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Accountant's Liability Newsletter, Number 30, Fourth Quarter 1992

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Accountants' Liability Newsletter

Number 30 Fourth 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
25 YEARS
OF CONTINUOUS PROTECTION

Expanding Areas of Liability Claims

Audit engagement claims and, in general, financial statement practice engagement claims tend to be far more serious than those arising out of other types of engagements frequently performed by accountants. In the years to come, claims arising out of audit engagements are likely to shift in focus since most auditors today have taken additional quality control measures in order to protect themselves against the types of claims which were common during the 1980's.

Claims Arising Out of Audit Practice

One of the new areas which is likely to prove a problem to accountants is claim activity based upon weaknesses in client internal controls. One of the lessons of the claims brought in the 1980's was that virtually all financial frauds involved companies with either weak internal control or internal controls which were overridden by the client management. As a result, the SEC, Congress and the AICPA have devoted substantial additional energies to devising frameworks for the establishment of internal controls and have emphasized the importance of maintaining adequate internal controls.

Continued on page 2

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AICPA Professional Liability Insurance Plan

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Liability
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In fact, both the United States Congress and the SEC currently have proposals pending requiring the managements of public companies to issue annual reports on the adequacy of their internal controls and for the companies' independent auditors to comment on those reports.

In the past, most courts have refused to impose liability upon accountants for failing to report on the inadequacies in their client's internal controls. The accounting profession has always taken the position that in the face of weak internal controls, the auditor's duty is limited to undertaking additional audit procedures necessary to permit the auditor to render an audit report. There is no separate requirement to report on those inadequacies in the client's internal controls if the auditor feels confident regarding the accuracy of the company's financial statements. Indeed, the only time that accountants have been held liable as a result of their failing to report inadequacies in internal controls have arisen out of defalcation cases in which it was claimed that the accountant's warning of internal control weaknesses would have prevented the defalcation from taking place. There was, however, one case in which the court did impose liability on the basis of the auditor's failing to warn management of internal control inadequacies. In that case, Bily v. Arthur Young & Co. a California state court imposed liability on the company's auditors on the theory that had the company been advised of its internal control weaknesses, its subsequent interim unaudited reports would have been accurate and not misleading to investors[1]. There can be little doubt that there will be more litigation in this area.

The Chairman and at least one member of the U.S. House of Representatives Committee on Commerce have expressed concern over the failure of the accounting profession to disclose illegal acts committed by its clients. In response to initial criticisms of this nature, the accounting profession adopted Statement on Auditing Standards No. 54 pursuant to which an accountant is obligated to notify the client's management of illegal acts which they have discovered and to resign the engagement if the client fails to take remedial action. This standard has not been found acceptable to some members of Congress who are pushing for legislation which would require accountants to notify regulatory authorities in the event that their clients fail to take such remedial action. This problem may become even more acute in light of the recent adoption of the Securities Laws Enforcement and Remedies Act which imposes stiff penalties upon publicly held corporations and their officers and directors who violate the Federal Securities Law. In any event, this is an area in which the "expectation gap" remains and is likely to be the subject of numerous claims against accountants.

Another area of potential liability claims of concern to the accounting profession deals with clients' liability exposures under the environmental laws. It has become clear in the last decade that the cost of environmental cleanup is staggering; in fact, so staggering that most insurers are refusing to write environmental insurance. This, in turn, has lead to a host of litigation as to whether insurers providing general liability coverage may be held responsible for such cause notwithstanding express exclusions for environmental damage in their policies.

It is the sheer size of the cleanup costs that make it likely that other sources of revenue will be sought, and this includes claims against professionals who fail to warn others, their clients or persons dealing with their clients of those liability exposures. At present, most accountants are relatively unaware of the contingent liability exposures which their clients face under the environmental laws and it will be difficult for a court to understand how an accountant reporting on the financial well-being

[1]Editor's Note: This court decision was reversed by the California Supreme Court recently on the basis that the plaintiff lacked privity even under the restatement theory.

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.

The AICPA Plans provide insureds with:

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AICPA Plan Administrator
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*Premium financing available for the Standard Plan only.

of the client could overlook liabilities of such magnitude. These factors make it likely that some very serious claims will be brought against accountants for failing to make appropriate disclosures of contingent liabilities based upon violations of the environmental laws. One can expect the accounting profession to react to this phenomenon once it becomes apparent; however, in the meantime, there are likely to be some very serious cases based upon failures to make appropriate disclosures of contingent environmental liabilities.

