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**Accounting Malpractice:
The Future of Accounting Professional Liability Insurance**

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ACCY 499-H
Honors' Capstone Project
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Abstract

This report focuses upon the current problem of dramatically increasing professional liability insurance rates that accountants are facing. Robert Bower begins the paper with an overview of the current "crisis" in the insurance industry (p. 1). Bower discusses possible causes for this problem (pp. 1-12). He reviews several court cases which involved auditors which he believes to have played a major role in causing insurance rates to rise (pp. 2-8). Several solutions currently being put forth by such groups ranging from the American Medical Association to accountants in the United Kingdom are detailed and critiqued (pp. 12-20). Bower then concludes the paper with his opinion that a solution (combining those that he had discussed) should be developed and implemented soon (p.21).

Preface

I became aware of the problem of sharply increasing professional liability insurance rates for accountants in an interview with a partner of the CPA firm of Wagner, Sim & Company. This partner was extremely upset about the fact that his insurance rates were sharply rising. He complained that his firm was being forced to pay for increases in these insurance rates which were the result of the several lawsuits by the SEC clients of other CPA firms. He was especially upset because he didn't even have any SEC clients. This topic immediately interested me as it was just beginning to affect my future profession. I decided that this would be the ideal topic to further research for my Honors Capstone Project.

This report is intended to give the reader a better understanding of the current situation of accounting professional liability insurance. It starts with possible causes of the "insurance crisis" and then details several solutions. Although this paper does not recommend any specific solutions, it is intended to educate the reader and encourage him/her to help further the solution of this problem.

I hope that this report contains no major errors or vagueness, but in such a case, I apologize and remind everybody that nobody is perfect. I would like to thank all of the people who assisted me in this project. Most of all, I would like to thank Dr. Curtis Norton, a professor at Northern Illinois University. He assisted me in researching this topic and advised me when needed. I would also like to thank all of the firms that responded to the survey that I sent out. I am also appreciative to the University's Honors Program which helped me to achieve the most out of my education at N.I.U.

This paper took almost a year to compose, and although I am relieved to be finished, I hope the reader enjoys it.

Currently in the United States, there is a major insurance crisis. It is seriously affecting everybody from businesses to municipalities. For years it has been widely known that medical malpractice insurance was on the rise at a frightening pace. And now currently, the Illinois Board of Regents which governs 5 state universities is without insurance as they have been dropped by their insurance representative. What was once considered an extreme move is now common place as insurers are pulling out of market places. The accounting profession has not been immune to these rising rates. As a result of an increasing amount of lawsuits, damages and settlements therefrom, professional liability rates have begun to rise drastically. It is estimated that in the next year insurance rates will rise by more than 125% while coverage will be reduced by roughly one third.¹ This is much like what has happened to the medical profession. Something needs to be done to allow the accountant to continue to make a living. Furthermore, the future needs to be brightened to encourage young intelligent individuals to look to accounting as a career. These rising rates which now affect only the businesses will eventually trickle down to the consumers and they will ultimately bear the expenses. There are many reasons for this crisis, as well as many opinions and several solutions.

Many see the cause of the insurance crisis as resulting from the increasing number of lawsuits against the accounting profession. Since 1981, the top eight accounting firms have paid almost 200 million dollars as settlements or from judgments of these suits. Currently, the potential awards of ongoing disputes amount to more than 2 billion dollars. The suits have resulted from almost every major business failure, from the Penn Square failure to the E.S.M. Governmental Securities failure. The question then is: are accountants liable for these failures? This is one of the basic issues considered by the courts in determining who prevails in the lawsuits. The more the accountants are held responsible, the higher their

quality of work must be and in turn the greater the risk of responsibility for failure. As a result of being held more strictly liable, insurance rates have increased dramatically while coverage has decreased. Many firms have been dropped by their insurance representatives and are being forced to sign new policies at exorbitant rates since to practice without insurance is now suicidal.

In terms of being held professionally liable, a study of current lawsuits may create further understanding. The first case and probably one of the most publicized cases is that between Alexander Grant and Company (now called Grant Thornton) and those affected by the failure of E.S.M. Governmental Securities. The failure of E.S.M. has been commonly linked to the Ohio Bank Crisis. The situation was one in which the partner in charge of the audit of E.S.M., Jose Gomez, accepted a bribe in order to give the firm a clean bill of health. As a result of the subsequent failure of E.S.M., the Home State Savings Bank of Cincinnati collapsed and triggered the closing of 70 other Ohio Banks resulting in a loss of about 144 million dollars.²

There is no doubt that this corrupt partner was in the wrong and he has since been barred from the profession for life. But, are the other partners liable for this collusion and fraud of which most probably knew nothing about? Furthermore, upon deeper investigation into the failure, there were several flags which should have warned current and potential investors of the problems.

Many lawsuits were immediately filed as a result of the failure. One suit involved Marvin Warner, a Cincinnati financier and former ambassador to Switzerland, for the amount of 1.3 billion dollars.³ This lawsuit followed 18 that had previously been filed against Alexander Grant. However, in Warner's case, there clearly appears to be some misdoing on his part. Apparently, Mr. Warner and Burton M. Bongard, the CEO of the Cincinnati Bank, received several illicit profits in their personal dealings with E.S.M. The trustee for E.S.M., C.

Thomas Tew, has brought suits against these two for their alleged shady dealings. Mr Tew is seeking 6.5 million dollars from Mr Warner and 5.45 million dollars from Mr Bongard.⁴ This has been the result of their apparent attempts to boost the net loss of E.S.M. so that the results wouldn't look as bad. And in early 1966, to further exemplify Warner's fraudulent acts, he was indicted by an Ohio grand jury on 1 count of theft by deception, 4 counts of securities violations and 45 counts of willful misapplication of funds in relation to the Ohio Bank failures.

In delving even further, more has been uncovered. It was reported in the Wall Street Journal that Sylvester Hentschel, an Ohio Thrift examiner, had repeatedly reported to the governor of Ohio for over 2 and a half years preceding the collapse that E.S.M. was in bad shape and that several questionable practices between Warner, Home State, and E.S.M. were taking place.⁵ However, Governor Celeste, who himself was a friend of Warner's and received several campaign contributions from him, ignored Mr. Hentschel's warnings. Thus, audits made of the banks which dealt with E.S.M. revealed that problems existed. In this case, Alexander Grant is clearly liable for the wrong doings of one of its partners and partially for the failure of E.S.M.; but, it appears more that individuals such as Ohio Governor Celeste, Mr Warner, and Mr Bongard were also at fault, and especially responsible for the Ohio bank failures.

