PROFESSIONAL INDEMNITY INSURANCE

FACT SHEET

INTRODUCTION

Not all policies offer the same cover.

The differences could be costly for your business.

Professional indemnity (PI) insurance is one of the most complex and topical issues affecting the accounting profession and the standards of cover afforded by different PI policies can be as different as 'chalk and cheese'.

It is therefore important to ensure that you know what you are buying for that significant insurance premium you are being asked to pay.

Don't judge your PI insurance by its cover sheet – always look more deeply into the cover detailed in the policy wording so that you can understand the insurance well enough to be able to make the right, informed decision that is going to affect your ongoing business.

The wrong policy could be as bad for your business as no cover at all.

Before you make your decision about which PI insurance policy to purchase you should start by considering who is providing the product, both the broker and the insurer.

THE BROKER

The broker is your representative. They approach the insurance market on your behalf.

All brokers in Australia are required to be licensed under the *Financial Services Reform Act*.

It is important that you have confidence in your broker's ability to know your profession (including the minimum CPA Australia requirements), understand your risk profile and convey it to the insurance market.

Ideally, your broker:

- has the same business ethos as your firm
- has a strong and genuine understanding of your profession and your association's requirements
- has good insurance law knowledge and negotiating skills
- must be well connected in both the insurance and legal professions
- should be willing to assist CPA Australia where possible.

THE INSURER

You also need to consider issues surrounding which insurer is underwriting your insurance, such as:

- what experience they have with the accounting profession, particularly with CPA Australia members
- who will handle claims and what is their experience in doing so for accountants
- how broad is your cover
- will they be prepared to provide information to, or work with, CPA Australia to improve your risk.

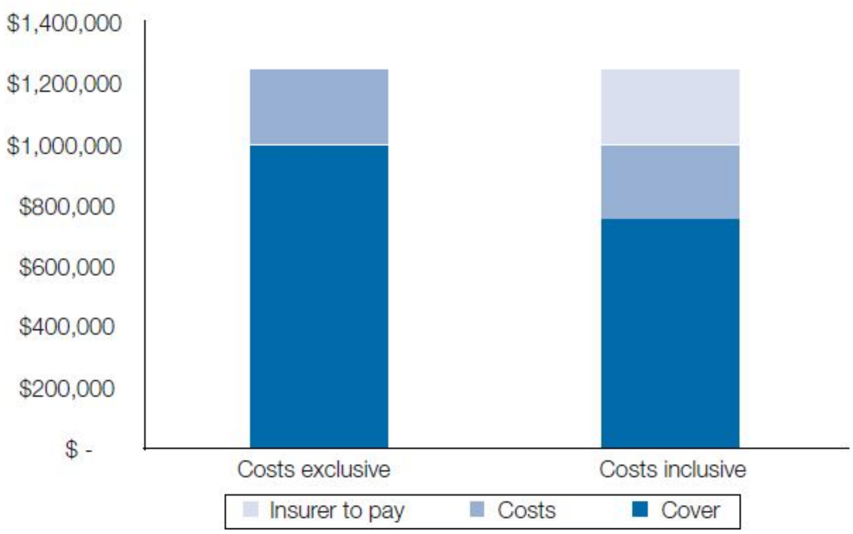
Next you need to consider the features of the policy, such as whether the policy is costs inclusive, the excess on the policy, whether all your work is covered and, if in Australia, the approach to Part IVA of the *Income Tax Assessment Act (1936)*.

A costs inclusive limit of indemnity

If a limit of indemnity is defence costs inclusive, the amount available to indemnify for compensation payable to a plaintiff and the plaintiff's costs is reduced by any costs incurred for investigating and/or defending the claim which can place you significantly out of pocket. For example, if your cover is $2 million, costs inclusive, and you have a claim which results in a liability to the claimant for $2 million and costs of $250,000 are incurred to investigate and defend the claim, then after payment of those costs your available cover to meet the claim is reduced to $1,750,000. You will not have cover for the other $250,000 of the claim, which may have serious financial consequences for you.

There has been much debate about this problem and the remedies that may need to be implemented to overcome it. In the Australian Securities & Investment Commisssion's (ASIC) consideration of insurance requirements for registered liquidators, RG 194, they require the limit of indemnity to be increased by 25%. In other considerations, it has been suggested that it might be necessary to increase the cover by as much as 50%, compared with a policy that is costs exclusive. Where the limit of indemnity is defence costs exclusive this means that the indemnifiable costs of defending a claim are paid over and above the limit of indemnity.

The following graph shows the possible differences in payments by insurance companies who offer these two different types of cover, assuming other things are equal.



In this example, the difference is a significant $250,000. There goes any saving you may have negotiated on your premium.