The accounting profession is under constant pressure to devise accounting principles to deal with changing economic phenomena. In this connection, the Financial Accounting Standard Board maintains a full agenda of projects designed to address accounting issues in a changing economic environment. Among the more controversial issues on the FASB's agenda is a rule requiring financial institutions to "mark to market" debt securities held for investment. This particular accounting principle is very controversial because of the failure of bank financial statements to reflect that the debt portfolios of many banks were substantially overvalued. In addition, the FASB has also recently issued a statement requiring that companies accrue liabilities for employee welfare plans in addition to pension plans. This will require many companies to recognize substantial liabilities which, in turn, may place them in violation of respective loan agreements and other covenants. As a result, it should be anticipated that there will be many companies who will resist implementing such accounting principles. And if accountants are not both sufficiently diligent and independent, they may find themselves embroiled in lawsuits dealing with this issue.

Claims Arising Out of Tax Preparation Services

One of the single largest categories of claims against accountants deals with claims based upon the accountant's services in preparing business or individual tax returns. These claims, unlike those commonly asserted in financial statement engagements, do not tend to be particularly serious and are frequently settled without resorting to litigation. Nevertheless, they are extremely numerous and occasionally do give rise to serious liability.

For the most part, business enterprises and their attorneys are not sufficiently sophisticated to recognize when an accountant has provided erroneous tax advice or negligent tax preparation

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Underwriters 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 liked answered in the publication, please address your questions to:

Michael J. Chovancak, Editor
AICPA Newsletter
c/o Aon Direct Group, Inc.
4870 Street Road
Trevose, PA 19049

Q. I recently overheard a discussion regarding different types of liability policies - one was referred to as "occurrence" and the other "claims-made". Could you please describe the difference between these policies, so that I may choose the most appropriate coverage for my accounting practice?

A. An "occurrence" policy provides coverage for liability arising from a covered event that occurs during the policy year *- no matter when the claim is made.*

A "claims-made" policy provides coverage for liability arising from a covered event, *only if the claim is made during the policy year and that the covered event occurred after the inception date* indicated in the policy.

One can readily see that the occurrence policy does provide a larger window of coverage to the insured, however this type of coverage is very difficult to price from the insurance company's perspective. A classic example of this type of policy is the general liability policy that was written in the 1940's and the asbestos-related claims made against this policy 30 and 40 years later. Certainly the underwriter when he established terms for cover-

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age in 1940 could not foresee that this policy would be called upon for claim payments 30 or 40 years later! Thus, the demand for the claims-made policy, which allows insurance carriers to more accurately and more rapidly determine the actual costs of the coverage provided and adjust their premium rates from actuarial results on an annual basis.

To understand a claims-made policy, one needs to understand two definitions.

1. Retroactive date (or prior acts date). If your policy has this date entered upon it either on the Declaration Page or via endorsement, *events that occur prior to that date are not covered under the policy.* Provided that you maintain claims-made coverage on a continuous basis, your retroactive date will not change - thus, in year two, you would in effect have two years of coverage; year three, three years of coverage; year 25 . . . . .

2. Extended Reporting Period (or tail coverage). This is a provision that allows the insured to purchase under certain conditions an additional period of time (usually one to three years) within which claims may be reported for events that occurred during the policy period (from retroactive date to date of cancellation or non-renewal of the policy). It should be noted that the *extended reporting period does not extend the policy per se, but merely extends the discovery time and the ability to report such claims as occurred only during the time that this policy was operative.* Additionally, provided that the claims-made policy is continued without interruption - the extended discovery provision is only necessary in the event of a cancellation or non-renewal of a policy - for example, retirement or merger/division of practice.

In summary, insurers are reluctant to offer occurrence policies because of the prolonged period of time which a claim can be made against the policy. In the accountants liability market, we know of no insurance company offering this type of coverage. The claims-made policy, if kept on a continuous basis, allows reasonable protection for the accounting professional for a broad range of accounting activities.

Liability
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services. They are, therefore, placed in a position of only asserting such claims when there has been an assessment for additional taxes imposed by the IRS or the state taxing authorities. As more and more attorneys become adept at bringing claims against accountants they will acquire the requisite expertise to recognize substandard practice in the tax area, resulting in even more of these claims being brought against accountants. At present, such claims generally involve the failure to file requisite tax returns, the failure to make appropriate tax elections on a timely basis and the failure to make adequate provisions supporting estimated taxes or income tax withholding.