The next question is how liable is Alexander Grant to third parties and to which third parties are they liable. As a result of the bribe, Alexander Grant was prohibited from soliciting new clients in Florida for a period of sixty days. All 500 partners, some who at the date of the failure no longer worked at Alexander Grant, are being sued by such entities as Pompano Beach, Florida and other municipalities and groups. Because accounting firms are only allowed to be set up as partnerships, (also as Professional Corporations but with the same liabilities of each partner as in a partnership) the partner's personal assets are also at

risk. An Alexander Grant attorney has said "obviously there is a certain amount of unfairness about attempting to sue so many wholly innocent partners, particularly in this case where the innocent partner's were betrayed by one one individual partner."⁶ Additionally, in terms of Alexander Grant's insurance coverage, the amount is now known by several of the cities seeking damages. Such information should never have been disclosed and is detrimental to the relationship between the insurer and the insured. When the amount of the coverage is known, the result may affect the amount of damages sought and the jury decisions as to the amount of the awards. Clearly this confidential knowledge could have an adverse impact on the rates for insurance coverage.

The actual damages to third parties as a result of the failure is quite diverse. Those who have invested in E.S.M. have lost their investment. In addition to the Ohio Bank Crisis, 2 cities and 2 counties who held interests in the now defunct corporation have had their debt ratings downgraded.

Regardless of Alexander Grant's questionable practices, they did not cause the failure of E.S.M. nor did they form an actual relationship with the third parties. The questions decided by the courts would be whether Alexander Grant was responsible to the third parties. The case can be argued for both ways, in that yes, they were as the third parties relied on the results of their audit of the financial statements and no, in that they at no time knew who they were dealing with and had little or no contact with the third parties.

The accounting profession as a whole is also under intense fire for the failure of several other companies who had just been given a clean bill of health in their audit report. This has lead to an increase in the number of lawsuits filed, an increase in the amount of damages sought and even a congressional subcommittee investigation into the integrity of the accounting profession and whether their current form of self-government is adequate. This subcommittee, headed by Michigan Representative John D. Dingell, is trying to determine if

the 50 year-old regulatory system is adequate to deal with today's problems.

Besides the E.S.M. case, there have been many other suits filed. Most of these other cases have no proof whatsoever that the accounting profession is at fault for its client's failure. Many people view the lawsuits as the results of the investors who have lost their investment because of the failure. As a result, the investors feel that somebody must be responsible. They, thus, sue the firm's accountants as this is a group that might be able to subsidize their loss. To many, the accountants are the most logical and responsible for the failure. To top it off, they are often insured and have the "deepest pocket".

The question out of this that arises is whether external auditors (public accountants) are responsible for the failure of the client after they have given them a clean bill of health. One very explicit claim by the auditors is that they don't profess to detect all types of fraud; they only try to make sure the financial statements are close to being accurate with reasonable assurance. Many accountants claim the the public expects them to do too much; that, there is an overexpectation as to what an audit is supposed to do.⁷ When accepting an assignment to audit, the accountants draw up an engagement letter. In this letter it is clearly stated that they do not guarantee the detection of fraud. Victor Earle, general counsel for Peat, Marwick, Mitchell, and Company (the nation's second largest accounting firm), explains that accountants do not try to predict a company's success or failure; and, fraud can be nearly impossible to detect if company officials are collaborating.⁸

However, many firms believe that the increasing number of law suits is a result of some accounting firms who settle their disputes.⁹ These settlements are said to cause potential plaintiffs to think that the firms are willing to settle and thus a larger number of lawsuits are filed. A majority of the plaintiffs are hoping that the defendant will settle out of court. Thus, it is a widespread belief of many of the public accounting firms that they should fight off the suits in hopes of deterring future cases.

Other cases which show the current state of affairs of legal arguments include Peat, Marwick, & Mitchell's (PM&M) audit of Penn Square.¹⁰ It is this case which is said by many to have started the "sue your accountant" trend. The justice department is just one of many groups that is suing PM&M for providing false and fraudulent reports to federal bank regulators. This suit is on the heels of the FSLIC 120 million dollar lawsuit charging that PM&M did not perform a proper audit of Penn Square. As is almost always the case, the defendant is in the process of vigorously defending itself.

One very notable case is that which involved Arthur Young (another big eight accounting firm) and Bell & Beckwith.¹¹ For years, Arthur Young had taken pride in the fact that they have never settled nor lost a lawsuit. But in this case, the cost to defend itself versus settlement was just too much. The economies now often make it cheaper to settle a suit than to clear one's name. Clearly a system as such has many flaws and some action must be taken. Arthur Young in no way was admitting its guilt, but rather they were admitting that proving their innocence was too costly.

Another case involving Arthur Young, is one in which they are being sued by the Bank of England. One top accountant who is dealing with this case, as Arthur Young defends itself, has observed that "it has now become very fashionable to sue the auditors."¹² This statement shows the opinion that what is taking place is not really justice but rather to many some whimsical and outrageous demands placed upon the accounting profession.

There are also several cases in which only injunctions against the accounting firms and no punitive damages are being sought. 2 such separate cases involve Price Waterhouse¹³ (another big eight firm) and Peat, Marwick, and Mitchell.¹⁴ In each case, the Securities and Exchange Commission is seeking a court injunction to prohibit each firm from continuing some undesired practice.

One notable case is that involving Alexander Grant's audit of the Auto-Train Company.¹⁵

In this case, Alexander Grant issued a qualified opinion of the company's financial statements for the years 1978 and 1979. Such an opinion states that because of certain expressed conditions they cannot give a clean unqualified opinion. Even with this, the courts awarded a suit to the plaintiff and Alexander Grant was forced to pay 11 million dollars in damages. This is clearly a case when the auditor stated that because of a given circumstance the financial statements could not be relied upon. When such a statement is not considered a defense, one must ask what must the auditors do to protect themselves.

A final case, which accountants hope will reaffirm a past dying precedent, is one involving Arthur Andersen (the nation's largest accounting firm). Here, a third party was bringing suit against Arthur Andersen. Credit Alliance Corporation was suing Arthur Andersen because of the failure of one of its clients. An original judgment was set for 8.8 million dollars against Andersen, but upon appeal the case was thrown out of the court. The court said that Arthur Andersen was not reliable to a party other than its client because they had not developed a relationship with that third party. This decision is viewed by accountants as being a major victory for the accounting profession.¹⁶ If it holds up in subsequent cases, it can greatly protect the auditor from third parties that dealt with its failed client.

