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Accountant's Liability Newsletter, Number 1, October 1982

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

ROLLINS BURDICK HUNTER

accountant's liability newsletter

AICPA Professional Liability Plan

Number 1: October 1982

Accounting Practice Pointers:
No. 1 of a Series

EVALUATING AND AVOIDING THE SUIT FOR FEES

Suits by CPAs for their fees have resulted in a mixed bag of success and disaster. Before filing suit subtract the time and expense of litigation from your probable recovery and then weigh the risk of a counterclaim which will itself require time and attention. Where numerous suits for fees seem indicated, an adjustment in your billing and collection practices may be indicated.

Time and Expense of Litigation

The American rule requires that all parties pay their own attorneys' fees. Unless your engagement letter contains an unusual clause providing that the client will pay reasonable attorney fees and collection costs, you will have to bear them thus reducing any recovery by one-third or more.

Whenever a lawsuit is filed, it is standard procedure to send written interrogatories to the other side. This means you will have to sit down with your attorneys and file sworn answers and the time this takes will depend upon the complexity of the issues. Another standard procedure is to take the deposition of the parties which involves orally answering questions under oath before a court reporter. At this time you will probably be required to produce your working papers for inspection. You will need to prepare for the deposition and meet at the appointed time and place so that this could easily cost you a half day of billable time.

If the suit for your fee is defended, you will have to go to court. In small claims and other courts this may mean sitting and waiting until your case is called. The simplest case could involve loss of a half day here. However, obtaining a judgment for your fee gives no

(continued on page 2)

IMPLICATIONS OF COURT DECISIONS FOR PUBLIC ACCOUNTING PRACTICE

Audit Confirmation of Payables May Result in Liability for the Client: Buxton v. Diversified Resources Corp., 634 F.2d 1313 (10th Cir. 1980).

Facts

Plaintiff sued on a $20,000 loan and the defendant corporation asserted the Utah statute of limitations as a defense to the claim. From 1971 through 1973 audit confirmation letters had been signed by the controller for the $20,000 obligation. In 1974 and 1975 the president signed letters in the following form requesting confirmation to the auditors of an obligation of $20,000 plus interest:

> Our auditors are making an examination of our financial statements which indicate the following amount payable to you on notes:... Please confirm the accuracy of the above information.

Outcome

The court held:

- The president had authority to sign the audit confirmations.
- The confirmations constituted a written acknowledgement of the debt which extended the statute of limitations.
- The debtor corporation was estopped from asserting the statute of limitations defense because the obligor had been lulled into inaction.

The court based its decision on *Victory Investment Corp. v. Muskogee Electric Traction Co.*, 150 F.2d 889 (10th Cir.), *cert. denied*, 326 U.S. 774 (1945), which, applying Oklahoma law, held that submitting a balance sheet to the trustee for bondholders showing the obligation as a current liability extended the statute of limitations on the bonds.

(continued on page 4)

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assurance that you will collect. Courthouses are full of uncollected judgments. If the judgment debtor is out of business or operates from hand to mouth so there are no visible bank accounts, receivables, or assets subject to sheriff's sale, you may never collect the judgment.

Litigation is often a slow process that takes months or years to conclude. Consider that your time must be expended now while any collection may be long delayed in evaluating an amicable settlement for less than the full amount.

Risk of Counterclaims

It is standard practice to file a counterclaim for deficient work whenever a CPA sues for a fee. In order to avoid payment of the fee the client must show that the work was so poor that it lacked any substantial value. Other damages, depending upon the circumstances, may include defalcation losses, IRS penalties, or professional fees to correct resulting problems. In order to recover damages the client must show a loss caused by your failure to use the usual procedures employed by the average CPA in your community. However, the counterclaim risk cannot be ignored. For example, in the case of *Ryan v. Kanne*, 120 N.W.2d 395 (Iowa 1969), the CPA recovered a fee of over $3,000 but had to pay a malpractice claim of over $23,000. The risk of a successful counterclaim is greatly increased if money changed hands based on either audited or unaudited financial statements. In the *Ryan v. Kanne* case the unaudited balance sheet was the basis for investing in a newly formed corporation.