Many times these claims are "discovered" when a firm changes its accountant and they, in turn, point out the oversights of their predecessor. This has become a relatively frequent practice, as accountants are always looking for ways in which to secure their clients' loyalty. While this is perhaps a shortsighted approach, it is likely to keep the number of claims against accountants based upon tax preparation and advisory services at a relatively high level.

Financial Projection and Forecast Claims

As investors become more sophisticated they are insisting upon receiving financial projections and forecasts in addition to historical financial statements before making investments. For many years the SEC prohibited the use of forecasts and projections in connection with the sale of securities out of fear that such prospective financial statements would be an invitation to fraud. Although the SEC was and is clearly right about the potential dangers of prospective financial statements, it has since recognized the value of those statements which are currently permitted in virtually all states with the possible exception of Pennsylvania. While accountants are understandably reluctant to provide these services because of their potential liability exposure, many accountants find themselves having no choice in order to maintain their client relationships.

For the most part, the courts have declined to find liability where the accountant reviewing a forecast or projection clearly sets forth all of the material assumptions underlying the forecasts or projection and has used reasonable efforts to ascertain the appropriateness of those assumptions. In fact, for several years the U.S. Court of Appeals for the Second Circuit has taken the position that there can be no liability for erroneous forecasts or projections if they are accompanied by appropriate warnings regarding their reliability. Unfortunately, the U.S. Supreme Court in a recent decision has taken the position that such caveats alone are not sufficient to absolve an accountant from liability if the accountant's own efforts were not reasonable under the circumstances.

Claims Arising Out of Consulting Services

As noted above, many accounting firms have moved heavily into the area of management consulting services in an effort to expand the scope of their activities, achieve high profit margins and minimize their liability exposures. For the most part, there have been very few

claims asserted against accountants arising out of management consulting services. Those claims which have been brought have generally dealt with the efforts of accountants to design and install computerized data processing systems for clients that failed to live up to the client's expectations.

One of the reasons management consulting services have tended to be an area of relatively few claims is the general lack of standards governing practice in this area. As these engagements become more common and accountants obtain greater expertise in performing them, professional literature regarding these engagements will be developed and this, in turn, will make liability suits against accountants more common.

Impact Of The Savings and Loan Debacle

The pending and impending suits against accounting firms arising out of the collapse of savings and loan institutions are likely to have a very material effect on the accounting profession and its insurers. Indeed, several of the Big Six firms have had a significant number of such claims asserted against them which could conceivably result in the demise of at least one of those firms. Accordingly, everyone in the accounting profession is taking the "S&L Debacle" very seriously and sparing no effort in the defense of these claims.

Moreover, because of the potentially lethal effect of these claims, the larger accounting firms have become particularly sensitive to adverse publicity, lest that publicity itself destroy the firm's good name, diminish its clientele and become a self-fulfilling prophecy. Indeed, the problem has gotten so serious that at least one Big Six firm has expressed deep concern over the very mention of its name in any article involving claims by the FDIC.

Whether or not the S&L claims result in the demise of one or more of the Big Six accounting firms, it will nevertheless have a devastating effect upon the pool of insurance that is currently available to insure these firms and to reinsure policies being written for smaller accounting firms. Thus, as noted above, the S&L claims are likely to be a principle factor in causing a severe reduction in the amount of insurance that will be offered to accountants in the second half of this decade and the price for that insurance.

Of equal concern to the accounting profession is the effect that these claims will have on the law of accountants' liability. In recent years, the accounting profession has been relatively successful in stemming the tide of new legal doctrines affecting the liability of accountants. Because of the highly political nature of the claims being asserted by the FDIC, the chances are very high that there will be a significant number of decisions against the defendant accounting firm simply to allow the FDIC to recover a portion of the losses which it has sustained in combating the S&L crisis and thereby minimize the burden to the American taxpayers.

This potential for creating bad law will be further exacerbated by the likelihood that the number of legal issues to be litigated will be extremely large. In many cases, lawyers choose not to litigate certain legal issues because of the costs of doing so and the relatively small amount of money to be saved by litigating that particular issue. Because of the extremely large sums of money at stake in the S&L claims, virtually every issue will be cost-beneficial to litigate because the costs of doing so will be small in terms of the savings that will be reaped by prevailing on that issue. Thus, not only will bad law result from the S&L crisis, but the volume of that law could be unprecedented.