As a result of the case of *Ultramares v. Touche* in 1931, the courts had held for a long time that in such a case the accountants are liable for negligence only to their clients and those whom they know will be relying on their reports. At the time, this case set a precedent and made it very hard for third parties to successfully sue accountants as they had the burden of proving fraud on the accountants part. However, beginning in the 1960's the courts were softening their stance on this matter. Then, in 1963, in *H. Rosenblum v. Adler*, the courts held that accountants could be held responsible to any "reasonably foreseeable third parties" who rely on their reports. Then, further, in 1984, Chief Justice Warren Burger

reaffirmed this new belief that accountants held a higher duty to the public in the case of the *United States v. Arthur Young*. However, all was not finished as the *Credit Alliance v. Arthur Andersen & Co.* case seems to have reaffirmed the *Ultramares* beliefs.¹⁷

The conclusion is to what extent are the auditors responsible for the failure of their clients or the reliability that other parties have placed on the opinion of the financial statements issued by the auditors. Cases point in both directions and there are no laws to govern the situations. Society, as well as accountants, must answer the questions: what are the responsibilities of the auditors; and, what can be done to protect them against several illegitimate claims which have caused both legal expenses and insurance rates to rise.

Another situation which further puts accountants in a bind is what occurred between Peat, Marwick, & Mitchell and their client Berkshire Hathaway, Incorporated. Berkshire dismissed PM&M as their principal auditor and hired Touche Ross (another big eight firm).¹⁸ Their reason for dismissal was because they were dissatisfied with PM&M's inconsistency regarding accounting methods used in two sales of stock held in other companies. They did it one way to avoid a qualified opinion by PM&M, but on a second sale PM&M decided that a different way was more correct. This led to a disagreement and eventually to PM&M's dismissal. So auditors, who are supposed to maintain independence in all matters relating to the examination, must be careful since in doing so they may be let go. This makes it difficult to maintain this independence.

Lee Burton, former editor of the *Journal of Accountancy*, in an editorial for the *Wall Street Journal*, believes that most of the problems in the accounting profession are a result of "double-think".¹⁹ Marketers hired to help accountants to keep a healthy image in public have said that the public should be told that the audit of financial statements are retrospective and should not be relied upon to predict the future. That is to say, they cannot guarantee the absence of all fraud, nor do they give assurance about the competence of

management or the future viability or profitability of the entity. Mr. Burton thinks that most of the misunderstandings will be cleared up if accountants avoid "double-talk" and "double-think".

The rising number of lawsuits are clearly one possible cause for the rising insurance rates but there are also other reasons which indirectly caused the rise in lawsuits as well as reasons which are separate from the lawsuits.

Aggressive competition may be the cause of the increasing number of lawsuits.²⁰ Recently, throughout the accounting profession, there have been numerous changes in auditors as new auditors replaced old ones because they charged less. As a result, prices went down everywhere; and, costs were cut. The firms being audited were cutting costs by changing auditors who said they could perform their audit for less money. As a result, profit margins of the accounting profession as a whole have been reduced. This has made it necessary for the auditors to cut corners and quality on their job in order to cut costs. The trade-off has resulted in audits which are not as complete and do not detect as many errors or irregularities. The lower quality audits cause the auditor's opinions to be more susceptible to error thus leading to more lawsuits for incorrect opinions. To further top it off, the rising number of lawsuits have caused an increase in the insurance rates which further hinders profitability and causes more corner cutting. This circular snowball effect must be stopped to keep the profession attractive to new incoming accountants and to ensure quality.

Other reasons for the insurance rate increases are the poor financial results of the insurance industry as a whole.²¹ As mentioned earlier rates are rising all over as lawsuits have become almost a pastime of America. People are more aware of their rights and claims against insurance companies and are no longer afraid to fight for their money. Insurance companies are being forced to pay out more claim thus hurting their profitability. In addition, for the past few years, insurance companies had been making most of their profits

off of their investments and not the actual processing of insuring. Thus, they were able to charge less than needed to make a profit. However, with the recent decrease in interest rates this aspect of profitability has gone away. In any business, when your profit margin falls, you increase your prices. The insurance industry is doing just this; they are increasing prices for coverage.

Some insurance companies just drop certain types of insurance as they see no possibility for any profitability. This has occurred to many accounting firms. Their past insurer drops them and they are forced to scramble for a new policy; since there is less choice and more risk, they are forced to take unreasonably high rates. Insurance companies are in a position now where they say pay our high rates or go without insurance. It is not really the insurance companies fault; either, they have a right to make a return on their services as they are by no means a monopoly.

The insurance industry also is trying to protect itself and at the same time decrease rates. They have recently proposed a change from handling claims on an occurrence basis to a claims-made basis.²² The occurrence basis policy covers all claims, regardless of when made, against a company in relation to events which occurred while the policy was intact. This basis was hard on the insurers as once you no longer insured a company, you could still be required to pay claims. Insurers found it extremely difficult to estimate how much the potential claims would be; and thus, setting rates was difficult and were usually overstated to protect the insurers from excessive later claims. Additionally, insurers were complaining that they were being forced to provide coverage for events which they never charged for. The new claims-made basis would make it much easier for the insurers to estimate the amount of the potential claims. These policies would cover all claims made against the company while the policy is in effect regardless of when the event which caused the claim to transpire took place. This change in policy basis, however, has not caused the insurance

rates to decrease by much as the other factors have caused insurance to rise by much more than this slight decrease. Also, many states, including Illinois, have not approved a switch to the new claims-made basis. These states have reservations about the amount of protection the policy change would offer to its consumers. Lloyd's of London, probably the most famous insurer, will no longer insure on the occurrence basis. Now, they only insure under the claims-made basis.²³

All examples that have been mentioned so far involved only the large Certified Public Accounting firms. Does this mean that only large accounting firms are being affected by the increase in insurance rates. The answer is no. Rather the small and medium sized firms are being affected even more, although possibly unjustly. Currently, only publicly-held companies registered with the Securities and Exchange Commission are required to have their financial statements audited. These audits and failures thereof are what cause the mass amount of third-party lawsuits. Small and medium sized firms rarely have any SEC clients. Their prominent clients are individuals, partnerships, and privately-held corporations. In a survey of 30 CPA Chicagoland firms conducted by the author of this paper, (see appendices A, B, & C) the smaller sized companies had very few SEC clients. Of the 11 companies that replied to the survey, 10 would be considered small or medium. (none of the big eight firms replied to the survey; but because of the extreme competition among these eight, it can be understood why they wish to keep their information confidential) All 10 of these firms were experiencing increases in insurance rates from 1984 to 1985 ranging from 19% to over 600%. This can be added to the fact that the amount of coverage decreased. Most of these firms believed that part of the rise in insurance rates was due to the increase in lawsuits filed against accounting firms. But not one firm felt that the rise in its rates was due to lawsuits filed against it. These 10 firms estimate that their rates will increase from 20% to 900% in the upcoming year. One firm specifically blames the rise in insurance rates on

lawyers who are out looking for cases as they are working on a contingent fee basis. When asked what size of firms are being affected the most by the rising rates, 8 out of 9 of these small and medium firms said that small firms were. These firms believe that they will be forced to merge with larger ones in order to survive. Some also believe that they are unfairly carrying the burden for the increase in lawsuits against the larger firms. It is much harder for small firms to pass on increases in fees needed from insurance through to their clients. They will be forced to absorb the loss and in many cases will not be able to. The effect of these increases has caused 8 of these 10 firms to raise their billing rates. In doing so, however, they run the risk of losing some of their clients. 7 out of these 10 firms have had lower profitability. As mentioned earlier, this causes corners and costs to be cut thus hurting the quality of the work performed. Only 2 of the 10 firms have resorted to billing for more hours worked so as to maintain profitability and combat this rising insurance cost. Overall, these small firms are hurting just as much as the big firms and some action must be taken.