Defalcations are an important cause of malpractice losses for the small CPA firm. While a CPA should think twice about suit for a fee where a defalcation has taken place, the inherent uncertainties in litigation and the variety of factual possibilities do not permit statement of a general rule. Thus in *O'Neal v. Atlas Automobile Finance Corporation*, 11 A.2d 782 (Pa. Super. 1940), the jury found for the CPA on the claim for unpaid fee and against the defendant's counterclaim for negligent failure to discover the bookkeeper's fraud. However, the pertinent question is considering the time, expense, and worry, was it really worth it?

One problem presented by a counterclaim is that it is a suit for malpractice. All malpractice policies require notice to the insurance carrier upon any claim or occurrence which may lead to a claim. If you fail to notify your carrier, then you are uninsured because of a breach of a condition in the policy. On the other hand, notice to the carrier means the carrier must defend the counterclaim. Numerous counterclaims can result in expenses leading to loss of malpractice coverage or being placed in an assigned risk pool at higher insurance rates for less coverage. One attorney says he advises the client that he can defend the counterclaim as part of the suit for the fee so that notice to the carrier is not necessary. However, if the counterclaim results in a judgment, it will be uninsured.

Where the facts indicate a minimal risk for a successful counterclaim, suit for the fee may be beneficial especially in the unusual case where the engagement letter provides for collection of attorneys' fees and costs.

Practice Management

Weekly Billings. While CPAs advise others on setting credit limits and establishing current billing practices, they sometimes neglect such matters in managing their own practice. A good internal accounting system for charges to clients is important to efficient billing and collection. Weekly progress billings can be a major step in avoiding the suit for fees. One San Francisco sole practitioner recounts that he has never lost a fee in thirty years of practice. He always gets a retainer in advance, used to close the last progress billing, and requires the client to sign an engagement letter providing for payment of costs of collection including attorneys' fees. He says his basic rule is: "If I don't get a check on Friday, I don't go to work on Monday."

Promissory Notes. Another effective procedure is to require the client to sign a promissory note for past due balances. This constitutes an admission by the client that the amount is owed and poses a much easier collection problem than suit on an account. One Baltimore CPA says "We got the idea for notes on past due balances when the interest rates went so high." The standard note requires interest and payment of costs of collection including attorneys' fees. One national firm (not Big Eight) provides in the engagement letter that the client agrees to sign a note on past due balances. A suit on a note is not considered a suit for a fee when applying for malpractice insurance under the AICPA sponsored plan.

Some CPAs now require interest on past due balances in the engagement letter. For examples of this practice see "Carrying Charges on Receivables," *Journal of Accountancy*, July 1981, p. 50 and "Carrying Charges on Past-Due Receivables," *Journal of Accountancy*, January 1981, p. 34. One CPA relates that while the engagement letter does not provide for interest, the firm practice is to add 1½ percent per month through the accounts receivable billing procedures and that generally such amounts are collected.

Remember that AICPA Ethics Rules (ET § 191.103) require that the audit fee for last year's engagement must be completed by the end of field work while SEC rules require payment of an audit fee prior to starting the next audit.

Retention of Client Records. One problem that frequently arises is that the CPA refuses to surrender working papers to a successor because the fee is unpaid. Under AICPA Ethics Ruling 505-1, the CPA must furnish to the client upon request any working papers (or copies) that constitute client books and records

(continued on page 3)

regardless of whether the fee is paid. This includes working papers that substitute for journals and ledgers as well as adjusting and closing entries and supporting computations such as a depreciation schedule. The California State Board strictly enforces this rule by virtue of its own rule 68.

Summary and Conclusion

Before filing suit against a client for a fee you should consider the probable *net recovery* after deducting for the expense of litigation including the value of your own time. Then weigh this net recovery against the risk of a counterclaim and the reporting requirements of your malpractice insurance. Consider that litigation takes months or years while your time outlay will start now.