Unfortunately, the law resulting from these cases will not simply affect larger accounting firms which audit savings and loan associations and other financial institutions. The issues involved in these cases largely center around common law negligence and the relative responsibility of an accounting firm and its clients for credit losses. Accordingly, the resulting decisions will likely affect virtually every accountant involved in financial statement practice.

Mr. Goldwasser is a Senior member of Vedder, Price, Kaufman, Kammholz & 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 fifth 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.

In Print

AICPA Issues Guide To Meeting The Professional Liability Challenge

To help firms cope with the current explosion of malpractice litigation and its impact on business and the economy, the Management of an Accounting Practice (MAP) Committee of the American Institute of Certified Public Accountants (AICPA) has released the book *Managing the Malpractice Maze.*

"CPAs and other providers of professional services are beginning to realize that implementation of defensive measures can offer protection against lawsuits," said Mark F. Murray, J.D., author of the book. "They can decrease their chances of being sued, and, at the same time, improve the quality of services, which benefits the client."

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Getting Sued: Even When You Win, You Lose

By Julia Winn

Even though Mr. Smith suspected his CPA firm was going to get sued, it still came as a shock the first time he read the words on the legal document - negligence, negligent misrepresentation, contractual violation of performing the auditing service, securities law violations and consumer fraud. [1]

"Considering this was a transaction between two very large corporate entities, we never did quite understand as accountants how there was consumer fraud in this," he says. Regardless, that's what the lawsuit said.

The lawsuit grew out of an acquisition whereby Mr. Smith's client was acquired by another company. Five years later two former employees sued the new owner for violations of employment contracts. The company's defense strategy relied on the accuracy of the financial reports on the company they had acquired. That's where Mr. Smith's accounting firm came in. They had audited those financial reports.

When you first meet Mr. Smith he strikes you as a thoughtful, soft-spoken man. He is also a very proud man - proud of the work he has done as an accountant for 23 years. His pride told him not to settle. But his business instincts said otherwise. He knew that the requested damages exceeded his liability insurance policy limits and if he totalled up all the billable time he would lose as a result of being occupied with his defense it would probably be higher than a settlement. So the businessman in him said, "Let's talk!"

"The other side was absolutely ludicrous in their demands for settlement," he says. "There was no justification for a settlement of any size based upon the work we had provided."

The work he provided was financial statements dated 18 months prior to the acquisition. During the 18 months between the audited statements and the acquisition, Mr. Smith's client lost a great deal of money. "Enough money that any acquirer who looked at them should have realized you don't rely on financial statements that stale when you have significant negative economic things occurring."

In his favor, Mr. Smith's liability insurance company went out and found the best lawyer they could, a lawyer who also was a CPA. The advantage was the lawyer did not have to learn the theories and standards of accounting.

"During the trial when I did not respond to their attorney's questions exactly as expected, they didn't know where to go and how to handle it. With our attorneys no matter what the answer was they immediately honed right back in and made the situation as good as possible."

To prepare for his defense, Mr. Smith had to review approximately five steamer trunks filled with work papers. By the time the trial came up he had to know everything on each one of those pieces of paper.

"You stack all these papers up in front of the jury and when a question is asked where you need to refer to the work papers you go over there and grab THE file and turn to THE page that answers the question. That's very impressive to the jury."

The first day in court was a tense one. Six jurors had to be selected. Mr. Smith's attorneys were looking for jurors who had as much knowledge about the business world as possible. It was the defense's contention that what the CPA firm did was correct and any reasonable person would be able to understand that.

"It's kind of scary, though," he says. "In civil procedures you have six people on a jury. Take the six people in your firm who know the least about public accounting and they will know more than the most knowledgeable juror you have."

In keeping with the defense strategy, Mr. Smith's lawyers put the plaintiff's witnesses through a rigorous cross-examination. In one instance the witness said he relied on management's words but not on a written report. "But we believed they had a written report," he says. "During depositions we found out a report existed. We asked to see it and the plaintiff's attorneys said no. The plaintiffs attempted to keep the report as a privileged communication between them and their attorneys. The judge didn't buy it and said we could see the report."

Mr. Smith took the stand twice, once called by the plaintiffs as a hostile witness and once as a witness for the defendants. "They attempted to show through documentation in my work papers I had conspired with the client to improve the financial statements."