Several possible solutions are in the works in hopes to combat the rising rates for accounting professional liability insurance as well as for all insurance in general. These solutions require some agreement with the government, most likely by legislation. However, the insurance industry is vehemently opposed to governmental interaction through rate regulation.

One such proposal is being discussed by U.S. Senator Paul Simon [D., Ill.]. He is sponsoring legislation intended to strip insurance industry exemptions from federal anti-trust laws in order to curtail the sharply increasing rates.²⁴ Simon believes that the federal regulation is needed in order to prevent insurance companies from fixing prices or agreeing to avoid providing coverage for certain industries. Insurers claim that they are not setting price agreements or agreements not to handle high risk areas. The insurance

companies say that legislation which recommends rates and policy guidelines would actually hurt competition.

Another alternative solution to the problem of rising insurance rates as a whole, which is currently being considered by Illinois Governor James Thompson would be to modify tort law.²⁵ This method, favored by insurers, would enable the business community to get commercial insurance at reasonable prices and also aid local government. However such a plan would limit the rights that an individual consumer would have against the business and in effect possibly promote corrupt practices by business.

Another solution that is being suggested is limiting the amount of fees a lawyer can receive.²⁶ This proposal is put forth by the people that believe the increasing amount of legal activity is a result of money hungry lawyers who encourage their clients to sue at the drop of a hat. They also believe that lawyers working on a contingent fee basis, often advise their client to seek higher damages. Such a cap on fees might limit the amount of damages but it is questionable if the number of cases would drop. The ambulance chasing lawyers may not be discouraged by such a plan.

Still, another alternative solution is to put a cap on the amount of the awards that juries can make.²⁷ Such a cap may discourage lawsuits and would certainly cause the amount of damages sought to be reduced. Also, this would in effect limit the fees for the lawyers working on a contingent fee basis. However, such set caps could be very nominal to some companies while extremely detrimental to others. The companies to which the maximum capped damage is relatively small might find it more cost efficient to commit an act against the will of society. Such a plan should be considered carefully and allow for exceptions. The question is who deserves more protection, big business or the small consumer.

Yet, another plan involves modifying the doctrine of comparative negligence.²⁸ This would allow the defendant in a case to pay for only his share of the negligence when several

parties are involved. This would be good when the plaintiff is partially negligent for the injury; however, in situations in which several business are being forced to split the difference, this would have very little effect as the same amount would be paid by the insurance companies, but only on the behalf of different insurees. Such a plan has its good points but does not appear to be an answer to the problem.

The "deep-pocket" theory states that some judges and juries award unreasonably high awards to injured parties because they view the insurance companies as being able to pay the high awards. The elimination of this theory would be a great help in limiting the number of extremely high awards and shocking verdicts.²⁹ This would cap the total amount of damages and protect the insurance companies from these illogical juries. Accountants are viewed by many as having the deep pockets.

The above proposals all involve limiting the liability of the defendant. Specific negligent area which may not be limited, and probably shouldn't be, are awards for medical costs. However, punitive damages for pain and suffering are an ideal place where limits can be created and unreasonable lawsuits avoided.

Another way which would definitely limit the number of lawsuits brought to court would be a penalty for frivolous lawsuits.³⁰ These lawsuits not only waste the courts time, but when lost, they cost the plaintiff some money in terms of lawyer and court fees. And it has often been the case where the plaintiffs prevail from such obviously frivolous cases. One such example is that which occurred in California. Someone was standing in a phone booth and a drunk driver came along the street and jumped the curb and smashed his car into the phone booth. The injured individual who was in the phone booth sued the phone company and won. This case exemplifies how the courts can sometimes go too far. A penalty for bringing the cases to court would help cut down on the number of these lawsuits; people would be afraid to take a chance on something that is too far fetched. It would also free up

some time in our already overloaded judicial system. A commonly suggested penalty is requiring the plaintiff to pay the defendant's legal costs. The drawback is, though, it might discourage several individuals from seeking legal remedies to situations in which they are afraid they might lose. This in effect might enable the large companies to scare individuals into not suing. This trade-off is well worth considering.

Consumer advocate Ralph Nader also has his eye on the insurance problems. His solution calls for a federal investigation into the insurance crisis. Included in his plan would be for governmental regulation and a federal reinsurance program that would provide those who can't get insurance with it.³¹ From a global point of view, this may be a good solution, but as is often the case, the governmental body may get caught up in red tape and swayed by the lobbying of interested parties. Furthermore, such a plan does not deal concretely with the astronomical rise in insurance rates.

These solutions are more for society's problem of rising insurance rates on a whole and they would have some benefits and adaptability to the accounting problem. Presently, the American Medical Association (AMA) is also proposing solutions for their rising insurance rates.³² The medical profession's problems are very similar to that of accountants; they are trying to protect themselves from the liability imposed upon them for malpractice. Their proposals include several modifications and refinements of those mentioned earlier.

One such modification proposed by the AMA ties in with limiting the contingent fees received lawyers by establishing a percentage amount that decreases as the amount of the award increases. This change improves the earlier idea, and would not discourage lawyers from representing clients with little to gain.

The AMA also hopes to eliminate awards for punitive damages. This would be detrimental to the public as the punitive awards serve a purpose in that they discourage negligence on the part of the doctors and encourage careful preparation and care. The AMA also favors

limiting the amount allowed for pain, suffering, and mental anguish. Their proposal also calls for penalizing frivolous lawsuits and additionally setting some mechanisms to screen out groundless lawsuits before they go to trial.

The American Bar Association (ABA) has expressed their displeasure with the AMA's proposal.³³ They believe that the medical profession is just seeking special treatment and that enactment of their plan would be grossly unfair to the public as a whole. The view of the ABA is that there is no need for restructuring of the tort law and that limiting liability would not be in the public's best interest. They can accept penalties for frivolous lawsuits but argue that setting up screening mechanisms would create injustice; and that, it is the courts who should decide the validity of cases. The ABA also says that in recent years the costs to physicians relating to malpractice insurance have stabilized and are no longer a great concern as the medical profession appears to have adjusted. The ABA goes on to further say that it can live with overall tort reforms as long as they apply to everyone and not just doctors.

