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Accounting Law Bulletin

RESPONDING TO THE HANDWRITING ON THE WALL

The handwriting on the wall is clear: the days of a growing economy have come to an end (at least for the foreseeable future), and this nation is likely to experience a period of economic hardship. Even if the economic stabilization legislation works as hoped, property values will continue to fall and credit availability will continue to contract. Equally important, American consumers are tapped out. Many have no savings, have depleted the equity in their homes and have maxed out their credit cards. Since consumer spending represents roughly two-thirds of the American economy, the coming (if not current) recession is likely to affect a broad spectrum of the economy, with sales contracting in virtually every industry. Particularly hard hit will be businesses that are highly leveraged and those with high fixed costs. The necessary credit may not be available to sustain the operations of the former, and the latter group will not be able to reduce their costs in the face of decreased demand for their products. Thus, a large number of your clients are likely to incur substantial losses and some will be forced out of business.

Not only is this likely to reduce firm revenues and make client collections slow, it is likely to spawn a large number of accounting malpractice claims, which can have a devastating effect even on firms whose practices are in full compliance with professional standards. This means that all accounting firms must reevaluate their own operations and take steps to fortify their practices against the adverse conditions they are likely to face over the next few years.

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Experience shows that professional liability litigation generally comes 18 to 24 months after the economy dips into a recession. This means that a malpractice litigation is likely to arise out of the work your firm performed between January 2008 and December 2010. This will be the critical period. Therefore, accounting firms, in order to protect themselves, must check their past work as well as exercise extreme care in their future activities.

Managing Risk

Perhaps the most effective means of avoiding liability claims is to drop those business clients that are likely to fail. Whether or not an accounting firm has performed admirably for such clients, if the client is forced into bankruptcy, the chances of the firm's being sued by the client's creditors and/or shareholders is better than even. Thus, by dropping these clients immediately, a firm is less likely to be left standing when the music stops. Moreover, when faced with declining fortunes, many businesses resort to overstating their earnings and financial position in order to maintain their customers, suppliers and lines of credit. Because of the increased likelihood that the client's financial position and earnings will have been misstated, there is a greater probability that the accounting firm will be sued when that client fails.

The industries that are likely to be the most adversely affected in the months to come will be the real estate and construction industries, which have been in steep decline for the past twelve months. Their prospects remain bleak and will likely not improve for at least two more years. Most segments of the retail industry are also likely to be hard hit. The retail industry depends upon consumer spending, which is likely to be seriously curtailed for the immediate future. Similarly, the restaurant and tourism industries are likely to suffer greatly in the coming months. Nor will manufacturing be spared in this recession. Manufacturers' high fixed costs and dependence on financing will place them in serious financial jeopardy. Even those manufacturers that export their products will also likely be adversely affected because the recession that started in this country is spreading abroad. Although the healthcare and pharmaceutical industries are perhaps best situated to weather the current economic downturn, they too are faced with the prospect of legislative action that may adversely affect them. Accounting firms of all sizes will have to consider the likely effects of the recession on the industries of each of their clients.

One of the cardinal rules for avoiding liability claims is not to make the client's problems your problems. This means that all engagements must be performed with strict adherence to the standards of the profession and that accounting firms not allow themselves to help a client in trouble by (a) overstating the value of its assets, (b) understating its actual or contingent liabilities or (c) by otherwise assisting the client in misleading its customers, creditors or suppliers. Every accountant has longstanding clients, and the temptation to help such clients weather a financial storm is often great. Thus, not only should it be firm policy not to go out on a limb for a client during the coming months, but the firm must adopt controls to make sure that its partners, out of a sense of misguided loyalty, do not violate this policy. This will require all financial statement engagements to be reviewed by the firm's quality control department, which should be instructed to report to the firm's management any and all potential misstatements.

Conversely, firms should carefully limit their audit and financial statement practices as these areas are the most likely to give rise to liability claims.

If possible, accounting firms should also seek to steer their practices into those practice areas that are least prone to liability claims. This would include litigation support services, which are likely to experience explosive growth over the next few years. Tax advisory services are also likely to be in high demand as clients seek ways to mitigate their losses. These services, if subject to careful quality control, can be kept relatively free of liability claims. Conversely, firms should carefully limit their audit and financial statement practices as these areas are the most likely to give rise to liability claims. Similarly, tax preparation engagements are likely to be more prone to problems as clients that are suffering have an incentive to understate their tax liabilities.

