Accountant's Liability Newsletter, Number 4, September 1983

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

ROLLINS BURDICK HUNTER

accountant's liability newsletter

AICPA Professional Liability Plan

Number 4: September 1983

Accounting Practice Pointers: No. 4 of a Series

DESIGNING YOUR FIRM'S TRAINING AND CPE PROGRAM

By reference to the charts in this issue showing claims and losses in the AICPA Professional Liability Plan, you can design a training and continuing education package that integrates into your overall quality control program. While your budget for travel to expensive courses may be limited, many states offer free registration for the CPA who will agree to arrive early and act as on-site administrator. A careful selection of outside and in-house programs can prove both economical and effective for all firm personnel.

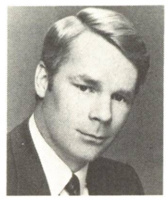
Audit Training

Losses in the auditing and defalcation categories account for almost half of all dollar loss in the AICPA Professional Liability Plan. Detailed study indicates that some of these result from inadequate staff training relative to the characteristics of the particular industry. Experience also indicates that qualified opinions and particular audit difficulties tend to be a function of an industry group. Staff fail to grasp the implications of certain items or the difficulty of applying auditing standards where they are not conversant with industry accounting practices and relevant industry audit guides. An example of this "uniqueness" is the difficulty of auditing liabilities of a grain elevator where records are withheld from the auditor.

The AICPA offers a number of industry oriented courses sponsored by most state societies. These include farming and ranching, construction, extractive industries, oil and gas, coal, banks, savings and loan, federal programs, local government, school districts, health care, insurance, nonprofit organizations, and real estate. At least one person in your firm should attend a course for each industry in which the firm has clients.

(continued on page 2)

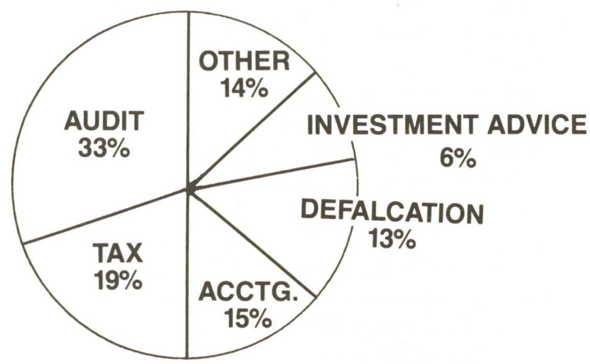
CAUSES OF MALPRACTICE CLAIMS AND LOSSES IN THE AICPA PLAN



Written by William J. Crowe II
Senior Vice President
Rollins Burdick Hunter Co.
Call toll free: 800-221-3023

Here is an overview of dollar losses in your AICPA Professional Liability Insurance Plan:

DOLLAR LOSSES



While defalcation losses arise in both audit and nonaudit situations, note that audit and defalcation categories combined account for almost half of all dollar losses. Analysis of tax losses reveals that most tax return errors are small but that CPAs need to be more cautious in giving tax and investment advice which can result in significant dollar exposure.

Here is an overview of the frequency of malpractice claims by functional category:

(continued on page 2)

ROLLINS BURDICK HUNTER
605 Third Avenue
New York, N.Y. 10158
Toll Free: 800-221-3023

CPE (continued from page 1)

Tax Staff

As the charts in this issue indicate, tax problems generate more malpractice claims than any other functional category. Most firms having several professionals can benefit by designating one or more persons responsible for the firm's technical tax expertise. One small firm of five partners reports excellent results from designating two "tax partners." A memo from a tax partner gave the CPA immediate notice of the IRS' position that fair value of the personal use of an auto is dividend income from the professional corporation. He was able to correctly advise his physician client that only reimbursement of "fair value" would avoid an IRS assessment.

Tax areas that are particularly vulnerable for errors and omissions are S corporations, corporate reorganizations and corporate liquidations. There are AICPA courses on S corporations and on purchase, sale or liquidation of a business sponsored in over fifty locations. The AICPA course on tax planning for corporations and shareholders is offered in a number of the largest business centers. One tax partner might want to consider the AICPA program on taxation of estates and trusts offered in some fifty locations or the AICPA Annual Estate Planning Conference.

Practice Management

A number of claims against firms in the size range of eleven to twenty-five professionals indicates growing pains where the firm failed to develop management policies and continued to function as a loose confederation of sole practitioners. This can have catastrophic results where there are no firm-wide policies and practices concerning engagement letters, quality control, records retention, cross-checking of audit work, internal audit and control of client trust accounts, etc. Regardless of whether you are a member of the PCPS, you can attend the annual PCPS Conference where a wide variety of quality control problems are discussed. The AICPA Management of an Accounting Practice Committee presents a two-day conference each year to help you compare your problems, procedures and techniques with firms of similar size throughout the nation. Subjects include new measures for evaluating and compensating partners, profit control, planning for growth, and a wide variety of relevant topics. If your firm has not integrated your computer and word processor into your quality control system, you might consider one of the various computer course offerings or the AICPA Annual Microcomputer Conference.