In tying this in with accountants, the situation is slightly different. They are now experiencing what the doctors experienced a few years ago. However, adjusting to the rising rates may have an even greater negative effect upon accountants since the insurance industry as a whole is in a state of turmoil. The proposals above if structured and interwoven correctly, could solve the problem for both accountants and others affected by the insurance crisis. Additionally, there are more alternatives that have not yet been mentioned but could easily be structured to benefit accountants as well as others.

Currently in the United Kingdom, accountants are facing a similar problem of rising insurance rates and a rising number of legal disputes against them. It has been already said that the current insurance industry is not only raising their rates but also cutting the amount of coverage provided. Once this amount of coverage is exceeded, the party seeking

indemnification goes after the partnership's assets and if still not satisfied may go after each individual partner's assets. This unlimited liability is the basis of partnership law. Further accountants are not allowed to incorporate and must therefore always retain personal liability. Because of this fact and that fact that insurers are no longer willing to underwrite large-loss policies regardless of the premium, accountants in the UK are seeking legislation that would allow them to incorporate.³⁴ This would limit their potential loss to that of their investment and personal assets would be shielded. From an objective point of view, it seems that accountants should not be personally liable for an act of fraud by another party of which they knew nothing. Furthermore, if their partnership is sued it would be punishing enough to lose one's job, one's investment in the partnership (which is somewhat substantial), and most likely tarnishing the individuals reputation. Additionally, accountants should be able to protect themselves from their investments just like anyone else can. There could still be the instances similar to the piercing of the corporate veil in cases where one or a few of the parties are grossly negligent.

There is, however, a valid argument from the point of view that incorporation should not be allowed. Some people believe that accountants should be personally held liable for their actions in a partnership as they are playing an active role in the day to day activities and providing personal services. The independent auditor is considered by many a surrogate on behalf of the public.

At the present time, in West Germany, accountants are allowed to incorporate and they have limited liability. This limited liability is usually a fixed multiple of the audit fee. This plan in West Germany appears to be successful in terms of protecting the accountants from large losses.³⁵

In the UK, Mr. Jenkins, of the Accounting Institute there, has made notice of the fact that the mounting lawsuits are viewed even by objective third parties as being

unreasonable. This is evidenced by the fact that the outside insurance companies will in some cases no longer provide insurance no matter what the premium is.³⁶

And yet, another plan to prevent lawsuits was developed by Price Waterhouse.³⁷ This plan involves the creation of a self-regulating body underneath the SEC that monitors the accounting profession. One of the goals of this body would be to strengthen the audit process to improve fraud detection. If this were to occur, it would most likely cut down on the number of lawsuits filed. Additionally, the Price Waterhouse plan calls for federal legislation to limit the liability of outside auditors stemming from financial collapses of companies. Included in their plan would be sanctions for bad audits which might include suspension or ban from practice. Price Waterhouse's chairman, Joseph E. Connor, has stated that "the economic viability of the profession hangs on whether we can bring some sanity to the liability process." Currently the total claims against accounting firms are for more than 2 billion dollars whereas the total aggregate value of the accounting firms are around 500 million dollars.³⁸

The profession is responsive to Price Waterhouse's suggestions for stiffer audits and liability caps, but they are against the thought of a self-regulatory body under the SEC. Many accountants believe that such a group would only further create problems and messy red tape. They see such a group as really being unnecessary.

Also working on the problem is the American Institute for Certified Public Accountants (AICPA). They have set up a committee to study how to limit an accounting firm's liability exposure through new legal approaches or through federal and state legislation.³⁹ Seven years ago the AICPA instituted the peer review program (a system in which members of the accounting profession monitor the activities and procedures of a firm to ensure quality). This program, although successful, has not prevented audit failures, resulting from the lack of quality, to the extent hoped.

Then, there is the alternative of self-insurance.⁴⁰ Many firms have resorted to this not because they wanted to, but because they had no alternative. Through such a plan the firm sets up funds to pay potential claims. These funds would be invested until the claims needed to be paid. However, such a plan poses a problem for the accounting profession. As noted earlier, there is a ratio of 4 dollars of claims to every 1 dollar of capital. But for small and medium sized firms which never have been sued and are in effect helping to pay for the lawsuits of the larger companies, this alternative is quite viable.

Setting of a captive is another choice.⁴¹ Although this is a complicated solution, it is very attractive to many businesses. A captive is in essence a new insurance company. Firms within a given industry or profession which are experiencing the same types of problems would band together to form this sort of group self-insurance company. They would in effect be setting up a group fund to pay for any claims that might arise against the members of that fund. This plan has many advantages and could be the best solution for accountants; but, complete cooperation among the members of this plan is vital.

On an individual basis, it has been recommended to some firms that they sell themselves to the insurers.⁴² To do so, such a firm would show the potential insurer what its strong points were and why it would "beat the averages" and deserves a lower rate for coverage. This process requires the firm to pinpoint its problem areas and deal with them. This solution only solves the problem for an individual firm and not the current insurance crisis that all firms are experiencing. Not everybody would be able to sell themselves to insurers, their situations might still be too risky.

A solution which does not solve the rising rates problem but does solve the problem for firms who can't find any insurance is to turn to professional associations.⁴³ These associations guarantee insurance for all of its members, although they are not actually the insurers. Currently, this is where the biggest activity among certified public accountants is

taking place. This AICPA plan is also experiencing large rate increases as premiums have increased 100% in the last year. And, the underwriters of this plan notified the AICPA that they would be dropped at the end of 1985 unless, they accepted further increases in rates and the size of deductibles.

A final course of action which should be done in all cases, but would not immediately solve the problem, would be to focus on ways to minimize liability exposure.⁴⁴ This could be done by constantly reviewing the adequacy of a firm's accounting controls and procedures. When determining the price for a particular engagement, the accountant should look closely at the risks present and set his fee accordingly. Accountants should also try to limit the reliance that third parties place on their opinions of the financial reports. Their opinion should include the purpose of their examination, a list of those who should rely on the report, and a disclaimer of liability to all third parties. These actions could decrease the number of lawsuits against accountants and in the long run help solve the problem.

Of these many solutions, the survey detailed earlier polled the Certified Public Accounting firms on the methods that they favored. Only 1 of 10 firms favored government regulation by limiting the amount that insurance companies can charge as a solution to the increasing rates. Whereas, 9 of 10 firms are in favor of putting a limit on the amount that can be awarded in a lawsuit. This is clearly the course of action that accountants feel would best control the rising rates. Only 2 of 10 firms viewed allowing public accounting firms to incorporate as a solution; only 1 of the 10 firms favored self-insurance.

