

The Willis Index

Willis

Accountants' and Auditors' Newsletter
The Accountants' PI Insurance and Risk Management Quarterly

Q1 2006

Business as Usual

Our last newsletter in the fourth quarter of 2005 was anticipating the effect of the hurricane season on the reinsurance renewal process, and more importantly the professional indemnity market.

We are delighted to report that whilst there have been significant rate increases in the Property & Energy market, within the Casualty and Professional Indemnity sectors rate increases have been moderate or non-existent. This is good news for buyers.

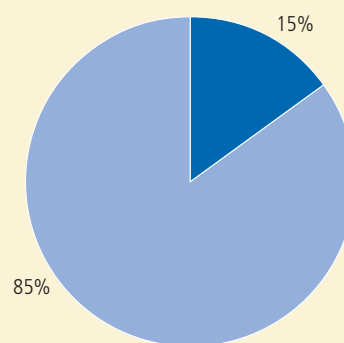
As background, Reinsurers have applied rate increases on their direct Insurers (regardless of class), and this places pressure on them to look for justification for an increase. Reasons for justification are not solely restricted to claims record. However, one also needs to consider the broader environment in which Insurers operate. Given the long-tail nature of PI business, Insurers are more inclined to invest in the equity markets than their counterparts in Property, and it is possible that a rising stock market could facilitate stable rates, with no hit to overall profitability.

This being said, underwriters are prepared to aggressively attack rates on the programmes of the largest accountants where considerable premiums are on the table. Equally, whilst seeking to maintain stable rates on their renewals, underwriters would appear to remain willing to offer rate reductions to secure new business. Willis will provide a further update in our Q2 edition of the WILLIS INDEX.

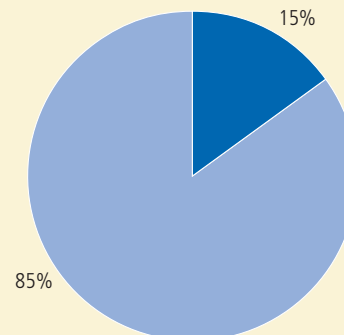


PI Primary Premium Movements

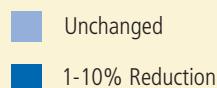
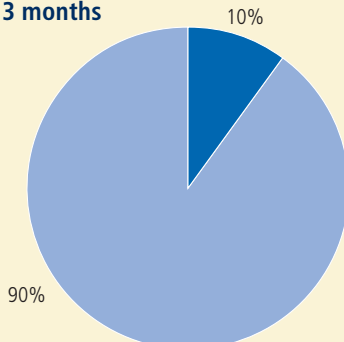
Rate Movements – last 3 months



Rate Movements – next 3 months



Predicted Excess Layer rate movements – next 3 months



The data is based on criteria presented by multiple risks and does not relate to any one risk in isolation. The rate reductions are not cumulative.

The Willis Index is a quarterly publication reporting on the relevant issues affecting the Professional Indemnity Insurance industry, and the impact they have upon those in the Accountancy sector. The main feature is the Willis benchmarking commentary on Professional Indemnity premiums which has been taken from an analysis of sample rate reductions received over the last three quarters.

Our quarterly analysis will provide buyers with an overview of insurance market conditions and our assessment of the outlook.

In this issue we include a review of the changes involving clients who are Authorised Firms, the implications of providing an employee reference and a revisit to old wounds made famous by Enron in terms of Special Purpose Vehicles.

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BEWARE: Know Your Client Or You Could face Prison

Re-Opening Old Wounds



In terms of Professional Indemnity Insurance it was first thought that only firms who were undertaking FSA regulated activities themselves would have an increased risk factor, but it transpires that this is not entirely true. Joanne Willmore now looks at the dangers which can expose a firm's Professional Indemnity programme to risks created by their clients who are regulated as authorised firms.

Under FSA regulations, accountants now have an increased responsibility for clients who are authorised firms. These firms, and now their accountants, have a number of specific duties imposed on them. These pertain mainly to the provision and quality of information, but they can also include an accountants duty to notify the FSA if;

- their authorised client has been removed from office
- their client has breached any of the FSA's requirements
- their client can no longer satisfy the threshold conditions
- the client may cease or has ceased to be a going concern
- they have ceased to act on behalf of the client
- their client triggers obligations under whistle blowing regulations
- they cannot state that their client's accounts provide a true and fair view.