If you find yourself in the position of suing for numerous large unpaid fee balances, you should question your own practice management. Consider

- advance retainers used to close the last progress billing
- weekly progress billings
- interest on past due balances
- engagement letters providing for costs of collection and attorneys' fees
- engagement letters requiring promissory notes on past due balances.

Accounting Firm Defenses:
No. 1 of a Series

COMPLIANCE WITH "USUAL" PROFESSIONAL PRACTICE AS A MALPRACTICE DEFENSE

While accountants, like other professionals, *must use due professional care*, they do not guarantee their work. Clients are not entitled to perfection nor to the care, competence, and judgment provided by the best CPAs. Professional accountants undertake to provide only the usual care and competence applied by the average CPA in the local community. These principles apply alike to all functional areas of practice whether auditing, tax return preparation, tax advice, investment advice, or accounting services.

Auditing

CPAs do not guarantee the figures on audited financial statements. For example, in *Delmar Vineyard v. Timmons*, 486 S.W.2d 914 (Tenn. App. 1972), there was evidence that the CPA omitted some payables and used an excessively high percentage in converting the value of the store's retail inventory to cost. In rejecting the malpractice claim, the court said:

> Generally, it is established law throughout this country that an accountant does not guarantee correct judgment, or even the best professional judgment, but merely reasonable care and competence...
>
> The standard of care applicable to the conduct of audits by public accountants is the same as that applied to doctors, lawyers, architects, engineers and others furnishing skilled services for compensation and that standard requires reasonable care and competence therein.

Tax Return Preparation

CPAs do not guarantee the accuracy of tax returns which they prepare. In *Lindner v. Barlow, Davis & Wood*, 27 Cal. Rptr. 101 (Cal. App. 1963), the CPAs prepared federal income tax returns for five years relying upon W-2 forms that payments received were taxable. The payments were voluntary on behalf of Hearst Corporation which had employed taxpayer's deceased husband. When the widow read of a tax court decision indicating that such payments were not taxable, she filed a claim for refund on the three open years and sued the CPAs for income taxes paid in the two closed years. In their defense the CPAs proved with expert testimony that the "usual" practice among CPAs in San Francisco was to accept the W-2 form as evidence of whether payments were taxable. In rejecting the malpractice claim, the court quoted the following:

> Accountants have been recognized as a skilled professional class... subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions....
>
> They have a duty to exercise the *ordinary* skill and competence of members of their profession, and a failure to discharge that duty will subject them to liability for negligence. Those who hire such persons *are not justified in expecting infallibility*, but can expect only reasonable care and competence. *They purchase service, not insurance.*

As further authority that accountants do not guarantee the accuracy of tax returns that they prepare, consider the case of *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961), where the California Supreme Court ruled that attorneys are liable for negligence to the beneficiaries under a will. However, in rejecting the malpractice claim the court held that where the will failed because of a technicality, the attorney was not liable. It ruled:

> The attorney is not liable for every mistake he may make in his practice; he is not, in the absence of an express agreement, an insurer of the soundness of

(continued on page 4)

his opinions or of the validity of an instrument that he is engaged to draft; and he is not liable for being in error as to a question of law on which reasonable doubt may be entertained by well-informed lawyers.... These principles are equally applicable whether the plaintiff's claim is based on tort or breach of contract.

Tax Advice

CPAs who give tax advice are not necessarily liable for malpractice when the advice proves wrong. For example, in *Smith v. St. Paul Fire & Marine Insurance Co.*, 366 F. Supp. 1283 (M.D. La. 1973), *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974), a lawyer advised that a Louisiana judgment of possession would not trigger the alternate valuation date for an estate for federal tax purposes. The real estate was sold and the estate tax return was filed using the alternate valuation date. Following the filing of this return, a lower federal court in Louisiana ruled that a judgment of possession established the latest alternate valuation date that could be used. The heirs then sued the attorney for malpractice for the additional taxes that would result from disallowance of the alternate valuation date. In rejecting the malpractice claim, the court noted that other attorneys practicing in the same area were advising their clients to the same effect and quoted this from a North Carolina case:

> An attorney who acts in good faith and in an honest belief that his advice and acts are well founded and in the best interest of his client is not answerable for a mere error of judgment or for a mistake on a point of law which has not been settled by the court of last resort in his State and on which reasonable doubt may be entertained by well-informed lawyers.