When asked if they planned to take any actions against the rising rates, 7 of the 10 small and medium sized firms replied that they intended to do so. Expected courses of actions to reduce liability insurance rates ranged from better quality control, to research into the feasibility of forming a captive (insurance pool) with other firms. Some firms expected to do nothing more than locate an alternate insurer or increase their deductible. One firm detailed

a plan that was being organized by a California firm which involves getting 400 quality firms together to apply for coverage from two groups that are currently underwriters for Lloyd's of London. These firms are becoming more aware of this increasing problem and are looking for solutions.

It is clear that a serious problem exists not only for accountants but for everyone who desires insurance. Something must be done; and, it must be done soon. Small businesses as well as accounting firms are in serious trouble as profitability decreases and the attractiveness of entering into these businesses is seriously diminishing. A combination of the above plans should be implemented in hopes of driving down rates and decreasing unnecessary lawsuits. At the same time, though, one should not lose sight of what is in the public's best interest. The specific functions that accountants perform are important to society. The accounting profession is needed and is here to stay. However, as the profitability declines, so will the quality of the accountants work. Accountants as a group must ban together to study the possible alternatives and to formulate a plan that will ensure a strong and continuous future for their profession. They must realize that their quality of work should improve thus increasing the reliability of their audit reports. This, coupled with increasing the public's awareness of what they do, will help decrease the number of legal actions partaken against the accounting profession. Accountants should realize, though, that they are not in the boat alone. They should realize that some of the solutions might be easier to implement and sway public and governmental opinion if they are for the benefit of all and not just a few. Accountants are skilled at weighing the costs and benefits of a solution; they are also skilled at working with others. It is these skills that accountants should look to in order to solve their individual insurance woes as well as the crisis facing others.

Endnotes

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- ²"Financier Sues Grant over E.S.M. Audits," *Chicago Tribune*, 14 May 1985, Sec 3, p. 3.
- ³"Financier Sues Grant over E.S.M. Audits," p. 3.
- ⁴"E.S.M. Trustee Sues Ohio Financier, Associate for \$12 Million," *Chicago Tribune*, 1 October 1985, Sec 3, p. 1.
- ⁵James Ring Adams, "How Ohio's Home State Beat the Examiners," *Wall Street Journal*, 3 September 1985, p. 18.
- ⁶"500 at Grant 'Could Be Liable' in E.S.M. Case," *Chicago Tribune*, 6 September 1985, Sec 3, p. 6.
- ⁷Sallie Gains, "The Continuing Controversies in Audits," *Chicago Tribune*, 5 May 1985, Sec 7, p. 3.
- ⁸Work, p. 54.
- ⁹Work, p. 54.
- ¹⁰Andy Passtor, "Justice Department Sues Peat Marwick, Charging Fraud on Penn Square Audit," *Wall Street Journal*, 5 July 1985, p. 4.
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- ¹²"Britain Plans to Sue Arthur Young & Co.," *Wall Street Journal*, 21 June 1985, p. 2.
- ¹³"Price Waterhouse, 3 Partners Charged by SEC over Audit," *Wall Street Journal*, 21 June 1985, p. 2.
- ¹⁴Pastor, p. 4.
- ¹⁵Alexander Grant Assessed \$11 Million in Lawsuit," *Wall Street Journal*, 22 July 1985, p. 4.
- ¹⁶Lee Berton, "State Court Ruling for Arthur Andersen Is Seen as Major Victory for Accountants," *Wall Street Journal*, 22 July 1985, p. 4.
- ¹⁷Stephan H. Collins, "Professional Liability: The Situation Worsens," *Journal of Accountancy*, November 1985, pp. 59-60.

- ¹⁸Berkshire Hathaway Dismisses Its Auditor in Accounting Dispute," *Wall Street Journal*, 8 July 1985, p. 29.
- ¹⁹Lee Burton, "Double-Entry Doubletalk," *Wall Street Journal*, 17 September 1985, p. 16.
- ²⁰Sallie Gains, "The Insurance Crisis: Why?," *Chicago Tribune*, 15 December 1985, Sec 7, pp. 1&4.
- ²¹Work, p. 34.
- ²²Sallie Gains, "Why Some Insurers Won't Sell Insurance," *Chicago Tribune*, 16 June 1985, Sec 7, pp. 1&4.
- ²³Sallie Gains, "Why Regulators Fear New Insurance Policy," *Chicago Tribune*, 20 October 1985, Sec 7, pp. 1&4.
- ²⁴R. Bruce Dold, "Insurance Crisis Has Simon Pulling Out Antitrust Weapons," *Chicago Tribune*, 7 February 1986, Sec 2, p. 2.
- ²⁵Dave Schneidman, "Thompson Urges Action on Insurance," *Chicago Tribune*, 9 February 1986, Sec 2, p. 2.
- ²⁶Schneidman, p. 2.
- ²⁷Schneidman, p. 2.
- ²⁸Schneidman, p. 2.
- ²⁹Schneidman, p. 2.
- ³⁰Matt O'Connor, "Liability Insurance Battle Lines Drawn," *Chicago Tribune*, 16 March 1986, Sec 7, pp. 1&4.
- ³¹R. Bruce Dold, "No Payoff Yet in Insurance Crisis," *Chicago Tribune*, 3 December 1985, Sec 2, p. 4B.
- ³²Joseph Taylor, "AMA's Malpractice Stand Ripped by Lawyers," *Chicago Tribune*, 10 February 1986, Sec 1, p. 3.
- ³³Taylor, p. 3.
- ³⁴George Anders, "UK Accountants May Incorporate to Ward Off Suits," *Wall Street Journal*, 28 June 1985, p. 22.
- ³⁵Anders, p. 22.
- ³⁶Anders, p. 22.

³⁷Price Waterhouse, "Comments and Issues," *Accounting Trends and Events*, November 1985, pp. 2-4.

³⁸Lee Berton, "Price Waterhouse Urging Formation of Groups to Regulate Accounting Firms," *Wall Street Journal*, 20 November 1985, p. 10.

³⁹Walter Stock, "Letter to the Participants in the AICPA's Professional Liability Insurance Program," *American Institute of Certified Public Accountants*, 30 June 1985, pp. 1-2.

⁴⁰Sallie Gains, "Insurance Squeeze Molds Alternatives," *Chicago Tribune*, 26 January 1986, Sec 7, pp. 1,5&6.

⁴¹Gains, "Insurance Squeeze Molds Alternatives," p. 6.

⁴²Gains, "Insurance Squeeze Molds Alternatives," pp. 5-6.

