to Peoria or vice versa.

It was a very interesting meeting. The partner from the large firm gave me a great deal of additional literature and, at that point, I started to think this was going to be an excellent program. And the more I studied about quality review the more I became convinced it was going to be beneficial for the accounting profession. It gives you insight. It is possible to get tunnel vision when you start doing things year in and year out over a long period of time. Sometimes it's good to get a little jolt.

Because of the quality review program, you have to do things more formally than you might have done previously. As an established local firm, we have a lot of ongoing business as most accounting firms do. You get to know the client, you get to know your work papers, and you get to know what the issues are without writing them all down.

But when it comes to quality review, they (the reviewers) like to see it in writing because they don't know your clients and how long they have been with you, they don't know you and they don't know your philosophy. Therefore, everything should be documented.

In real estate, they say the three most important things are location, location, and location. In quality review, it is documentation, documentation, and documentation. For example, we used to get engagement letters for all of our audits and most of our reviews. Now we get engagement letters for everything-compilations as well as review and audit.

Since the program is new to us, the firm thought it would be worthwhile to have a consulting review before proceeding with our quality review. In the consulting review, they try to tell you the things you will have to do to get an unqualified opinion. The way the consulting reviews are done, they have to leave all the information with you. It is strictly for your benefit. With the rules the way they are, it's hard to flunk the first quality review. I think you should still try to do as good a job as possible. We wanted to do that.

The consulting review was immensely helpful. It pointed out the documentation issue I just mentioned plus a lot of other little issues we needed to sharpen up on. We were able to implement a lot of these things between the consulting review and the actual quality review.

There's one other thing I think can be accomplished by a consulting review. It gives you the opportunity to see and talk to the people who are going to do the quality review. If you see it isn't going to work in terms of rapport, you have the option of not doing the quality review with them. Once you get into quality review, you don't have that option. You have to tough it out.

It was a very, very nice way to get initiated into a quality review. Obviously it costs money to do that. But I think that like anything we do in life, if you are not going to be willing to spend proper funds to get something done right, you probably shouldn't do it at all.

One of the things we didn't discuss in the consulting review was the amount of information they were going to need from us. The reviewers needed a list of all the hours for all of our different clients. They needed to know which ones were reviews, compilations, and audits. They needed to know how many personnel hours were spent on them. It took us quite a while to get all this information for them.

I am the administrative partner in our firm. I would say it took me between 50 and 100 hours to prepare for the review. So it does take a lot of time. But I was careful to do things right. I was very concerned about getting an unqualified report.

One problem we did have, and the director of quality review was very nice about this, was the written response to some of the items the reviewer had written. I think we were probably one of the first ten quality reviews done in Illinois and so I responded to the items in an overall letter. They said, "That's not what we want." So I responded again, a little more specifically. And they said, "That's still not what we want." What I finally found out was the reviewers wanted each item to be answered specifically. Each one, one at a time. I was frustrated and the Director of quality reviews was frustrated because it was a new process and neither of us really knew what the reviewers were driving at. Finally, the Director just said, "Gene, address each issue and tell us what you are going to do." I said, "Fine. Now that I know that's what they want, I can go ahead."

You can be negative or positive about quality review. If you are going to take a 100 percent negative point of view, your quality review is going to be a negative experience. If you take a positive view, you'll come out with positive feelings about it. It's very easy to perceive quality review as negative. It is intrusive. It does take time. It does cost money. (My firm's review cost $6,000.) But it's awful nice when it's in place and you need it.

Mr. Ginoli is the Administrative Partner of Ginoli & Company Ltd., a well established CPA firm in Illinois serving an area about 75 miles around Peoria, Illinois. The firm employs 35 people, 6 of whom are partners. Thirty percent of their work is taxes, 50% audit/compilations/reviews and 20% consulting. This article previously appeared in "Insight", a monthly magazine published by the Illinois CPA society and is used with permission.

The Power

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Other Quality Controls

The underwriter for the AICPA Professional Liability Insurance Plan is aware that not all firms undergo the review process. For example, firms with no audit or accounting clients normally do not undergo a review. However, such firms are nevertheless eligible for insurance in the AICPA Plan. The underwriters look not only at the area of practice, but consider the quality control policies the firm has implemented.

The use of engagement letters is especially important. Historically, if a liability claim is made and there is no documentation regarding the scope of service, courts tend to favor the client. As of May 1992, 89% of the firms surveyed in the AICPA Professional Liability Plan use engagement letters for audits. Of those firms performing reviews, 87% use engagement letters. Of firms doing compilation work, 80% use engagement letters. The use of well constructed engagement letters should provide a firm and client with a clear understanding of the duties and responsibilities of the engagement prior to the commencement of work.

Another important quality control is Continuing Professional Education (CPE). Meeting these requirements shows that the firm is maintaining professional educational standards as required by most state societies.

Furthermore, many firms utilize an internal inspection program to provide a method of self monitoring quality control systems based on the firm's scope of practice. This inspection should also include functional evaluations.

Another quality control mechanism is NOT suing to collect fees. Suits for fees often result in countersuits by the client relative to the work performed on the engagement. Even if the countersuit is frivolous in nature, it must be defended at significant cost.

Accordingly, as a means of quality control, a firm should consider the client acceptance process: Who is the client? Can we effectively perform the engagement? Can the client afford the service? What will be our policy should the client fall on hard times and is unable to pay?

All of these areas are important areas of quality control. Peer review is not a replacement for sound quality controls. Quality or peer review is viewed as a control mechanism that moves the accounting industry closer to uniformity. It furthers the goal of the AICPA by ensuring quality performance from its members. Firm participation in the review process is an essential seed for harvesting sound accounting decisions.

Special thanks to Dale Rafal Atherton - AICPA, Beth McCarthy - MACPA State Society, Sharon Neff-Crum and Forster Management Corporation.

ABOUT THE PROFESSIONAL LIABILITY INSURANCE COMMITTEE

We frequently write that the AICPA Plan is governed by a committee of CPAs - such as yourself. How much like yourself, you ask?

Well, the current demographics of the Committee are representative of all Plan insureds as noted below:

LOCATION: Representation of North, South, East, West and Midwest

SIZE: Representation of the smaller firm ($450,000 billings), through the mid-size firm ($2,700,000 billings), to the relatively large firm ($40,000,000 billings). With corresponding staff size representation of 8 through 500.

LIMIT OF LIABILITY: The predominant limit selected by firms of the Committee members is $1,000,000.

This is just a small peek at the Committee, however it does verify that all size firms are represented on the Committee. And, unlike most competing insurance plans, should you have an unresolved problem with the carrier or broker - you are invited to approach any member of the Committee for assistance.

7.50% Premium Finance Rate!

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

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