Investment Advice

A CPA who acts as an investment advisor does not guarantee that the advice will prove beneficial. For example, in *Midland National Bank of Minneapolis v. Perranoski*, 299 N.W.2d 404 (Minn. 1980), the CPA solicited investments in a partnership tax shelter from nonclients. In rejecting the investors' claims against the CPA, the court acknowledged that financial projections are actionable in fraud if they do not "accurately reflect surrounding past and present circumstances." The court held:

> He [the CPA] was bound to exercise care in recommending a particular investment, but he cannot have expected to guarantee its soundness. Third-party plaintiffs were aware that the success of Stone House as a business venture was dependent upon the market price of cattle. In 1971, the market price of cattle was increasing, and the evidence suggests that at the time Stone House was a sound investment. Stone House failed because from early 1974 until early 1975 the market price of cattle fell catastrophically. It would be unreasonable, in our view, for a jury to find that in 1971 Lurie could have foreseen this occurrence.

Accounting Services

The CPA performing accounting services is responsible only for the standard of care usually applied by CPAs in similar circumstances. Thus in *O'Neal v. Atlas Automobile Finance Corp.*, 11 A.2d 782 (Pa. Super. 1940) the jury found the CPA not liable for failing to discover the bookkeeper's embezzlement since, contrary to the client's contention, only a limited examination and financial review was contemplated in the engagement. Similarly in *Ronaldson v. Moss Watkins, Inc.*, 127 So. 467 (La. App. 1930) the CPA was held not liable for errors since a detailed audit was not contemplated in the engagement. It is important to recognize, however, that some courts have held CPAs performing accounting services liable for failure to discover embezzlement: *1136 Tenants Corp. v. Max Rothenberg & Co.*, 330 N.Y.S.2d 800 (N.Y. App. Div. 1972) (preparing unaudited financials); *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976) (bookkeeping services).

Summary and Conclusion

CPAs do not guarantee the accuracy of audited financial statements, the accuracy of tax returns, nor the wisdom of their tax or investment advice. However, in order to avoid misunderstandings in this regard, many CPAs feel it is prudent practice to warn clients:

- An audit is designed to search for material fraud but, because of inherent limitations in any audit, it may not be relied upon to uncover material fraud.
- Tax return preparation involves numerous grey zone items subject to resolution against the taxpayer.
- Tax and investment advice is always subject to risks as enumerated and explained.
- Accounting services are performed on a best efforts basis and it is *not* generally possible to guarantee specific results.

IMPLICATIONS OF COURT DECISIONS
(continued from page 1)

Implications for Auditors

Audit confirmation of payables may result in extending or reviving debts that may otherwise be barred by the statute of limitations. When confirming payables, auditors may want to consider whether the audit client has valid reasons for contesting a claim and whether the confirmation might waive this of several defenses that the client may wish to assert. In making such a determination it may be helpful to consult the client's counsel.

RECENT COURT DECISIONS

Accounting Firm Liable for Tax Opinion Letter: Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), cert. denied, Coopers & Lybrand v. Sharp, No. 81-433, 2/22/82

An accounting firm was held liable on its tax opinion letter used in selling limited partnership tax shelters. Liability under section 10(b) of the Securities Exchange Act of 1934 was based on respondent superior and the accounting firm's strict duty to supervise employees drafting and issuing such a letter. Because the tax opinion letter allegedly contained both omissions and misrepresentations, the court held that plaintiffs were entitled to a rebuttable presumption of reliance upon the letter.

The measure of damages was defined as the amount of money paid by each investor minus the value the investment would have had if all facts known to the Coopers & Lybrand employee had been disclosed. The court also affirmed the award of prejudgment interest and rejected the accounting firm's argument that it did not have the use of plaintiff's money during the relevant time period. The court apparently never resolved the common law fraud claims which, according to its note 3, depended on the particular law of each state since the jury found the injury was not foreseeable to the accounting firm.