⁴³Gains, "Insurance Squeeze Molds Alternatives," p. 5.

⁴⁴Collins, p. 64.

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Blank Example of Survey

Appendix A

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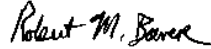
December 9, 1985

Department of Accountancy
Northern Illinois University
DeKalb, IL 60115

Dear sir:

I am currently a senior at Northern Illinois University majoring in accounting and enrolled in the university's Honors Program. As part of my requirements to graduate with honors, I must complete a senior capstone project. For this project, I have chosen to investigate the future of Accounting Professional Liability Insurance rates. In order to assist me with this project, I am conducting a survey of many different sized CPA firms and many insurance companies. Enclosed is a short questionnaire. Would you or another member of your firm familiar with professional liability insurance respond to this questionnaire? A preaddressed envelope is enclosed for return mailing. I appreciate your assistance in taking the time to assist me. The questionnaire is numbered for follow up purposes. Your response will be kept strictly confidential. Once again, thank you.

Sincerely,



Robert M. Bower

Accounting Major at N.I.U.

Survey on Accounting Professional Liability Insurance

Firm _____

1. How many professional staff does your firm employ? _____
2. Approx. how many SEC clients do you have? _____
3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983 \$ _____

1984 \$ _____

1985 \$ _____

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average
5. How long have you been insured by your present insurer?
6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

7. Have changing insurance rates affected your firm, in terms of:

Higher billing rates yes no

Lower profitability yes no

More billable hours yes no

Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways?

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

Thank you for your time. Please return questionnaire in self addressed envelope.

Summary of Survey Results

Appendix B

SURVEY RESULTS				
Name of firm				
Size of professional staff	52	-	150	3000
Number of SEC clients	5-10	0	2	300+
Insurance Rates Per \$100,000				
1983	\$70	\$4,948	\$100	-
1984	\$140	\$5,455	\$110	-
1985	\$1,000	\$17,500	\$154	-
%Δ from '83 to '84	100.00%	10.25%	10.00%	-
%Δ from '84 to '85	614.29%	220.81%	40.00%	-
Expected % Δ for 1986	200-300%	300.00%	400.00%	25.00%
Firms view of extent of coverage	Above Average	Average	Above Average	Average
Length of present insurer	> 20 Years	> 7 Years	> 10 years	10 Years
Rates have caused:				
Higher billing rates	YES	NO	YES	NO
Lower profitability	YES	YES	NO	NO
More billable hours	NO	NO	NO	NO
other				
Agree with statement B	In part	NO	Didn't Underst	NO
Additional comments	See Survey			See Survey
View largest impact upon comments?	Small Firms	Small Firms	Small Firms	Everyone
Planned actions comments?	See Survey	See Survey	See Survey	None
Ways to reduce:				
Rate caps	NO	NO	NO	NO
Law suit Caps	YES	YES	YES	YES
Self-insurance	NO	NO	NO	NO
Incorporation	NO	NO	YES	NO
other	None	None	None	None
Agree w/ # 12	NO	NO	NO	NO
additional comments:	YES	YES	YES	YES

Completed Surveys

Appendix C

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 110 (150 total)

2. Approx. how many SEC clients do you have? 5

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$ <u>200</u>
1984	\$ <u>413</u>
1985	\$ <u>1500</u>

4. How extensive do you believe your coverage to be:

far above average above average average below average well below average
average for industry but not as comprehensive as we could like

5. How long have you been insured by your present insurer? 8 months

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)? 25%

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

We view the problem as one attributable to a climate in the courts that holds corp's (and other companies) unfairly accountable for misuse of their products/services and with a 30:14 verdict is reached, the amount of damages is unrealistically high.

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways? they won't be able to get coverage
and/or won't be able to afford what
they can get.

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

1. Better quality control
2. Research feasibility of forming a part of other firms

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

DISAGREE

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 45

2. Approx. how many SEC clients do you have? 10

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	<u>184</u>
1984	\$	<u>269</u>
1985	\$	<u>754</u>

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer? IN EXCESS OF 10 YEARS

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

900%⁹⁷

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

NO VIEW

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways? Cost & availability of insurance

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

Yes - shape the market as best as possible.

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

✓ Rate caps (a specific limit which insurers are allowed to charge)

✓ Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

No

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 45
2. Approx. how many SEC clients do you have? 8
3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?
- | | |
|------|-----------------|
| 1983 | \$ <u>1,000</u> |
| 1984 | \$ <u>1,000</u> |
| 1985 | \$ <u>4,000</u> |
4. How extensive do you believe your coverage to be:
far above average above average average below average well below average
5. How long have you been insured by your present insurer?
2 1/2
6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?
100%
7. Have changing insurance rates affected your firm, in terms of:
- | | | |
|----------------------|------------|-----------|
| Higher billing rates | <u>yes</u> | no |
| Lower profitability | yes | <u>no</u> |
| More billable hours | yes | <u>no</u> |
- Other (please specify)
8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?
yes

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways?

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

yes, As the previous.

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

NO

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 70

2. Approx. how many SEC clients do you have? NONE

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	<u>3600</u>
1984	\$	<u>4500</u>
1985	\$	<u>6800</u>

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer?

3 YEARS

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

400/300%

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

PARTLY

9. Rising insurance rates will have the largest impact on: *NOT QUALIFIED TO ANSWER*

small firms

medium sized firms

large firms

In what ways?

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

Joined PCPS - PASSED PEER REVIEW IN 1984

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

NO — WE HAVE NEVER BEEN SUED

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 300
2. Approx. how many SEC clients do you have? 300
3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	_____
1984	\$	_____
1985	\$	_____

4. How extensive do you believe your coverage to be:
 far above average above average average below average well below average

5. How long have you been insured by your present insurer?

10 years

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

25%

7. Have changing insurance rates affected your firm, in terms of:

Higher billing rates	yes	<u>no</u>
Lower profitability	yes	<u>no</u>
More billable hours	yes	<u>no</u>
Other (please specify)		

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

larger firms always on a claims made basis

9. Rising insurance rates will have the largest impact on:

- small firms
- medium sized firms
- large firms

In what ways? *business*

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

- Rate caps (a specific limit which insurers are allowed to charge)
- Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

No

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? _____

2. Approx. how many SEC clients do you have? NONE

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	<u>4948</u>
1984	\$	<u>455</u>
1985	\$	<u>17500</u>

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer? 10-1-78

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)? 300%

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)? No

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways? Will not be able to pass increases to clients in terms of higher billing rates and will not be able to absorb this high cost in current profits

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

It may not be possible to take any action to reduce rates, we have some control over quality control but it may not reduce rates

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

NO it is not the claims against our firm but the industry as a whole and the amount of the awards being given in court cases. In addition there are too many cases without merit that are being filed against accountants by attorneys working on contingency fee basis, while we as accountants must pay our attorneys large fees to defend us.