The financial services sector is famed for capitalisation issues and there has been a large degree of merger and acquisition activity. The critical point is that if there is a failure in any of these FSA requirements it is possible that the accountant may be disqualified from acting for authorised firms and the reputational issues which could impact upon their fee earning capacity, and also influence Professional Indemnity Insurers' premium rating.

In addition, if the FSA decides to investigate the firm's clients then any person (which can include the firm's current and past auditors/accountants) can be required to provide information. This brings into question the ability of the firm to provide key details that are likely to have been archived. Importantly there is no requirement for the protection of privileged items. Non compliance with any FSA information request can at best be held as a contempt of court or at worst may be subject to two years imprisonment (and an unlimited fine), clearly a firm needs to pay particular attention to business risk management if they wish to remain in this industry sector.

In view of the difficulties insurers perceive in complying with these regulations, they are expecting the FSA to increase their actions in areas of non compliance, and they will be undoubtedly maintaining a watching brief over the liability issues which can impact upon firms operating in this sector.

For global firms the question of their ability to police compliance with European and international regulations is vital, and this will be a key issue for PI Insurers. It is advisable for firms contemplating a Professional Indemnity renewal to be mindful of this potential exposure. It is helpful to outline any specific system improvements or protections put in place to ensure compliance, and response to the FSA's and other international regulatory body's requirements. If assistance is required on what to provide we would recommend that the advice of a specialist Professional Indemnity Broker is sought.

If you would like any further information or have any questions on this topic please contact Joanne Willmore on +44 (0)20 7975 2216 or email willmorej@willis.com

As we write, the Enron scandal is once again in the spotlight, with the trial of its two top executives presently taking place. Additionally, attention is once again focused on Special Purpose Vehicles (SPVs), the entities Enron used to hide complex off-balance sheet transactions, prior to its collapse. Coincidentally, in the same week, the Japanese Institute of Certified Public Accountants called for increased regulation over the disclosure of Special Purpose Entities (SPEs). There are fears across the globe that SPEs and similar vehicles could pose a credit risk to their parent companies, since they may possess substantial debts.

Underwriters are extremely wary of such vehicles, and accountants globally involved in either advising or setting them up, face difficulties in obtaining coverage.

Parallels can also be seen with the hedge fund industry which is presently the source of much media interest and has now also attracted the attention of regulatory bodies globally. For example, the SEC is requiring many hedge funds based in the United States and Overseas to register, in an attempt to prevent fraud in the industry. Doubtless the spectre of regulation will focus underwriters' attention on the auditors that review their accounts and also those involved in assisting in their calculation of tax exposures.

Willis predicts that Professional Indemnity Insurers will begin to focus more on a firm's client base and in particular the type of service or products offered to them when deciding on rate and terms.

If you have any questions please contact: Steve Bonnington +44 (0)20 7975 2086 or email bonningtons@willis.com



With Reference to ...



We are all accustomed to hearing about how society is becoming more litigious so should we be surprised to learn that supplying a reference could expose a business to a claim? Willis now investigates this issue.

When an employer provides an employee with a reference, the employer must make sure that the reference is true, based on accurate facts, and is fair in substance. Failure to do so could expose the business to a claim for negligent mis-statement from the employee.

Even though a referee may be able to assert that each statement is factually true, there may still be exposure to an action if the reference taken as a whole gives an unfair (and damaging) impression.

Conversely, should an employee turn out to be negligent or dishonest in circumstances where the reference provided by the previous employer made them out to be hardworking or honest, the new employer may have a right of action in tort if it can be demonstrated that he relied upon that reference.

Interestingly there is no general legal obligation, under either common law or statute, for an employer to provide an employee with a reference, unless it is a term of an individual's employment contract that a reference will be provided. In the case of **Spring v Guardian Assurance** (1995) the Court did comment that an employer may owe a duty to provide a reference in three circumstances. Where there is an employment contract, where the employee is engaged in an area of employment where it is normal practice to obtain a reference from a previous employer before new employment is offered, and where the employee would have difficulty in finding new employment if the

previous employer failed to provide a full and frank reference. However, it could be argued that the comments from this case perhaps go further than the current law allows and it is therefore unlikely that a Court would readily imply a duty where an employer has refused to furnish an employee with a reference.