$80 Million Verdict Against Arthur Andersen & Co. Reduced Fund of Funds v. Arthur Andersen & Co., CCH Fed. Sec. L. Rep. ¶ 98,751 (S.D.N.Y. 1982).

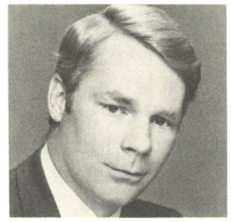
The trial court has now reduced the $80.7 million jury award but denied a new trial in a case involving allegations that an auditor knew, but failed to disclose, that one client was defrauding another client. Focusing on a particular clause in the engagement letter, the court said: "AA's failure to disclose to FOF any irregularities actually discovered in the course of its audit is a breach of a specific, material term of the engagement letter."

Courts Split As to Whether Sale of 100% of Stock Is Sale of a Security

It is important for accountants to recognize the "sale of a security" which may invoke liabilities or registration requirements under federal securities laws as well as state blue sky laws. In *SEC v. Howey Co.*, 328 U.S. 293 (1946), the U.S. Supreme Court held that units of a citrus grove development, coupled with a contract for cultivating, marketing, and remitting of net proceeds were securities. The court reasoned that form must be disregarded for substance and that a security is "a contract, transaction or scheme whereby a person invests his money in a common

(continued on page 6)

FREQUENT QUESTIONS AND ANSWERS ABOUT THE AICPA PROFESSIONAL LIABILITY INSURANCE PLAN



By William J. Crowe II
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Why should I join the AICPA plan?

CPAs need a stable insurance plan at reasonable rates to guard against malpractice losses. More than 10,000 practice units from all 50 states have joined together in your AICPA plan to broadly spread the risk for the mutual defense and protection of all. The plan is operated under the oversight of the AICPA Professional Liability Insurance Plan Committee whose members are drawn from smaller CPA firms just like yours.

We think the AICPA plan offers the broadest coverage you can find at competitive costs. Courts hold local CPA firms liable under federal securities laws when securities (such as limited partnerships) are being sold despite exemption from SEC filings. Your AICPA plan covers liability under federal securities laws while some may exclude it. Under the AICPA plan, you can obtain coverage for acts that occur prior to joining the plan while other plans may not offer this option.

How do I join the AICPA plan?

Just call me on the toll free line 800-221-4722 and I will quote representative rates and arrange to enroll you in the plan. You can write me at Rollins Burdick Hunter Co., 605 Third Avenue, New York, NY 10158.

What do I do if I anticipate that I may have a claim?

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Remember that your policy provides: "The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense." Never admit being at fault and do not agree to pay damages nor assume responsibility. Leave evaluation and negotiation to experts provided by your insurance plan.

enterprise and is led to expect profits solely from the efforts of a third party." Limited partnership interests are generally held to be securities. In *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093 (5th Cir. 1973), the court held that sales of fractional undivided oil and gas interests constituted sales of securities subject to antifraud provisions of federal securities laws.

In *Sprague v. Touche Ross & Co.*, CCH Fed. Sec. L. Rep. 98,354 (D. Mass. 1981), the court refused to dismiss a claim under federal securities laws relating to a demand note and convertible promissory notes. The court held that these might be securities if the facts show that (1) payment was to be dependent upon the success of a risky enterprise, or (2) the parties contemplated an indefinite extension of the note or conversion into stock. Similarly, in *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) the court rejected the defense that three notes aggregating $1 million issued to finance a brokerage firm were not securities. The court conceded that home mortgages, consumer loans, and notes formalizing open accounts were not securities.

Compare *Westchester Corp. v. Peat, Marwick, Mitchell & Co.*, 626 F.2d 1212 (5th Cir. 1980), where the court dismissed a section 10(b) Exchange Act claim holding that a contract for the sale of a real estate tract was not a "security" simply because it provided for periodic payments. The contract failed to meet the three requisites for a security since: (1) it was a commercial transaction and not an investment, (2) there was no common enterprise simply because of periodic payments, and (3) profits did not derive solely from a third party.