Further, even if it is doubtful whether a claim may exceed the limit of indemnity, the mere potential for it to do so by reason of the ongoing costs to defend the claim and/or the size of the claim can create additional costs for you at a time when you least need it and can otherwise complicate the defence of the claim.

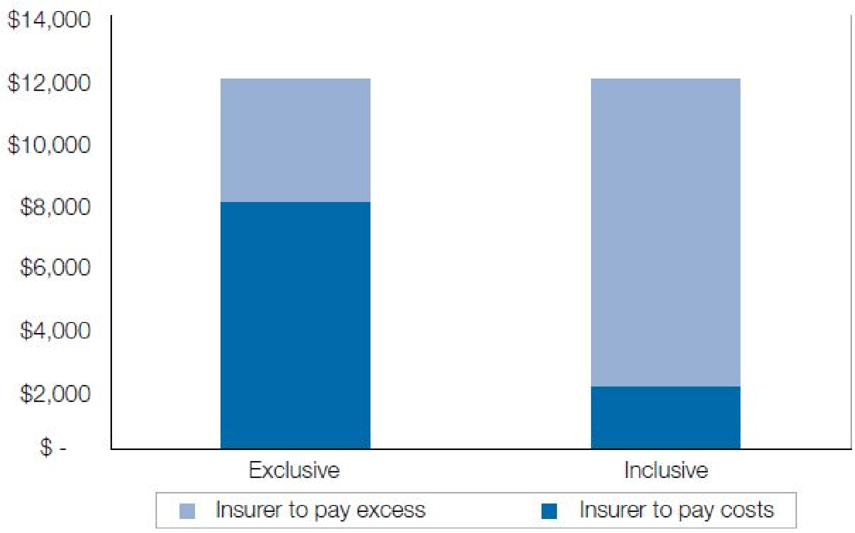
A costs inclusive excess

How would you feel about having to pay your excess even if no payment is made to the claimant? If the excess on your policy is costs inclusive, then this is exactly what could happen.

When your excess is costs exclusive you only have to pay that amount if a payment is required to settle with the plaintiff.

The graph below shows the effect that these two excess types can have on your cover, other things being equal.

In this example, a claim is made against the practice which results in a settlement payment of $4,000 after the Insurer incurs cost and expenses of $8,000. The cover is $500,000 with an excess of $10,000.



In this example, you would have to pay $6,000 more simply because of a costs inclusive excess. Even this difference could exceed any premium saving you may have received.

Cover for all of your work

There are a number of restrictions, limitations and exclusions on policies that can affect the cover you have for certain of your activities.

Don’t leave it until you have a claim to find out that some of your work is not covered. Get written confirmation of cover for all of the work you are doing. Some of the activities which could be worth investigating about the extent to which you will be covered include:

- audit work
- investment advice
- financial planning
- mortgage/finance broking
- insolvency
- mergers and acquisitions or buying or selling businesses
- migration
- work for deceased estates
- insurance.

Part IV A

There are a number of policies which exclude Part IV A or tax minimisation claims made in respect of tax advice concerning the general anti-avoidance provisions of Part IV A of the *Income Tax Assessment Act (1936)* (Cth of Australia).

Since its inception, Part IV A has often been invoked and litigated by the Deputy Commissioner of Taxation given its potentially wide scope.

Whilst these provisions apply to tax avoidance activities it is crucial to obtain cover in respect of such transactions as its scope has proven to be broader than originally anticipated.

It should be noted that broadly similar general anti-avoidance provisions also apply under Division 165 of *A New Tax System (Goods and Services Tax) Act (1999)* (Cth of Australia) and Section 67 of the *Fringe Benefits Tax Assessment Act (1986)* (Cth of Australia).

Other issues to consider

There are a number of other issues that should also be looked at but not all of them may be important to you, such as:

How many reinstatements of the limit of indemnity are being provided?

This varies from policy to policy. The preference should always be for unlimited reinstatement of the limit of indemnity. Other options include no reinstatements, one, two and sometimes three reinstatements.

Note: CPA Australia's By-Laws require members to have one or more automatic reinstatements following a claim.

Does the policy include unlimited retroactive cover?

Any limitation on your retroactive cover could affect cover for some or all of the work you may have done in the past. The impact of any such limitation needs to be carefully considered.

Note: CPA Australia's By-Laws require a retroactive date of no later than seven years before the beginning of the period of insurance.

Does the policy provide cover for any previous business that you may have operated?

Some don't. This could affect the cover you thought you had against a claim that may be made against you in connection with a previous business.

What extensions are being offered and what sub-limits might apply to them?

The variations are numerous. The normal extensions likely to be available include:

- libel and slander
- loss of documents
- fraud and dishonesty
- fidelity
- outgoing principals
- incoming principals
- inquiry costs and FICS.