Keep Cash Flow Strong

Until economic conditions improve, it is only prudent that every accounting firm take a more rigid posture in its client intake and receivable collection practices. This is not only to assure that the firm's own cash flow remains healthy, but also to help the firm to identify those clients who may be experiencing problems. This recession is not only likely to cause a large number of business failures, but may also take down a significant number of accounting firms as well. To avoid being among the casualties, firms should take steps at the very outset of the professional relationship. For example, every engagement letter must specify that the firm's invoices are payable within 30 days and that the firm reserves the right to suspend or terminate its services if its invoices are not paid in a timely manner. This provision must be rigidly enforced if it is to have the desired effect. In addition, engagement letters should state that if the firm elects to terminate its services, the client is responsible for paying for all services rendered prior to the termination, irrespective of whether the engagement has been completed.

Notwithstanding the application of client termination and tight collection policies, almost every accounting firm is likely to have clients who are forced into bankruptcy, some of which will likely owe the accounting firm money for past services. For the most part such monies will not be recoverable. If the accounting firm is to continue serving the client following its bankruptcy petition, the firm will have to waive those unpaid fees in order to avoid any conflict of interest with the client. Moreover, it is a dangerous practice to assert a claim in a bankruptcy proceeding as this may precipitate a malpractice counterclaim that may be tried in the bankruptcy court, which has proved to be a hostile forum for accountants. The better practice when dealing with a client facing potential bankruptcy is to require the client to pay for the firm's services in advance. In this way, not only will the firm avoid having to file a claim for its unpaid fees, but the firm may also minimize the risk of a preference claim by the bankruptcy trustee seeking to recover monies paid during the ninety days preceding the client's bankruptcy petition.

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Maintaining Sufficient Insurance

Over the course of the next three years, the chance of incurring a malpractice claim could easily be twice as high as it was over the past five years. This means that accounting firms must make sure that their malpractice insurance is in order. This not only means that the firm has a level of insurance to meet its likely needs, but also that it covers the full scope of the firm's practice. In the former regard, it may be wise to increase the level of coverage and accept a higher deductible amount to offset the likely increase in premiums. This, of course, assumes that the higher coverage will be available, which it may not be. It is also important for a firm to have its insurance with a strong and reputable insurer. During periods of high claims, weak insurers tend to look hard for ways to avoid paying claims; that is, if they do not withdraw from the market altogether, leaving their insureds scrambling to place their coverage elsewhere, if possible.

Conclusion

Although the business of most accounting firm clients will suffer during a recession, accounting firms themselves are likely to remain busy as their clients may require even more services. However, to the extent that firm clients go out of business or the firm elects to terminate clients, there may be a decline in firm business. Therefore, this could be a good time for accounting firms to shed their weaker professional employees and to replace them with higher quality professionals from firms forced to downsize or to go out of business altogether.

If you have questions, please contact Dan L. Goldwasser (212-407-7710) or any other Vedder Price attorney with whom you have worked.

VEDDERPRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
312-609-7500 FAX: 312-609-5005

1633 BROADWAY, 47th FLOOR
NEW YORK, NEW YORK 10019
212-407-7700 FAX: 212-407-7799

875 15th STREET NW, SUITE 725
WASHINGTON, D.C. 20005
202-312-3320 FAX: 202-312-3322

www.vedderprice.com

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Group Members

Daniel J. Barlin	212-407-7709
Steven R. Berger	212-407-7714
William J. Bettman	312-609-7776
Charles S. Caranicas	212-407-7712
John H. Eickemeyer	212-407-7760
Dan L. Goldwasser	212-407-7710
Daniel Green	212-407-7735
Kevin J. Kuhn	312-609-7652
Jonathan A. Wexler	212-407-7732

If you have any questions regarding material in this issue of the *Accounting Law Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact Dan L. Goldwasser 212-407-7710 or at dgoldwasser@vedderprice.com, John H. Eickemeyer 212-407-7760 or at jeickemeyer@vedderprice.com, or Steven R. Berger 212-407-7714 or at sberger@vedderprice.com.

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Vedder Price P.C. is a national, business-oriented law firm with over 260 attorneys in Chicago, New York and Washington, D.C. The attorneys in the firm's Accountants Professional Services Group focus on the sophisticated advice necessary for accountants and accounting firms to preserve, develop and enhance their accounting practices.