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 52

2. Approx. how many SEC clients do you have? 5 to 10

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	42 70
1984	\$	140 140
1985	\$	1,000

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer?
Over 20 years

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?
200 to 300 %

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

Only in Part - This has caused part of the problem but frivolous suits and a lack of understanding of our profession by the courts are also heavily to blame

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways? *Because of the inability to handle the cost under their fee structure and the inability to pass the cost on to clients.*

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

1 - Getting a group of regional firms to form their own off-shore insurance company

2 - Working with a California firm that is trying to get 400 quality firms together to apply to two underwriters at

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates: *Things that have an interest*

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm. *No*

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 65

2. Approx. how many SEC clients do you have? 1

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage? ANNUAL PREMIUM \$10,000 COVERAGE

1983	\$ <u>8,504</u>
1984	\$ <u>18,354</u>
1985	\$ <u>21,890</u>

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer?
UNKNOWN HOWEVER WE HAVE HAD THE SAME ORGANIZATION FOR THE YEARS COVERED IN YOUR SURVEY

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?
\$6,8750 FOR \$5,000,000 COVERAGE

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates yes no
- Lower profitability yes no
- More billable hours yes no
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?
THE U.S. HAS BECOME A LITIGIOUS SOCIETY AND AS THE SITUATION HAS BEEN WITH OTHER FIRMS OF PRODUCT LIABILITY INSURANCE THE ACCOUNTING PROFESSION HAS BECOME THE PARTY VIEWED AS BEING THE ONE VIEWED "HAVING DEEP POCKETS"

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways? THEY WILL PROBABLY LIMIT THE WORK THEY PERFORM AND SUBSEQUENTLY MERGE WITH OTHER LARGER FIRMS TO PROTECT THEMSELVES. THIS COULD NUMBER THE DAYS OF THE SOLE PRACTITIONERS

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

YES BUT THEY CONSIST OF NOTHING MORE THAN LOCATING AN ALTERNATE CARRIER

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

THERE HAVE BEEN NO CLAIMS AGAINST THE FIRM. THIS INCREASE IN RATES SEEMS TO BE A TREND IN TERMS OF LARGE SETTLEMENTS BROUGHT AGAINST PUBLIC ACCOUNTING FIRMS.

Thank you for your time. Please return questionnaire in self addressed envelope.

IF YOU HAVEN'T DONE SO, YOU MAY WANT TO CONTACT ROLLINS, BIRDICK, HUNTER (605 THIRD AVE NY, NY 10158 - (212)-661-9000) WHICH ADMINISTERS THE AICPA INSURANCE PLANS INCLUDING THE PROFESSIONAL LIABILITY PROGRAM.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 15

2. Approx. how many SEC clients do you have? 10

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983 \$ _____

1984 \$ _____

1985 \$ _____

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer?

7 yrs

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

50%

7. Have changing insurance rates affected your firm, in terms of:

Higher billing rates yes no

Lower profitability yes no

More billable hours yes no

Other (please specify)

8. Do you view the present insurance rates as a result of an Industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

Yes

9. Rising insurance rates will have the largest impact on:

- small firms medium sized firms large firms

In what ways?

Larger firms who have more \$k claims will not be
as much impacted in expenses as their claims - smaller firms
will pay

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they? *no*

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

no

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 145
2. Approx. how many SEC clients do you have? None
3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?
- | | | |
|------|----|---------------------------|
| 1983 | \$ | <u>473.⁰⁰</u> |
| 1984 | \$ | <u>484.⁰⁰</u> |
| 1985 | \$ | <u>1124.⁰⁰</u> |
4. How extensive do you believe your coverage to be:
 far above average above average average below average well below average
5. How long have you been insured by your present insurer?
More than 5 years
6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?
Don't know - 10 to 30%
7. Have changing insurance rates affected your firm, in terms of:
- | | | |
|------------------------|------------|-----------|
| Higher billing rates | <u>yes</u> | no |
| Lower profitability | yes | <u>no</u> |
| More billable hours | yes | <u>no</u> |
| Other (please specify) | | |
8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?
Don't know

9. Rising insurance rates will have the largest impact on:

small firms

medium sized firms

large firms

In what ways?

Can they pass the additional costs to their clients.

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

Increase deductible amount.

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates: *Don't know*

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

No

Thank you for your time. Please return questionnaire in self addressed envelope.

Survey on Accounting Professional Liability Insurance

1. How many professional staff does your firm employ? 100

2. Approx. how many SEC clients do you have? 2

3. What have your approximate professional liability insurance rates been in the past three years per \$100,000 of coverage?

1983	\$	<u>100</u>
1984	\$	<u>110</u>
1985	\$	<u>132</u>

4. How extensive do you believe your coverage to be:
far above average above average average below average well below average

5. How long have you been insured by your present insurer?

10 years

6. How much do you expect your Accounting Professional Liability Insurance rates to rise in the coming year (in percentage)?

2-3%

7. Have changing insurance rates affected your firm, in terms of:

- Higher billing rates (yes) no
- Lower profitability yes (no)
- More billable hours yes (no)
- Other (please specify)

8. Do you view the present insurance rates as a result of an industry crisis causing a transition to a claims made basis, i.e. from a system in which the policy covers all lawsuits filed as a result of events occurring while that policy was in effect to a system in which a policy only covers claims made against the company while the policy is in effect (the current policy at that time)?

Don't understand question

9. Rising insurance rates will have the largest impact on:
small firms medium sized firms large firms

In what ways?

Yes, Rising insurance rates will have to be passed on to clients

10. Do you plan to take any actions to reduce your professional liability insurance rates? If so, what are they?

~~Yes~~

11. Which of the following actions would be effective in reducing the cost of professional liability insurance rates:

Government regulation by:

Rate caps (a specific limit which insurers are allowed to charge)

Lawsuit caps (limits as to amount that can be awarded in a lawsuit)

Self-insurance

Allowing public accounting firms to incorporate

Other (please specify)

12. Do you agree with the following statement: My insurance rates have increased as a result of more claims made against my firm.

We have never had a claim against our firm so far

Thank you for your time. Please return questionnaire in self addressed envelope.

**Top Eight Accounting Firms
(The Big Eight)**

Appendix D

The Big Eight
(in alphabetical order)

1. **Arthur Andersen and Company**
2. **Arthur Young and Company**
3. **Coopers and Lybrand**
5. **Ernst & Whinney**
6. **Peat, Marwick, Mitchell, and Company**
7. **Price Waterhouse**
8. **Touche Ross**