In *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981), a case not involving accountants, the court held that the sale of the entire corporate stock did not fall within federal or Indiana securities laws. The new Eleventh Circuit in Atlanta agreed in its decision of *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982). However, in *Golden v. Garafalo*, 678 F. 2d 1139 (2d Cir. 1982) the Second Circuit held that stock in a business corporation is expressly defined as a security under federal law and rejected the "sale of business" exception adopted by other circuits.

CPA Desires to Consult Without Practicing: Florida Board Revokes Certificate: Court Reverses Board: Cenac v. Florida State Board of Accountancy, 399 So. 2d 1013 (Fla. App. 1981).

Cenac, a Florida CPA, formed a corporation to consult on Medicare and Medicaid reimbursement and informed the board, pursuant to statute, that he was permitting his CPA certificate to be marked inoperative, thus exempting him from reestablishing his competency. When he was asked if he was a CPA, he would answer that he was "nonpracticing." In finding Cenac was practicing and revoking his license because of rule violations, the board erroneously rejected the hearing officer's finding that Cenac was not holding himself out as a CPA. The court reversed and remanded for an agency order consistent with the hearing officer's findings of fact. The court noted that upon remand there must be adequate support for an agency decision that Cenac was practicing public accounting.

Soliciting Firm Clients in Anticipation of Termination Held Unfair Trade Practice: Biever, Drees & Nordell v. Coutts, 305 N.W.2d 33 (N.D. 1981).

While employed with the plaintiff CPA firm, the defendant CPA conducted periodic audits of certain Minnesota school districts. While still employed, he contacted these clients and indicated that he, as an individual, was interested in performing the audit work and recounted his past experience with such audits. At the time of this solicitation, he had not informed the employer CPA firm that he was contemplating leaving nor that he was contacting clients on his own behalf. There was no written nor oral agreement as to how long the employment relation was to continue.

After the employee's voluntary termination in June of 1979, the firm obtained a court order enjoining the former employee from performing audit or other services for such clients through December 31, 1981. In affirming the injunction, the North Dakota Supreme Court held that if an employee solicits the employer's customers in anticipation of starting a competing business, the employer is entitled to an injunction for a sufficient length of time to permit it to compete on even terms.

Where Auditor Fails to Discover Management Fraud, Landmark Case Establishes Common Law Defense to Suit by Client: Cenco Inc. v. Seidman & Seidman CCH Fed. Sec. L. Rep. ¶ 98,615 (7th Cir. 1982). Cert. filed, No. 82-169, 7/29/82

This case involved Cenco's claim against its auditor based on common-law counts for breach of contract, professional malpractice (negligence), and fraud. Federal jurisdiction over the claim was based on the court's pendent jurisdiction in a federal class action suit by stockholders, and the court applied Illinois law in deciding the common-law counts. The trial judge instructed the jury:

- acts of the corporation's employees are acts of the corporation itself if the employees were acting on the corporation's behalf,

(continued on page 7)

RECENT COURT DECISIONS *(continued from page 6)*

- a breach of contract is excused if the promisee's hindrance or failure to cooperate prevented the performance,
- contributory negligence is a bar to negligence, and
- a participant in a fraud cannot recover damages since there could have been no reliance upon the fraudulent representations.

Based on the instructions the jury decided in favor of the auditor and Cenco appealed. The appeals court affirmed and held that the instructions were proper since the uncontested facts showed that fraud had permeated Cenco's top management.

Second Circuit Carves Out an Accountant's Work Product Privilege to Protect Tax Accrual Working Papers from IRS Scrutiny: United States v. Arthur Young & Co., 677 F.2d 211 (2d Cir. 1982).

The court balanced the policy needs of auditors for a candid evaluation of potential tax liability and the public policy needs for IRS access to information relating to tax liability. It then carved out an accountant's work-product privilege to protect auditor's tax accrual workpapers from IRS summons except upon a "sufficient showing of need to adequately justify invading the integrity of the auditing process."

LETTERS TO THE EDITOR

How does our newsletter rate with you? Do you know of a court decision or loss-prevention/risk-management technique that should be covered? Can you offer better ideas than those we have discussed? Please write the editor.