In-House Programs

Claims and losses indicate that small firms can profitably spend time in-house on such fundamentals as:

- Indicia of fraud and follow-up testing where fraud is indicated
- Audit and disclosure of contingencies and lawyers' letters
- Full disclosure including related-party transactions and fall-in revenue after the cut-off date
- Awareness of client compliance with sales tax and workers' compensation laws

The AICPA *Management of an Accounting Practice Handbook* is a three volume looseleaf set containing tabs on virtually every aspect of firm practice and procedure. An in-house training program could proceed through these volumes and use the handbook material as a starting point for discussing the particular firm's practices and procedures in each of the respective areas covered. In-house programs are particularly effective for developing and implementing your particular firm's practices, procedures and practice-development program.

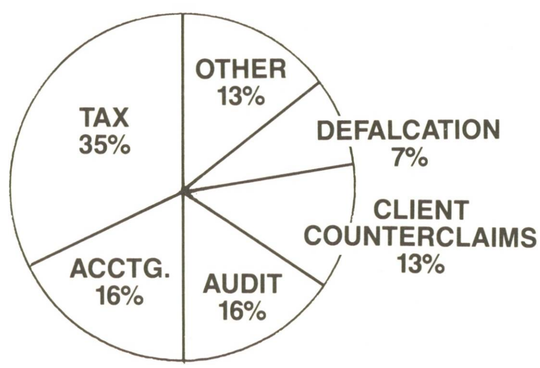
In-house programs are often used to bring relevant materials learned in outside programs to the attention of other firm personnel. Those attending outside programs present a synopsis during the in-house training sessions. While the larger firms can afford to bring in the expert for in-house programs, smaller firms can accomplish this same result by teaming up in groups of twenty-five or more professionals for CPE purposes with each firm supplying a member for an interfirm CPE committee.

Conclusion

Careful thought to the design of your firm's training and CPE program can serve to develop and implement your firm's policies, procedures, practice-development and quality-control program. In order to succeed you should consider your particular needs for outside technical training in terms of industry, tax, MAS and practice management. This must then be balanced with in-house coverage of your particular firm practices, procedures, quality controls and practice development needs.

Claims (continued from page 1)

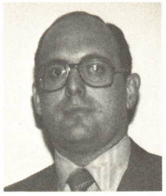
FREQUENCY OF CLAIMS



A significant number of claims are generated by the insured firm's suit for fees. More frequent billings, credit limits and interest on receivables might be helpful in reducing this number.

If you consider these charts when establishing your firm's policies, procedures, internal controls, and continuing education, you can design a loss-prevention/risk-management program for your particular practice.

RECENT DEVELOPMENTS OF INTEREST



Written by H. James Cantwell,
Member of the Illinois Bar
Senior Vice President-Claims
L. W. Biegler Inc.
(Underwriter for the AICPA Plan)
Call collect (312) 876-3162

New Jersey Extends Foreseeability Rule:
H. Rosenblum, Inc. v. Adler, 93 N.J. 324 (1983)

New Jersey accountants may be held liable to third party investors for failure to withdraw a negligent audit report prior to a merger despite lack of knowledge of the merger when issuing the audit opinion.

Failure to Supervise Trust Accounts Can Cause Uninsured Liability

Claims and court decisions indicate that some CPAs do undertake to collect and disburse client funds. Unfortunately this sometimes occurs with no fidelity bond coverage, no internal audit, and no crosschecking on the partner handling the funds. Handling client funds without proper safeguards or fidelity bonding may result in punitive damages that are not covered by your insurance. While your AICPA plan protects the innocent partner, you are *not covered for punitive damages nor for a verdict in excess of the policy limits*. Punitive damages are not covered by most malpractice policies since about half of the states do not permit this coverage.

In an Oregon case the court held that co-partners in a CPA firm were liable for the alleged misappropriation of client funds by a deceased partner.[1] In holding the co-partners liable, the court said:

> If a third person reasonably believes that the services he has requested of a member of an accounting partnership is undertaken as a part of the partnership business, the partnership should be bound for a breach of trust incident to that employment even though those engaged in the practice of accountancy would regard as unusual the performance of such service by an accounting firm.

In a Florida case two innocent CPAs found themselves uninsured for a partner's alleged breach of trust.[2] The particular malpractice insurance policy excluded affirmative dishonesty but did not undertake to protect the innocent partners. The court held that the losses had to be prorated between the insured portion (losses due to mismanagement of funds) and an uninsured portion (losses due to misappropriation of funds).