Some of these may be automatic if the policy provides cover for any civil liability. Sub limits on some of these extensions can range from $50,000 to $500,000. Any other extensions being offered may be a bonus.

In what jurisdictions and territories are you covered by the policy?

The general standard would be to cover anywhere in the world excluding USA and Canada. Some policies may limit cover to Australia and/or New Zealand only whilst some others will extend to cover worldwide without restriction.

Will the policy cover any firm that you may acquire or merge with at any future date?

There may be cover but there may also be a requirement in the policy stipulating that you will have to advise your insurer within a specified period. An acquisition or merger would also normally be viewed as a change to a material fact and as such would need to be disclosed to the insurer. Such change is likely to incur an additional premium for cover to continue. You should confirm the position if you intend to merge with or acquire a firm.

Note: your duty of disclosure applies any time your risk changes.

Professional Standards Legislation

Professional Standards Legislation (PSL) in Australian states and territories sets specific requirements in relation to professional indemnity coverage and indemnity limits. A number of PI insurance products currently available to you may not satisfy those requirements. You will need to clarify all coverage and indemnity limit issues with your broker.

COMPARISON CHECKLIST

Compare the insurance offered to you by brokers with the cover provided under the CPA Australia Professional Indemnity Insurance Scheme using CPA Australia's PII comparison checklist.

FREQUENTLY ASKED QUESTIONS

What is a 'Claims Made and Notified' policy? How does it differ from an 'Occurrence' Policy?

A 'claims made and notified' policy requires all claims and any fact, situation or circumstance likely to result in a claim to be notified to the insurer within the period of insurance during which the claim is made or becomes known. The actual mistake could occur at any time where the policy provides unlimited retroactive cover, otherwise it must have occurred subsequent to any date specified which limits the retroactive period.

In an 'occurrence' wording the circumstance must occur during the period of insurance, whilst the notification of this event can occur at any reasonable time subsequently.

What fact, situation or circumstance should I notify to my insurer?

Any fact, situation or circumstance, which a reasonable person in the insured's professional position would have thought might result in someone making a claim against them. If still uncertain refer the matter to your insurance broker for comment. The old rule of thumb is that, if you called your insurance broker, you have considered it important and most likely will report it. You pay a lot of money for your PI insurance policy, do not be afraid to report a circumstance.

Why do I have to fill out a proposal form?

Most PI insurances are not renewable contracts, so the policy will terminate on the expiry date indicated. If you therefore require a subsequent policy, you will need to complete and submit a new proposal form for assessment prior to the termination of the current policy. That assessment will allow the underwriter to understand your profession and other characteristics of your business before providing you with a quote. The information provided in the proposal either forms part, or all, of the information that an underwriter will rely upon to provide that quote. Generally, each insured is quoted individually, since one insured's circumstances (i.e. the type of profession, type of work performed, number of years in the profession and experience) may vary considerably from another. It should also be used as a prompt to consider if there are any claims or circumstances that may need to be notified before the current insurance expires. Any new claim or circumstance must be included on the proposal form but must also be reported separately, in writing, to satisfy the requirements of the insurance policy.

What is the retroactive date? What is the date of inception?

The retroactive date is the date after which acts, errors or omissions of the insured are covered. That is, any act, error or omission arising from work done after the retroactive date will be covered under the policy. The inception date is the date of the start of the policy period.

What is automatic reinstatement?

Unlike other forms of liability policy, the sum insured of the PI policy is limited so that the limit applies to the aggregate of all claims against the policy in the policy period. The automatic reinstatement allows this aggregate limit to be increased as for the number of reinstatements specified in the policy, while the limit for any one claim remains the limit of the sum insured.

What is meant by a 'Known Circumstance'?

Claims arising after the policy inception, from circumstances the insured knew, or should have known, at the time of the policy inception may give rise to a claim, are excluded. This is because such claims are not fortuitous at the time of entering into the insurance but, on the contrary, there is a real possibility that a claim may eventuate. It is paramount to insuring oneself after a loss is known.

How are my premiums calculated?

Generally, an underwriter requires all of the information they request in their proposal form and any other additional information they may request to assess a premium for your insurance. Rates for the accounting profession are now most commonly based on the activities undertaken by the practice, previous history and the level of cover required. Those rates are then applied to the fees which are used as a measure of the amount of risks associated with each individual practice.

What are the most commonly made claims?

Audit has very low numbers of reportable incidents but the claims can be severe.

The most frequently reported incidents involve taxation but their severity tends to be lower because the claims are normally only for any charges for penalties and interest. Although there have been major losses for clients from some tax effective schemes, Part IV restricts the schemes from some insurance coverage.

Financial planning/incorrect financial advice and the sales of businesses are other common areas where high claims are reported.