"For instance, we had a preliminary meeting to the audit where management asked me questions about various accounting procedures. From the data we had at the time we responded with a letter saying this is not a problem. In the course of our audit we found information in one matter that indicated our answer in the original letter was not right. So we changed the accounting to reflect what the current new information showed."

"They attempted to demonstrate what we did was not correct accounting but rather our attempt to assist management in overstating their financial statements."

"I might add here the overstatement of the net worth of the company was less than 10 percent of net worth. Not an extremely large number which one might assume judging from all the things they alleged."

The trial took four weeks. It came to an end on a Tuesday. After the judge finished giving the jury instructions there was only three hours left to deliberate before the judge sent them home for the night. In the morning the jurors had questions for the judge.

"Judging by the type of questions they asked I went back to the lawyers' offices and anticipated the jury being out a long time. I went to lunch about an hour after I got to the lawyers' office."

"Five minutes after I went to lunch the jury was back. I wasn't even in the courtroom when they read the verdict - not guilty. I don't know if I could have taken being in the courtroom and listening to them read the verdict. The jury was only out seven hours. That's all."

The whole ordeal lasted three years. Mr. Smith estimates the insurance company paid out $350,000 for his legal fees. He says the estimate he heard in connection with the other side was $1 million dollars. And they lost!

But the insurance didn't pick up all the costs. There was the $10,000 deductible the accounting firm had to pay in cash. Then there was the lost time, a lot of lost time. "We spent approximately 1,500 hours defending ourselves. That's 1,500 hours of manager and partner time at $100 an hour. That's $150,000 we would not have had to incur."

"It cost lots in neglect. I shouldn't say neglect, but it's the time you would normally devote to providing your clients with the best possible service. When you take yourself out of that role for three, four months clients don't like it."

"In our case, the partners decided we were not going to tell anybody anything until after the lawsuit was over. So our clients didn't understand what was going on. They said, 'you were here for 15, 20 years giving me service whenever I needed it. Now I can't find you. What's the problem?' "

"They understand when it's over. But there is a period of time where you are not creating good will for the firm."

And the emotional toll is high. "It hurts when you work real hard in your job and try to do it to the best of your ability and then someone comes along and cavalierly says the work you did was absolutely terrible."

Mr. Smith recalled when the plaintiffs were done presenting their case, the defendants presented motions to have the charges dropped. Out of the jury's presence, the two sides argued. "To sit there and hear the plaintiff's attorney say, 'Your Honor, you can't throw this count out. There was an absolute conspiracy here and you can't pull the CPA firm out. And he (Mr. Smith) was probably the head conspirator'. You say to yourself, 'What would mom think today?' After hearing the motions the judge dropped two counts."

Mr. Smith ruefully admitted he was probably not the most pleasant person to live with. It was difficult for him to explain to his children why daddy wasn't home. "Two weeks into the trial my middle daughter asked me if I was innocent or not. When you are nine years old that's a legitimate, fair question."

"No, my family wasn't in the courtroom. They didn't need to see their father abused and beaten up by the courts."

"Am I glad it's over with? Yes. Christmas was much better this year than the year before."

Julia Winn is the Editor of "INSIGHT" a periodical issued by the Illinois CPA Society. This article is used with permission.

[1] The subject of this story was granted anonymity.

***"In Print"* Continued from page 5**

Managing the Malpractice Maze alerts CPAs to the full extent of malpractice litigation against accountants, addresses strategies for reducing the likelihood of claims, and improves the chances of successful defense if a claim is brought. The book provides such practical information as identifying and screening high-risk clients, engagements and industries, drafting effective engagement letters, and choosing among malpractice insurance carriers and policies to select the policy best suited for the firm's professional needs. The book also features a 10 step plan to follow when a claim is brought, discusses practicing uninsured, documenting engagements and implementing a quality control system. Appendices include sample engagement letters and engagement checklists.

To order a copy of *Managing the Malpractice Maze* (product #090380), call the AICPA Order Department at ***800/334-6961***. In New York state, call ***800/248-0445***.

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 and West

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 a unresolved problem with the carrier or broker - you are invited to approach any member of the Committee for assistance.

Season's Greetings and Wishing You a Prosperous New Year from The AICPA Plan

AICPA Professional Liability Insurance Plan Committee

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The Accountants' Liability Newsletter is a quarterly publication mailed as a complimentary service to all AICPA Professional Liability Plan insureds. The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.

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