---

[1]Croisant v. Watrud, 432 P.2d 799 (Ore. 1967).

[2]Duke v. Hoch, 468 F.2d 973 (5th Cir. 1972) (applying Florida law).

New Hampshire Applies Forseeability Rules to Unaudited Financials:
Spherex, Inc., v. Alexander Grant & Co.:
451 A.2d 1308 (N.H. 1982)

The Supreme Court of New Hampshire has held that accountants may be liable on a negligence theory to third parties who foreseeably will rely upon unaudited financials.

Attorney Who Filed Malpractice Suit Liable for Punitive Damages:
Raine v. Drasin, 621 S.W.2d 895 (Ky. 1981).

Where an attorney filed a malpractice suit against a physician without probable cause, the Supreme Court of Kentucky affirmed the award of $10,00 for loss of reputation and $15,000 for punitive damages.

Is There a Duty to Control Your Client?

As a general rule there is no common law duty to control the conduct of another nor to warn those endangered by the conduct. However, the courts are carving out an exception in cases in which the defendant stands in some special relationship either to the person whose conduct needs to be controlled or to the foreseeable victim.

In a recent Georgia case, the court held a hospital liable to the children for the father's murder of the mother.[1] Despite the father's voluntary admission for mental treatment, the court held the hospital had a duty to control the father when treatment revealed that he would likely cause harm to his wife. The court ruled the death was proximately caused by the hospital's negligence in issuing the father an unrestricted weekend pass. In a similar situation, the California Supreme court held that a psychotherapist has a duty to warn the intended victim of violence.[2]

In a copyrighted article in the *Chicago Tribune*, the author discusses the seeming contradiction in the role of accountants.[3] Alexander Grant was reportedly held liable by a lower court for warning clients to stop doing business with Consolidata Services Inc. of Ohio because its liabilities exceeded assets. On the other hand Arthur Andersen & Co. was held liable by a lower court in a suit by the trustees of its audit client, Fund of Funds, Ltd., for allegedly failing to disclose that Fund of Funds was being defrauded by another Andersen client.

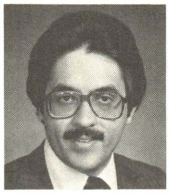
---

[1]Bradley Center, Inc. v. Wessner, 296 S.E.2d 693 (Ga. 1982).

[2]Tarasoff v. Regents of University of California, 551 P.2d 344 (Cal. 1976).

[3]Mary Holm Ansly "Lawsuits Try to Clarify Accountants' Role," *Chicago Tribune*, December 5, 1982.

A MESSAGE FROM YOUR AICPA PROFESSIONAL LIABILITY INSURANCE PLAN COMMITTEE



Written by Chairman
Steven N. Kreisman, CPA,
Levine & Kreisman, Inc.,
Denver

Your AICPA Professional Liability Insurance Plan is unique in that it operates under the oversight of your AICPA committee. Membership is rotated to produce a geographical cross section drawn from small CPA firms. Your committee selected Rollins Burdick Hunter Co. as broker and administrator of the plan and L. W. Biegler Inc. as plan underwriter.

The broker and underwriter provide us with a comprehensive status report each quarter. Since I assumed the chairman role, the thrust of our activity has been to identify common causes of malpractice claims and losses and to communicate these findings to you in this newsletter. Your committee has access to all claims files and receives detailed reports from the underwriter on all claims involving over $50,000. We are assisted in our analysis and communication role by Professor Denzil Causey who is consultant to the committee.

The objective of the plan has been to provide a stable market for malpractice insurance for small CPA firms. While we believe we have had considerable success, we hope that continuous probing for causes of claims and communication of our findings to you can provide the protection you need in an increasingly litigious society.

AICPA PROFESSIONAL LIABILITY INSURANCE PLAN COMMITTEE

Steven N. Kreisman, *Chairman* (Colorado)
Donald L. Bailey (Wisconsin)
Thomas P. Giusti (Ohio)
Robert D. Hunter (New Jersey)
Roland R. Mangiantini (California)
Richard L. Miller, Jr. (Illinois)
Walter Stock (Texas)

STAFF AIDES
Donald J. Schneeman
William C. Tamulinas

PLAN ADMINISTRATOR: Rollins Burdick Hunter Co.
C. J. Reid, Jr.
William J. Crowe II

PLAN UNDERWRITER: L. W. Biegler Inc.
Louis W. Biegler
H. James Cantwell
William F. Caplice, Jr.

NEWSLETTER EDITOR
Denzil Y. Causey, Jr.

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

AICPA Professional Liability Insurance
Plan Committee
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775