What is reinsurance?

Under the rules and regulations required of insurance companies, every company must have reinsurance behind the policy documentation you get from your insurance company. There are reinsurance contracts that vary in their structures but, basically, they share some of the risks.

If I refer work to an expert, rather than performing it myself, should I notify my broker if it appears that person may have made an error?

Yes, because invariably in any litigated matter a member may be drawn into the proceedings by virtue of a referral, even though the member is not considered negligent. Remember the adage, “When in doubt, notify”.

What do I do if the original insurer no longer exists?

We recommend that you seek assistance from your broker; it may be that the insurer has merged with another insurer.

What happens to claims made that rely on a policy taken out with an insurance company that goes out of business?

Unfortunately, there is no automatic coverage. The member should make an application as an uninsured creditor and seek legal advice.

I am selling my practice, what do I do?

If a member has been in practice for many years they may have a contingent liability for work undertaken in the practice, then transfer it with the sale. There is a risk associated with these liabilities from the purchaser’s perspective and there may be an additional cost for the purchaser in buying insurance in the future.

If, for whatever reason, in a contract of sale the transfer has not occurred, then obtain a run-off policy. It is important to note that once the policy runs out your liability does not stop.

How long should I take out run-off cover?

As the seven-year limitation period to take legal action begins when the damage/loss is realised by the plaintiff, it is difficult to advise you on a period. To give you an example, an architect in America built a bridge in 1929 and it fell down in the middle of the 1980s.

If I give advice to a client's Board of Directors, am I covered for this advice?

There are two main issues to consider. Firstly, what is the nature of your appointment? Is it for you as an individual to undertake a directorship with the company or for you or your practice as an accounting advisor? The other issue to consider is who receives the fee. If you are to sit on a Board as a Director/Officer of the company and the money goes to you as an individual, your actions are not covered. If you sit on a Board of Directors so that you or your practice can provide accounting advice to the company and the money is paid to the practice, the firm is covered.

If I am an auditor, and the underwriter has advised limited cover for audit but otherwise covered for services, and I seek another source of cover, how do I answer another insurer's question, "Has cover been declined?"

It just means that the particular underwriter is risk adverse to that particular area and does not wish to cover that particular insurance. You do not need to declare on your proposal form that you have been declined cover, even though you may have to accept a restricted cover.

I am in financial advice, how do I ensure adequate coverage?

The first question to consider, when filling out a proposal, is: "Am I seeking indemnity under my standard accounting insurance, or is my financial advice activity covered by the licensed dealer?" If the latter, your proposal should make this very clear as this will assist in presenting a more positive risk profile.

What types of activities would not normally be automatically covered under accountants' PII?

- More than 15% of income is derived from mergers and acquisitions
- More than 5% of income is derived from auditing listed companies
- More than 15% of income is derived from insolvency or receivership activities
- More than 15% of income is derived from investment advice
- More than 20% of income is derived from mortgage broking
- Any financial planning advice activities (including para-planning)
- Any non-accounting work e.g. teaching, information technology, business valuations, company secretarial services or management consulting activities (unless done in conjunction with accounting services).

Note that in some cases your broker may be able to negotiate with the insurer to allow for small variations.

Would recruitment activities be covered under accountants' PII?

CPA Australia accepts the inclusion of recruitment activities under the CPA Australia PII Scheme.

What other activities would be covered under accountants' PII?

- Services undertaken by the Executor of an estate or trustee services
- Work as a business nominee for a client e.g.as part of a client's registration requirements to be an Electrical Contractor.

How do I determine what is adequate cover?

CPA Australia advises you to conduct a proper risk assessment on the level of PII cover needed, irrespective of your minimum requirements under CPA Australia's By-Laws. You should consider:

- your potential risks based on the type of work you perform and the kind of cover required
- what you envisage will be the highest fee for a service provided for a client in any one year
- if you have sufficient PII to cover past work.

FURTHER INFORMATION

CPA Australia also provides the following guidance:

- Managing your professional risks with insurance
- Guidance note: Professional standards scheme
- Public accounting insurance
- Run-off cover
- Know-your risks: Lessons from public accounting insurance claims

CONCLUSION

You cannot afford to take professional risks lightly. A PII policy provides cover to you against allegations of professional negligence. Before you make your decision about which PII policy to purchase you should seriously consider who is providing the product (both the Broker and the Insurer), what is covered and how it works.

If you are not sure about any of these issues, then you should discuss the offer you have been given with the broker of the same. As a general rule you should then ensure that any advice provided is confirmed in writing.

The above material is only general in nature and not intended to be specific to the reader's circumstances. The reader should therefore seek independent advice from a broker or solicitor before making any decisions or relying on the information provided.

Acknowledgement

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