Even so, most employers do request and supply references from and for employees, and as most Professional Indemnity policies would not respond to a resultant claim it would seem that this is a risk that businesses are obliged to carry.

But what if the reference or recommendation is being provided to a client and is in a business capacity?

In the late 1990s, many of the top to mid-tier accountants diversified their business activities, in order to take advantage of the opportunities for growth in the field of Human Resource, Management and IT Consultancy. These activities attracted a higher profit margin than conventional audit work, and enabled the accountants to integrate themselves more deeply into the clients' business processes.

Some firms have clearly identified that in providing such services the profile of their business and that their risk exposures has changed. They are therefore more inclined to purchase specialist bespoke covers to address those risks. However, many firms have simply integrated these activities into their existing Professional Indemnity policies, unaware that care needs to be taken when disclosing the activities they undertake in their proposal form to avoid expensive delays or possibly even the declinature of claim in the future.

A large accountancy practice found itself on the wrong end of a claim from one of its audit clients for whom it provided a management consultancy service. Having worked closely with the firm in question for many years it seemed logical for the practice to become involved in the recruitment of a senior accounts manager for them. Unfortunately, the individual selected subsequently went on to embezzle a large sum of money from his new employer. The money was spent rapidly and little was recoverable from the fraudster, so the firm looked to its auditor to meet the shortfall, contending that it had relied upon the auditor's recommendation (reference) at the recruitment stage.

The question for the Insurers of the practice was whether the work fell within the scope of 'Professional Business' in the insuring clause of the Professional Indemnity policy. This took time and incurred cost to ascertain.

Therefore, as accountancy/audit practices diversify further from what may be regarded as their traditional role, the potential for questions of this nature will increase. It would certainly be advantageous for all if they can be answered before a claim situation arises. Therefore, if you are unsure whether an activity that your firm carries out (no matter how rarely) falls clearly into the generic headings that may have been utilised on your proposal form, our advice would be to make a specific reference to it!

Any questions can be addressed to Jenny Cleator (cleatorj@willis.com).

Information with regard to the provision of employee references kindly provided by Max Hope, Solicitor CMS Cameron McKenna. More details on this subject can be found on www.law-now.com

Meet the Team



Steve Bonnington

Steve joined the insurance industry several years ago having graduated with an honours degree from a top UK Business School. His insurance experience has involved many clients working in areas of accountancy and audit practice, including one of the Big 4.

In his current role, Steve maintains a high profile within Willis' specialist Professional Indemnity division where he is an account executive, with knowledge of international insurance markets. He maintains responsibility for servicing a range of clients including some major accountancy firms, and he regularly contributes articles to a number of specialist industry publications.

Steve comments "I have been tracking the developments concerning accountants' liability with interest, and having worked with the smallest of firms to one of the largest it is true that many problems are shared, but merely a question of scale. However, with the fast pace of increasing regulation I feel that only the most efficient and proactive will win out, but only time will tell".

Breaking News

Willis has published a unique guide titled **The Willis Worldwide Directory of Directors and Officers Liability**.

This guide will be useful to accountants particularly acting Finance Directors who have an interest in the complex areas covered by D&O insurance. This guide details the personal liabilities of directors in 51 jurisdictions in Africa, Latin America, Asia, Australia, Europe and the Middle East.

Willis feel it is vital for senior executives to identify and understand their liabilities when considering international expansion or acquisition activity and prior to accepting overseas board appointments. We are delighted to announce that we have partnered with leading law firms around the world to gather this material in one easy to manage reference tool.

With the number of claims against Directors and Officers reaching an international all time high, this 600 page compendium, the most extensive of its kind to date, will be an invaluable reference for senior level executives, corporate counsels, company secretaries and risk managers.

The publication provides updated and expanded chapters on each jurisdiction, setting out key issues as well as matters relating to corporate governance and regulatory requirements.

We are delighted to announce that the directory is free to existing Willis clients or for information on purchasing the directory you should send an email to D&O@willis.com. It is available at a cost of UK£150, US\$270 or EUR 222.



Willis is one of the World's leading risk management and insurance intermediaries. We have 15,800 professionals in over 300 offices around the World.

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